

Why *Are They Asking for* So Much Collateral?

by Joe Garzone

In response to changing insurance markets, and the premium costs associated with them, many customers turn to alternative market insurance products including, but not limited to, deductibles and captives. One obvious attraction is a reduced premium obligation. Often overlooked, however, is the requirement that collateral be provided to the insurance company.

Collateral can leave many customers feeling confused and anxious, especially as the requirement increases over multiple policy years. Nonetheless, the need for collateral is a very real and justifiable one. Understanding its purpose and how insurers calculate the amount should help to alleviate any concerns.



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The Purpose of Collateral

When policyholders pay standard insurance premiums, insurers allocate a portion of the money towards their operating expenses and profit. The remainder is designated to pay estimated future claims. Under a deductible arrangement, only expense dollars and profit are collected, since claims costs within the deductible layer are reimbursed by the insured. Thus, the level of premium charged by the insurer is influenced in part by the insurance program chosen by the customer.

Thus, a standard premium arrangement charges higher amounts to cover claims costs and insurance company expenses. Alternatively, a deductible arrangement enables policyholders to pay lower premiums in exchange for assuming payment risk within a deductible layer.

Many companies opt out of the standard premiums if they have a predictable loss pattern and choose the deductible plan instead. Because the customer is reimbursing losses as they are paid, this can present a number of challenges. In particular, the insurer is not only projecting the amount of future losses, but also trying to evaluate a customer's financial wherewithal with respect to claims reimbursement.

From an insurance company's perspective, requiring collateral in conjunction with an alternative market product serves several purposes:

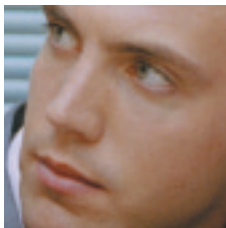
Statutory requirements. To be evaluated positively by the states in which they do business, insurance companies need to maintain a certain level of statutory surplus. At an elementary level, surplus is the amount by which insurance company assets exceed their estimated liabilities, most of which are claims obligations. Under statutory accounting rules, some receivables aren't considered legitimate assets unless they are supported by collateral. Therefore, securing collateral in these

instances allows the insurer to recognize the assets, and maintain their surplus level.

Rating agency considerations. A variety of independent organizations review an insurance company's financial condition. Rating agencies are among the most significant of these organizations. They focus on carrier solvency issues and their ability to satisfy anticipated liabilities. If an insurer is not supporting certain liabilities with collateral, rating agencies like A.M. Best, S&P, Moody's and Fitch could draw unfavorable conclusions about that insurer's financial strength.

Mandate to pay claims.

Once a deductible program is bound with a customer, state law mandates that insurance companies pay all claims, irrespective of whether or



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not reimbursement is forthcoming. When a deductible policy is written, and significantly less premium is collected, credit risk is created for the insurance company. In these situations, collateral serves as protection against policyholders who either cannot or will not reimburse claims within a deductible layer that they have contractually agreed to assume.

Financial Exposure Analysis

Calculating a collateral requirement first depends upon assessing a company's potential for loss through financial exposure analysis. The insurer starts by determining the amount of claims they expect to pay within your deductible layer, until all policy claims are closed. Traditionally, insurers use data from prior policy years to predict future losses. There are several vari-

ables involved in this analysis.

Exposure base. Your exposure base reveals your potential for loss. In the case of workers compensation, payroll tends to correlate with claims activity, as it reveals the total number of employees at risk for injury. All things being equal, the value of expected losses moves in the same general direction as fluctuations in the exposure base.

Inflation. When reviewing prior policy year data, keep in mind that a dollar buys less today than it has previously, and claim inflation differs from regular inflation. Claim costs rise over time due to such factors as rising medical costs. Therefore, payroll and loss dollars from prior years need to be adjusted for inflation.

Loss development factors. For any particular policy year, claims could be paid for many years to come. Therefore, when analyzing loss information, you need to account for unreported claims and potential adverse claim development. If you are only several years removed from writing a deductible policy, the timeframe to close all claims and what the final cash

outlay will be must be estimated. This is achieved by using loss development factors to predict your ultimate claims expense.

Loss rate. This number illustrates the rate at which your exposure base is incurring losses over time.

Several calculations must be made in order to determine the different trend patterns for review. An insurer's actuarial department provides the trend and development factors necessary in order to complete these calculations, which are performed for each policy year:

- Trended payroll = Payroll x Payroll inflation factor
- Ultimate losses = Incurred losses x Loss development factor x Claims inflation factor
- Ultimate loss rate = Ultimate losses/Trended payroll

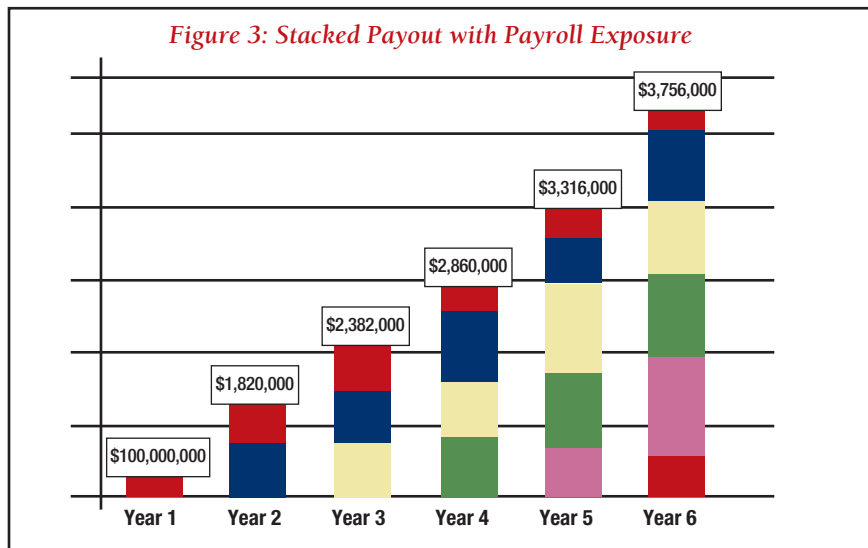
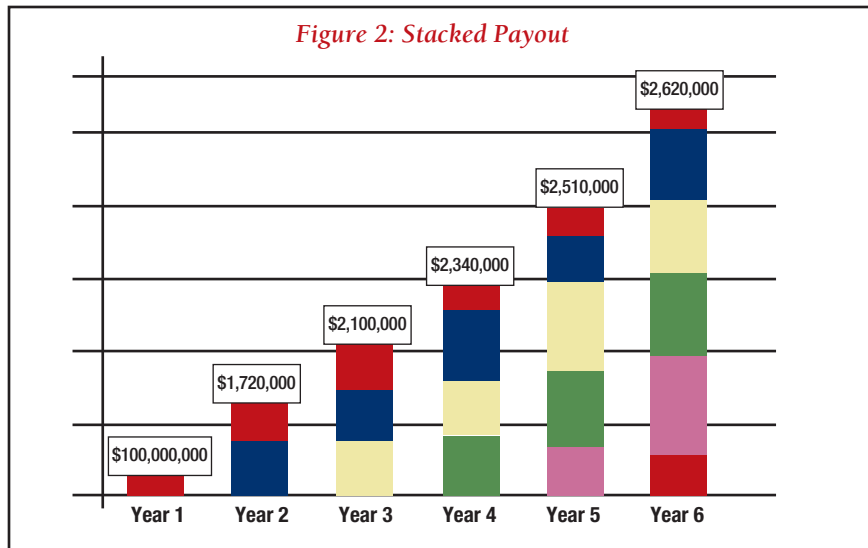
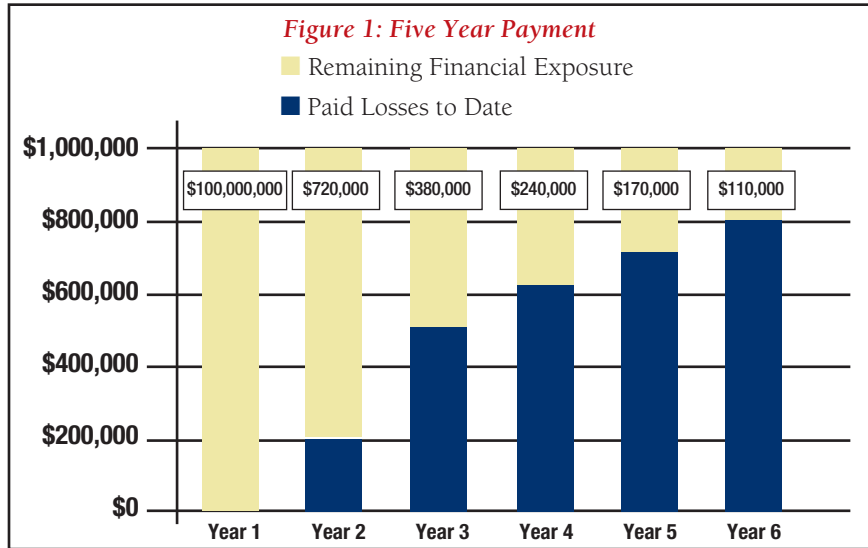
With this information, you can establish a pattern of flat, rising or falling losses over time. The standard deviation of loss rates is also a good measure of predictability. It measures the variability inherent in your loss rate history. Therefore, the lower the number, the better.

The upcoming year loss rate is ultimately predicted from a review of a variety of averages, weighted by the current year's payroll amount, to yield multiple loss estimates. The insurer chooses one as representative of your upcoming policy year estimate. They may adjust the number higher or lower, based upon the standard deviation mentioned above.

At this point, the insurer can begin to establish an estimated payout pattern for future policy years. For example, Figure 1 illustrates a five-year payout pattern based upon a \$1 million estimate of policy year losses. At the policy's inception, for a typical client, \$1 million in collateral would likely be required to secure a \$1 million loss estimate. Assuming the estimate is correct, and 28% of these claims are paid and reimbursed in the first twelve months, \$720,000 in financial exposure would remain. In conjunction, a collateral requirement of \$720,000 would also be necessary, even though the associated policy had expired. Finally, because losses pay out gradually over time, a decreasing collateral amount would continue to be required until this policy year's claims were closed.

What many customers fail to appreciate is the continuing collateral requirement many years after policy expiration. In fact, this requirement exists because exposures carry over into the next year and beyond, as evidenced by Figure 1. This results in a decreasing collateral requirement from year to year, until all claims from the policy in question have been closed.

This brings us to the concept of collateral stacking. Stacking is one of the biggest reasons insurers ask for so much collateral—and it is a critical decision point for the buyer contemplating a deductible product. Figure 2 demonstrates this principle. Assuming the estimated exposure for each policy



year is \$1 million, you can see after year one that \$720,000 in exposure remains, because only 28% of this policy year's exposure was paid in the first twelve months. However, at the inception of policy year two, another \$1 million in exposure was added, increasing the total to \$1,720,000. Given this exposure increase, the collateral requirement changes in kind. Moreover, as additional policy years are added, the security requirement continues to grow at a decreasing rate, until finally leveling off seven to 10 years into the relationship.

The example above is fairly straightforward, assuming the company experiences no growth in payroll. However, in most cases, an increase in payroll indicates the potential for an increase in losses. Typically, a correlation can be drawn between the two. Therefore, the collateral must also be adjusted to reflect that increase as well. The following example in Figure 3 illustrates this principle, assuming a 10% annual growth in payroll exposure. That increase means \$1.1 million will be added to the year two collateral requirement, as opposed to the \$1 million year two increase illustrated in the "no growth" example. When added to the \$720,000 carried over from year one, the two year requirement in a 10% growth scenario is \$1,820,000, rather than the \$1,720,000 discussed above.

As you can see, the collateral amounts are calculated with several key considerations in mind. However, it is important to remember that while there are specific formulas for calculating these numbers, they still represent estimates of future claims payments. For that reason, collateral amounts are not determined based solely on financial exposures within an insured's deductible layer. Financial strength must also be considered.

Financial Statement Analysis

In addition to the financial exposure analysis, a review of a company's fi-

ancial standing is also important to calculate a collateral requirement. Looking at financial statements can help an insurer determine whether the customer is financially viable. In turn, this is also a good indicator as to whether or not the customer will be able to reimburse claims or might default on payments.

Audited statements are preferred as they are independently verified and, in some instances, adhere to Sarbanes-Oxley regulations. For that reason, these statements carry a greater sense of authenticity and accuracy.

The financial statement analysis involves a review of different areas of the company: balance sheet, income statement and cash flow statement. This financial information, along with audit-



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ed statement footnotes, helps the insurer form an opinion about your company. Your banking relationships are also of particular importance. Your relationship with financial institutions demonstrates a credit record your insurer will want to know about when determining collateral. Your interest rate, payback period and credit line terms are all indicators of your financial health.

Merging Analyses

At this point, the insurer will weigh both the financial exposure analysis and the financial statement analysis. The two are assessed then merged into one collateral requirement. To most insurers, customers with a low financial and a low underwriting risk are considered desirable. Those with a high financial and a high underwriting risk are not.

However, sometimes the analysis

can reveal a financially strong company that has high underwriting risk or a company who is at low risk of incurring claims, but is financially weak. In these two scenarios, determining a suitable collateral requirement is particularly challenging.

Typically, the final collateral requirement is equal to the estimated loss exposure. However, if you are a financially strong candidate, collateral may be adjusted to give you a discount. On the other hand, if a default risk is perceived, collateral will be adjusted to include a surcharge.

Once the amount is set, your insurer accepts collateral via several methods, with the most preferred being a letter of credit. This is a contract between the insurance company and the bank. If your company defaults or goes out of business, the bank remains obligated to pay the insurer. Other acceptable forms of collateral include

custodial funds held by a third party and cash held directly by the insurance company. Finally, all forms of collateral must be supported by comprehensive security agreements.

Regardless of how you choose to handle your collateral requirement, keep in mind this instrument serves a valuable purpose in the insurance process. Without collateral, insurance company product offerings, especially within the alternative markets arena, would be severely limited.

From the insurer's perspective, accepting less premium and greater financial risk must be offset by some level of security. On the client side, paying less premium, providing a letter of credit and controlling their losses can often be less costly than purchasing a standard insurance product. Ultimately, the goal is to create a win-win relationship for both parties. **RM**

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