Insurance Collateral: Financial Drain or Safety Net?

February, 18, 2020

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Deductible Plan Collateral

- Collateral Concepts
- Various Forms of Collateral
- Negotiating Collateral with Carriers
Collateral Concepts
Large Deductible Plans

A large deductible plan is an insurance plan in which

- The insured is responsible for reimbursing the insurer for claims up to a certain dollar amount, and
- The insurer is responsible for paying claims in excess of the deductible amount.
- In addition to paying for all losses under the deductible, the insured must pay a deductible premium.
Program Components

- Guaranteed Cost
- Deductible Plan

Legend:
- Admin
- Carrier Loss
- Deductible
Purpose for Deductible Collateral

Deductible Plans Exchange Underwriting Risk for Credit Risk

- Workers Compensation policies are dollar one, per insurance regulation
- Deductible agreements are a side contract whereby the insured promises to pay the carrier a deductible portion of each claim (sometimes subject to an aggregate amount) in return for a reduction in premium
- The carrier requires the insured to post collateral for the unpaid deductible amounts because of:
  - Credit risk in case the insured can’t or won’t pay the deductibles
  - State regulatory requirements
  - Financial rating agencies’ surplus requirements and preserving financial rating
Deductible Plan Attributes

Deductible Plans From the Insured’s Perspective

- Potential Benefit
  - If loss costs are controlled the insured can keep the savings
  - Reduced insurance company administrative costs on losses within the working layer
  - Cash flow can improve by paying losses as they go, not all up front as premium
  - Encourages proactive risk management policies

- Potential Downside
  - If losses emerge unfavorably the insured can experience unexpected losses
  - Posting collateral can tie up credit lines or encumber assets
  - Escrow account to pre-fund expected loss payments can require jumps due to loss activity
  - Adds complexity in changing insurers
Deductible Plan Attributes

Deductible Plans From the Carrier’s Perspective

- **Potential Benefit**
  - Transfers risk in the working layer to the insured
  - Competitive pressure to offer this kind of plan to maintain market share
  - Reduced admin cost for deductible layer
  - Encourages proactive risk management policies

- **Potential Downside**
  - Credit risk needs to be mitigated by collateral
  - Actual losses might exceed projected collateral needs
  - Additional monitoring of insured’s financial strength
  - Additional monitoring of concentration of collateral with one financial institution
Various Forms of Collateral
Collateral Alternatives

- Cash or Funds Withheld
- Letter of Credit (LOC)
- Collateral Trust
- Surety Bonds
- Collateral Buy-down Programs
Cash and Funds Withheld

Cash Posted to Fulfill Collateral Requirements

- Gives control of cash asset to carrier
- Will impact insured’s working capital
- Should be created as loss fund to pay claims under the deductible program (depleting)
- Interest should be enured to the insured
- Value of required collateral adjusted annually
- Not preferred by carriers, because cash is vulnerable in case of bankruptcy
Letters of Credit (LOC)

LOCs represent an irrevocable guarantee of payment in a specified amount

- LOCs are the most commonly used form of collateral for deductible programs
- Offered by various financial institutions for a fee of specified basis points
- The amount of LOC is generally re-evaluated annually at renewal
- Reduced influence on collateral when changing carriers
- Ties up lines of credit for business operations (contingent liability)
- One concern of insureds is “pyramiding collateral”
# Pyramiding Collateral

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Collateral Trust

Cash or Cash Equivalents are Deposited Into a Trust Account

- The carrier is set as the beneficiary of the trust
- Retains ownership of cash asset by the insured, including investment gains
- Should be created as a working (depleting) trust for payment of claims, rather than a security trust
- Value of required collateral adjusted annually
- Eliminates the credit encumbrances associated with insurance-related LOCs
- Fees generally less than LOCs
Surety Bonds

Collateral Surety Bond is 3-Party Contract: Insured, Carrier, and Surety who guarantees the Insured will pay its deductibles

- Surety Bonds had fallen out of favor as deductible security
- Now carriers are accepting surety bonds as deductible collateral
  - But often only as a portion of total collateral, 25% - 50%
  - Probably require that the surety bond wording mirror LOC wording
- May be more cost effective than an LOC, but only if collateral is not needed for the surety bond
- Not reflected as a liability, so does not encumber credit
Collateral Buy-down Programs

Some Carriers Allow Insureds to Buy Down Collateral Obligations With a Fee

- AIG Collateral Flex for high deductible program
  - Annual deductible losses $500,000 - $5,000,000
  - Need strong credit profile
  - Can buy down up to 50% of the annual collateral requirement
  - Cost similar to LOC cost

- Aon Zero-Collateral Deductible Program (QBE)
  - Annual deductible losses $500,000 - $5,000,000
  - S&P credit rating of BB+ or better
  - One-time upfront fee for the life of the program
Negotiating Collateral with Carriers
Collateral Negotiation

- Risk Profile
- Financial Picture
- Quantitative Tools
- Alternative Solutions
Risk Profile

Paint the Best Picture to Set Insured Apart

- What makes this insured the best in class?
- How is their risk control working to reduce the number of claims?
- What is their post loss process?
- Have they undergone a process like accelerated claims closure that will reduce reserves or cost of risk?
- Are their employees engaged? Understand benefit changes
Financial Picture

Know the Basics of Insured’s Financial Profile, and How That Affects Collateral

- Financial credit rating (S&P, Moody’s, Fitch, D&B)
- Review financials
  - Liquidity Ratios: Measure ability to meet short-term obligations
  - Leverage Ratios: Measure the extent to which insured is financed with debt
  - Profitability Ratios: Measure ability to meet short-term obligations
  - Cash Flow Ratios: Measure whether firm is a cash generator or user.
- Consider relevant factors such as general economic conditions and how they impact the insured
# Financial Ratings Generalizations

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- **12 mos PLC**: Prime, High Grade, Upper Medium Grade, Lower Medium Grade, Non Investment Grade Speculative, Highly speculative, Substantial risks, Extremely speculative, In default, with little prospect for recovery, In default.
Quantitative Tools

Actuarial and Analytic Support

- Loss forecasts for various retention levels
- Reserve analysis for collateral being renewed
- Direct communication with carrier actuaries, working toward an understanding/revision of assumptions
- Alternative program modeling during the marketing process, including collateral structure
- Total cost of risk, including credibility range
Alternative Solutions

Different Collateral Approaches

- Working with legacy carriers
  - Actuarial/relationships/prayer

- Working with the current carrier
  - Paid loss credit: 6, 12, 24 months
  - Deductible program early close-out (defined age and LDFs)
  - Close out old open policy years for a price

- Loss Portfolio Transfers
  - Outstanding deductible reserves for multiple policy years are sold for a price, generally the incumbent carrier
  - The return of collateral provides a funding source for the deal
  - Though hypothetically possible, an LPT for a deductible program with an unrelated insurer is not practical in the current marketplace
Questions?