

COLLATERAL DAMAGE: MANAGING YOUR OTHER CASUALTY RISK FINANCE COST

Maybe in the end it all comes down to collateral. The current recession started with home mortgages, which are based on the value of homes - as collateral. One of the biggest hits to AIG was the liquidity strain resulting from billions in collateral the company was contractually obligated to post when its fortunes declined. Many observers have pointed out that if mortgage-backed securities, credit default swaps and the world of derivative investments in general had been regulated like insurance companies, with the accompanying collateral requirements, we might not be in the straits we are in now.

As an insurance buyer, you may face collateral issues of your own - generally not as cataclysmic, fortunately, but serious all the same, especially at a time when capital and credit are so hard to come by. The best way to manage your collateral requirements is to understand how collateral works, why the carriers want it and what can be done to control it. Ignoring the issue is not an option: the cost of collateral in some cases can exceed the cost of premium for your primary Casualty program!



WHAT IS IT?

Collateral is a necessary evil, a statutory requirement that protects the financial strength of insurance companies and ultimately lowers the cost of insurance. Sounds beneficial, but what's really behind it?

Collateral helps insurance companies manage their credit risk and protect their capital, i.e., surplus. It comes into play most commonly with loss-sensitive Casualty policies. Most loss-sensitive insurance creates a future financial obligation in which the insured promises to pay or reimburse the insurer for paid losses, premiums and assessments.



Generally speaking, insurance companies are in the business of assuming underwriting risks and avoiding credit risk, and collateral for claims guarantees that their reimbursements will be forthcoming. Although collateral may seem to be focused on the creditworthiness of the insured, the primary motivation for the insurers is to protect and retain their surplus.

Collateral is generally required to secure an insured's financial obligations in several cases:

- High deductible policies
- Retrospectively rated premium
- Reinsurance liabilities for fronted captive transactions, which may include assumed reinsurance losses payable, assumed loss reserves inclusive of IBNR (incurred but not reported claims), and assumed unearned premium reserves
- Bonds and sureties

Our discussion pertains to all of these except bonds and sureties.

WHY SO MUCH?

Simply stated, collateral allows an insurance company to recognize the losses or the premiums that you will pay them in the future. So how are the amounts determined?

Let's look at the underlying transactions associated with loss-sensitive insurance policies, i.e., those involving high deductibles. Unlike policies with self-insured retentions (SIRs), high-deductible policies provide first-dollar insurance coverage. In the case of a high-deductible Workers' Compensation policy, for example, the insurer assumes full statutory liability for all workers within the scope of coverage. High-deductible policies, in the end, perform in the same manner as a guaranteed cost Workers' Compensation policy, even though the employer (insured) contractually retains a significant portion of the risk. Regardless of the funding mechanics, deductible claims are paid by the insurer and the insured reimburses the carrier for claims paid within their insured retention.

Now, let's talk about the bean counting that underpins the collateral requirements. Insurance companies in the U.S. are subject to statutory accounting. Statutory accounting is very similar to cash-basis accounting. It is designed to be very conservative with one purpose in mind: protecting the policyholders. Statutory accounting requires insurance companies to record a liability for the expected losses under the contract inclusive of the losses retained by the insured in their deductible. The insurance company needs to allocate surplus/capital to cover these losses. Allocating working capital to support deductible losses prohibits insurers from investing in other new business opportunities.

A high deductible is really just a reimbursement mechanism that requires the insured to promise to pay back the insurer for those amounts the insurer will pay out in the retention layer. The insurance company in fact retains the obligation to pay these claims. Although the insured has promised to reimburse the carrier immediately, the carrier has still assumed both the credit risk and the timing risk of reimbursement. Insurance companies manage their credit risk with collateral and manage their timing risk with a loss escrow, loss funds or sweep account. The actual dollar amount is based on the expected outstanding claim payments. The figure is adjusted according to the credit rating of the collateral provider, as is standard practice in collateral agreements.

In addition to the insurance policy, the insurer issues a separate contract or payment agreement outlining the duties and obligations of insured and insurer. The payment agreement creates the obligation to provide collateral and describes the events that constitute a default.

To the extent an insurer has an acceptable form of collateral to secure deductible losses, statutory accounting allows the insurer to reduce its recorded liability for those losses the insured will be reimbursing to the carrier. Reducing the liability directly reduces the surplus needed, and relieves the burden placed on the insurer when it must lock away capital to satisfy its own collateral requirements.

There are several forms in which collateral can be posted:

- Evergreen letters of credit
- Irrevocable trust agreement
- Cash (inclusive of escrow)
- Contracts of indemnification

SIMPLE MATH

Total claim payments expected by policy year (Ultimate Loss)

$$\begin{aligned}
 & - \text{Claims paid to date} \\
 & + \text{Loss forecast for upcoming renewal (loss pick)} \\
 \hline
 & = \text{Losses Outstanding} \\
 & +/- \text{Adjusted for Credit Rating} \\
 \hline
 & = \text{Collateral Required}
 \end{aligned}$$

WHAT TO DO?

Collateral may be unavoidable but it can be managed if you take three steps:

1. Get the loss pick right
2. Choose the right insurance program structure
3. Actively include the carrier's credit management in the underwriting process

1. GET THE LOSS PICK RIGHT

At the risk of stating the obvious, correctly estimating the losses ahead is crucial to the equation. If the loss pick is too high, you will be financing more than you should. If your loss pick is too low, your costs will be lower now, but you may well pay for it later. How do you get the loss pick right?

- Develop a baseline for comparing the ultimate loss expectations of insurer and insured; this includes the confirmation of historical program structures
- Conduct a detailed analysis of losses and reserve development that includes loss probability distributions based on historical observations; use software tools and actuarial analysts as appropriate
- Work to narrow the differences in ultimate loss expectations between all parties
- Establish revised collateral requirements and maximize paid loss credits based on improved loss expectations and expected payout patterns



2. CHOOSE THE RIGHT PROGRAM STRUCTURE

Once you understand the true cost of collateral – in terms of the cost of capital that is unavailable for other business purposes – your strategic decisions about the size and type of retentions will include collateral in the equation. The question becomes not simply how much risk to transfer and how much to retain, but the manner in which the retentions are handled. SIRs represent a significant unknown, but the certainty of a loss-sensitive program comes at a price, and that price includes the burden of collateral.

- Identify available insurance and reinsurance market products.
- Develop program alternatives to lower the cost of financing retentions, providing collateral and potentially transferring the volatility above expected losses; options are based on the amount of capital exposed to risk and associated cost of capital at risk at various confidence intervals
- Evaluate program design alternatives by calculating cash flows associated with alternative program designs and after-tax present value analysis over an appropriate time horizon.

3. ACTIVELY INCLUDE THE CARRIER'S CREDIT MANAGEMENT IN THE UNDERWRITING PROCESS

Insurers' prime goal in collecting collateral may be securing their surplus, but they are also hedging against their own credit risk, and with that in mind, you should work with their credit management to open the lines of communication on their perceptions of your creditworthiness.

Collateral should never be the 800-pound monster in the closet; it is manageable. Just remember – develop the right loss pick, use the right program structure and make the effort to build the right relationships with your carrier. The right relationships should go beyond your underwriting and actuarial team to include credit management. As with any effective relationship, stay in front of the issues and communicate, communicate, communicate.

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