CONSTRUCTION PRACTICE

Willis HRH

BLUEPRINT

July 2009 - Issue 6 www.willis.com

A CONSTRUCTIVE APPROACH TO INSURANCE COLLATERAL

No, collateral is not your company's personal demon. It's universal. Insurance security demands are a real, if painful, fact of corporate life – a regulatory and business necessity that frequently puts insureds at odds with the very carriers with whom they otherwise seek a close working partnership.

Nowhere is the pain felt more acutely than in the construction industry, where risk assumption and loss mitigation must couple with the sanctity of bondable financial strength to insure the winning of new – and profitable – projects.

Posting collateral erodes the harmony of the construction cycle by absorbing working capital and restricting bank lines. In its most common form – the dreaded, yet seemingly stoic, letter of credit (LOC) – collateral magically grows, compounding its burden through the stacking of policy year upon policy year.

No one likes imposing harsh terms, so collateral demands from insurers are often complex and convoluted, using automated algorithms that can seem intractable and even incoherent. The numbers are often presented with sincere expressions of empathy and explanations of why they have no choice. Is there really nothing to be done about the collateral process? Is frustration the inevitable result? Not necessarily.

Collateral is a reality, to be sure. Insurance companies must maintain reasonable security against recoverable losses, especially where their insurance contracts oblige them to ultimately pay claims. Collateral is also mandated by an accounting and compliance regimen imposed by state and other governmental regulation. Excessive exposure to the risk of non-repayment of losses by insureds (credit risk) can adversely impact a carrier's standing with the capital and investment communities and their vigilant watchdogs, the rating agencies. Given the stakes, we often see strict financial underwriting policies imposed by the carrier's own executive management that tend to favor uniformity – even in areas where insurers do have some latitude and discretion.

Collateral, however, is not set in stone Your company's ability to influence the amount, the form and the timing of collateral is a function of several factors you can potentially control:

- Your financial situation
- Your understanding of your risks
- Your understanding of the process
- Your willingness to drive a discussion and advocate on your own behalf

COLLATERAL CONSIDERATIONS

1. **Know how it works.** Determining collateral requirements, while a mechanical exercise, is usually a function of many factors.

    - The ultimate "expected" losses within the retained or deductible layer assumed by the insured under the insurance contract is the biggest

driver. The term "expected" is in quotes because the variables and inputs used in determining this value are debated extensively in the industry. Carriers apply loss development factors (LDFs) to both paid and incurred loss values to project ultimate loss values by policy year and line. The LDFs, which are based on industry statistics, numbers provided by the insured or a combination, are reserve multipliers. LDFs times loss values equals collateral requirements.

- Financial stability, good cash flow, good working capital, good foreseeable EBITDA and stable project backlog translate into good credit risk.
- The risk margin or the amount of variability between the expected losses and worst-case losses is another variable – call it prediction risk.
- Your relationship and tenure with the carrier are also key drivers.

2. **Read the fine print. You must review and understand the exact terms of your collateral endorsement and provisions before binding the contract. In commercial insurance, there is no "I didn't understand" defense short of proving fraud.** Review not only the amount, but also how it is measured, maintained and adjusted by line, by policy year and by milestone. Often, only the amount, collateral form and premium installments are negotiated; reconciliation terms may not be considered for years. Don't treat these as standard language. Nothing is standard at this level of insurance. Review the payment agreement at every renewal and treat the renewal as an opportunity to modify past terms, whenever possible.

3. **Remember the fourth dimension.** Be sure to take time into account. Not only are timely payments cheaper, but time affects how much liquidity is needed and in what form. If I'm going to pay for something fairly soon, why would I encumber it with something permanent like say, an evergreen, stand-by, on-demand letter of credit? Seek paid loss credits for amounts that will be paid during the first 12 months; 25-30% of it is probably already in the TPA escrow anyway.

4. **Dig in to the data.** Collateral amounts are a function of the paid and outstanding unpaid losses for each line and policy year. The figures are based on the actuarially determined value of the projected-to-ultimate losses minus what's already been paid. Every policy year should have a loss history, even if the current outstanding reserve is zero. The data is the key. Do the following regularly.

- Make sure the reserves and paid amounts on the loss runs are correct and make sure that actual data sources are used by the carrier.
- Challenge open claims. Challenge individual claim reserves if they are high or inconsistent with a loss event. Challenge losses that you know have been paid but are still reserved at higher levels. Do regular claim reviews. Get an outside expert to periodically provide a fresh perspective; it's a good way to keep adjusters on their feet.
- Make sure the carrier is aware of large losses, since they are generally more intensively managed and usually reserved with more care. Make sure your carrier limits those losses in their development calculation or you'll be collateralizing their loss layer.
- Make sure the exposure bases (e.g., historical and current payroll, revenue, vehicle counts) are accurate and the carrier has the right numbers. Make sure that exposures associated with discontinued operations are excluded from future policy year forecasts.

- **Get your carrier to provide their collateral requirement calculation by policy year and line of coverage. Carriers are now usually willing to do this. Be prepared to challenge the carrier's assumptions, loss development factors and numbers. Insurance is a commercial endeavor; they want your business or they would not quote it.**

5. **Open the books.** Help make the carrier comfortable with your credit profile. An insurance company financial underwriter is a credit officer who views a loss sensitive insurance program much as a banker views a term loan. Projected Losses = Loan ($) Amount and Projected Payout = Amortization or Repayment Schedule.

   - Submit the last two fiscal years' financial statements with any available notes and supplemental materials supporting the highest quality level of assurance (i.e., in descending order: audit, review, compilation and management prepared.)

   - Disclose any recent developments (asset sale, merger, acquisition, legal proceeding, etc.). Any missing components of the financial statement submission (red flags) should be explained.

   - Develop a relationship with your insurer's credit officer comparable to the relationship your company has with your bankers. Invite your CFO and CEO, whose credibility ultimately defines your firm. Make sure the carrier's credit officer has the authority to commit the carrier to terms.

6. **Think before you jump.** Be aware that when you move from one carrier to another, collateral issues can get complicated. Plan accordingly. Understand all the implications of your carrier move and negotiate the terms of future collateral reductions as early as possible.

7. **Know the money options.** Understand and investigate the various forms of security in common use (LOCs, cash/asset-backed accounts, and insurance trusts). Depending on your company's financial profile, an alternative to LOCs may work well. Be aware, however, that carriers differ on what they will accept (other than LOCs), and how they structure and support the various forms.

Collateral is clearly becoming a bigger driver of risk buying decisions, bank relationships and carrier friction as the recession continues. While the ability to negotiate is more difficult in the current market, a proactive approach will go a long way toward helping you achieve the best outcome possible.

CONTACTS

For more information, or if you have any questions, please contact:

Charlie Woodman, CPA
404 224 5034
charlie.woodman@willis.com

Caroline Koenraad, CPCU
404 224 5073
caroline.koenraad@willis.com

Willis HRH is the leading construction broker in the world. With more than 650 construction Associates in North America in 200 offices, we offer unparalleled expertise to the construction industry locally, nationally and globally. Our clients range from local contractors to international integrated firms.