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## **Collateral The Casualty Insurance Hot Button of 2009**

Many companies are experiencing great difficulty satisfying the collateral requirements placed on them by their insurance carriers. With better information about the how the collateral process works and more effective strategies to deal with carrier demands, CFOs and Risk Managers could enjoy better outcomes.

### **Purpose of Collateral**

An insurance company uses collateral as financial protection against the risk of an insured defaulting on the payment of future retained losses in a large deductible or fronted captive program, or for future premiums in a retrospectively rated program. Insurance regulators understand the credit risks associated with these kinds of programs and impose strict accounting requirements on the carriers that write them.

A bank issued Letter of Credit (LOC) is the most common tool -- although not the only one -- used to satisfy the insurer's collateral need. For quite a number of years LOCs were readily available and affordable even for companies that were not in strong financial condition. But along came the worldwide economic crisis. Beginning in the Fall of 2008, capital markets underwent rapid and radical change in posture. Access to capital was chocked off and the cost of the scarce capital available rose dramatically. LOCs, once freely available and comparatively cheap, became harder to get and in some cases ten times more expensive. Only the most creditworthy businesses have been spared significant pain. Weakened balance sheets and downgraded financial strength ratings have only served to exacerbate the problem. Even though credit markets have crept back somewhat from their recent lows, fulfilling collateral demands remains a very difficult and costly problem for many companies. These realities have influenced the focus and priorities of risk and financial managers, and have given rise to alternative insurance program design considerations as well as the use of different means of satisfying insurance carrier collateral demands.

### **Knowledge and Leverage**

To develop the most effective strategy to deal with collateral, it helps to have a good understanding of how the insurance carrier determines the amount of collateral it needs. The process is complex and involves many steps and technical considerations. Given the complexities, it is advisable for the insurance buyer to obtain expert advice from an accredited actuary.

BWD Group's actuary provides a variety of services on loss sensitive programs, including loss projections, reserve analysis, retention analysis and collateral calculations. In calculating the collateral requirement, BWD's actuary uses the same methodology the insurance company uses in its computation. In so doing we are able to compare on an apples-to-apples basis our estimate of the insured's future responsibility for loss payments versus that of the insurance carrier. The credibility of the source and the comparability of the actuarial techniques become key leverage points in negotiations with carriers.

## **Collateral Determination**

The most critical step in determining collateral is calculating the future expected cost of losses. Actuaries first look backward at historical loss experience in order to project forward. The process involves a calculation multiplying limited reported losses (i.e., payments, reserves and expenses within the deductible/retention) for each policy period by a loss development factor (LDF). LDFs are promulgated by actuaries in a series of computations using loss data from recognized industry sources such as The National Council on Compensation Insurance (for workers' compensation) or the Insurance Services Office (for General Liability and Automobile Liability). Alternatively, if an insured's history of losses is deemed to be statistically reliable, LDFs may be developed exclusively from the insured's own loss data. Actuaries tend to prefer using the insured's own loss data, when credible, rather than industry averages or increased limits factors.

By subtracting actual paid losses from the ultimate loss cost projections for each policy period, a preliminary collateral amount is derived. The insurance carrier then applies a judgment factor based on the insured's financial condition (as well as macro conditions in the insured's industry) to determine the final collateral need. In the current economic environment, financial standing has profoundly stronger influence than in prior years.

## **Collateral Negotiation**

Knowing how collateral is calculated is one thing; applying this knowledge to gain a favorable end result is something else. To maximize leverage, as many elements as possible should be negotiated prior to the inception of the policy. Keys to obtaining the desired outcome include:

- Understand the carrier's methodology, including all of the factors and assumptions that went into the collateral calculation, and gain agreement with the carrier that methods will not change in future valuation periods.
- Request a schedule of loss development factors that will be applied over time to the limited incurred losses.
- Seek to have paid loss credits applied to the gross collateral amount. Paid loss credits represent the loss dollars that are expected to be paid during the policy year. The near term payment expectation largely offsets the need for security (subject to the insured's financial condition).
- Predetermine a schedule of dates when collateral will be reevaluated going forward.
- Make sure the carrier spells out when the collateral will ultimately be released. Typically, a carrier will not release the collateral until two years after all claims are paid.
- When moving your program to a new carrier, it may be advantageous to phase-in the collateral with a "step-up" letter of credit agreement. This agreement would not reduce the total amount of collateral needed but rather would provide for posting of collateral in increments over the course of the year until the security requirement has been satisfied.



## **Collateral Alternatives**

As mentioned, the most common form of collateral is a Letter of Credit (LOC). A standard, commercial LOC is a document generally issued by a bank or other financial institution, used primarily in trade finance, which provides an immutable source of funds.

The LOC can also be the source of payment for a transaction, meaning that redeeming the letter of credit will pay an insurance company in the event the insured defaults on payments under the deductible.

The parties to a letter of credit are the beneficiary (Insurance Company) who is to receive the money in the event of a default, the account party (Insured) and the issuing bank. Almost all letters of credit are irrevocable, i.e., cannot be amended or canceled without prior agreement of the beneficiary and the issuing bank.

Consolidation in the US banking industry has reduced the number of institutions providing LOC's and the risk-weighted capital allocations on banks has increased the cost of LOC's.

An alternative to the LOC is the collateral trust utilized for captives or large deductible programs. Under this option, a three party trust would be set up between Insurance Company (beneficiary), Insured (grantor) and the Bank (trustee). The trust is set up with bank approved by the insurance company. The securities held in the trust must be from the list of approved investments. These securities, in turn, serve as collateral for the underlying insurance program.

A Regulation 114 Trust is used to secure the obligations of a captive insurance company to the ceding insurance company under a reinsurance agreement. Under the trust agreement, the Grantor (captive) delivers to the bank securities with a market value of not less than the full amount of the Grantor's obligations due under the Reinsurance Agreement between the Grantor and the Beneficiary (fronting/ceding insurance company).

Should the Grantor fail to fulfill its financial obligations, the Beneficiary has the right to take possession of the trust funds to pay or reimburse the Beneficiary for the Grantor's share of the losses and allocated loss expenses under the Reinsurance Agreement. This would also apply to any unearned premiums due but not paid by the Grantor to the Beneficiary.

For those companies that have adequate assets to employ this method of collateralization, there are a number of benefits:

- the interest on the securities accrues to the benefit of the insured and can contribute to the required collateral amount
- the securities held in the trust can be shown as restricted assets on the company's balance sheet whereas LOCs appear as liabilities
- set-up costs and transaction fees are considerably less expensive than LOCs



## **Program Alternatives**

Because satisfying carrier collateral requirements has become so costly and difficult, many CFOs and Risk Managers are reaching out to their brokers for help, and as they approach renewal this includes examination and reconsideration of the design of their insurance programs. While soft market conditions prevail throughout most of the insurance industry, collateral has taken a radically different path, and that path has led to consideration of guaranteed cost programs and blended loss sensitive and guaranteed cost designs. When capital was widely accessible and inexpensive, and when balances sheets were strong, most of these kinds of programs were off the table. Now they are being considered seriously as are certain types of Retrospectively Rated programs that had fallen out of popularity for most of the past couple of decades. There is no magic solution and each case has to be examined on its own merits. BWD's casualty risk experts and actuarial resources are perfectly equipped to conduct the rigorous technical analysis necessary to determine the best fit based on market availability, cost, client needs and risk tolerance.

For more information, please contact any of our field-based client development executives or Tim O'Malley, SVP of Sales & Marketing, at 516-327-2721, [tomalley@bwd.us](mailto:tomalley@bwd.us).