Accounting for large deductible programs – changes on the horizon

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Large deductibles – overview of the challenge

Defining a large deductible

A deductible is the amount of a covered loss that an insured retains. A large deductible plan, has a per accident/and or occurrence limit of at least $100,000.

There are three types of liability deductibles:

- **Per claim deductible**
- **Per accident/occurrence deductible**
- **Waiting period deductible**

Large deductible plans are also common in property insurance.

There are four types of property deductibles:

- **Flat deductible**
- **Franchise deductible**
- **Percentage deductible**
- **Aggregate annual deductible**

Source: Proposed Changes to the Treatment of a Large Deductible

Growth in large deductible programs

Large deductible growth has been growing at a consistent rate year over year.

2011	2012	2013
3.68%	3.77%	3.90%

Source: NAIC/IAIBC Joint Working Group, 2015 Workers Compensation Large Deductible Study

The Professional Employment Organization (PEO) business generates annual revenue of $169bn and is a significant buyer of Large Deductible Program insurance. It has grown at a rate of more than 20% per annum for each of the past six years, and is expected to have continued significant growth over the next five years

Source: http://www.gnapartners.com/faq/what-growth-rate-peo-industry

Who uses a Large Deductible and Why?

Large corporations with strong cash flow/assets

Financial Impact:

- Reduces premium
- Improves Cash Flow
- Assures appropriate reserving

Risk Management:

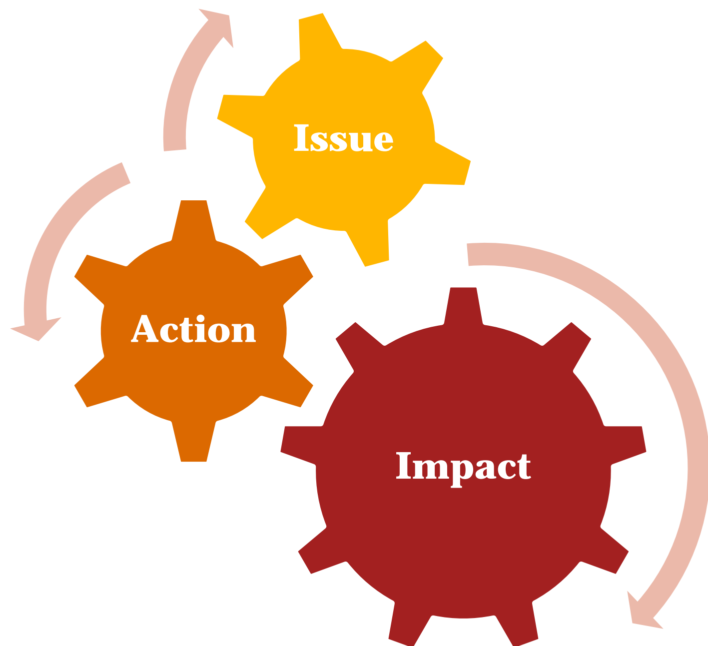
- Enhances Loss Control
- Improves claims management and reserving practices

Compliance:

- Promotes mitigation without an increased regulatory burden

Source: Proposed Changes to the Treatment of a Large Deductible

Management challenges for large deductible programs



Financial Assurance:

- Reserving
- Loss sensitive adjustments
- Write-offs
- Accounting Reconciliations
- Loss Funding Accounts
- Deductible Aggregate tracking
- Reinsurance Reporting/Collections (net of deductible exposure)

Risk Management:

- Claims Management/TPA Oversight
- Credit Risk Assessment
- Dispute/Collection Risk Assessment

Compliance:

- Accurate Reporting
- Penalties

What has gone wrong?

Insolvency:

- Since the early 1970's, there have been about 550 insolvencies of property and casualty insurers
- The most common cited principal cause: "under-reserving"
    - Under reserving leads to under collateralization
    - Reliance and Kemper (Lumbermens Mutual), the two largest US insolvencies, had business models that included a significant portion of large deductible business and faced reserving challenges
- Policy holder insolvency has left carriers holding the bag
- Policyholders are at risk for loosing any excess collateral as a result of carrier insolvency (specific to jurisdiction)

What else has gone wrong for insurers?

Asset Securitization:

- Decreased liquidity for failing to collect on deductible obligations or reinsurance in excess of the deductible
- Decreased surplus as a result of penalties for failing to secure asset
- Insufficient collateral due to under reserving within deductible layer
- Inadequate loss funding accounts driven by under reserving and accounting reconciliations

Financial Assurance:

- Reserve deficiencies for failing to reserve in excess of deductibles/aggregates
- Write-offs as a result of accounting reconciliations, credit worthiness, or as means to secure renewals

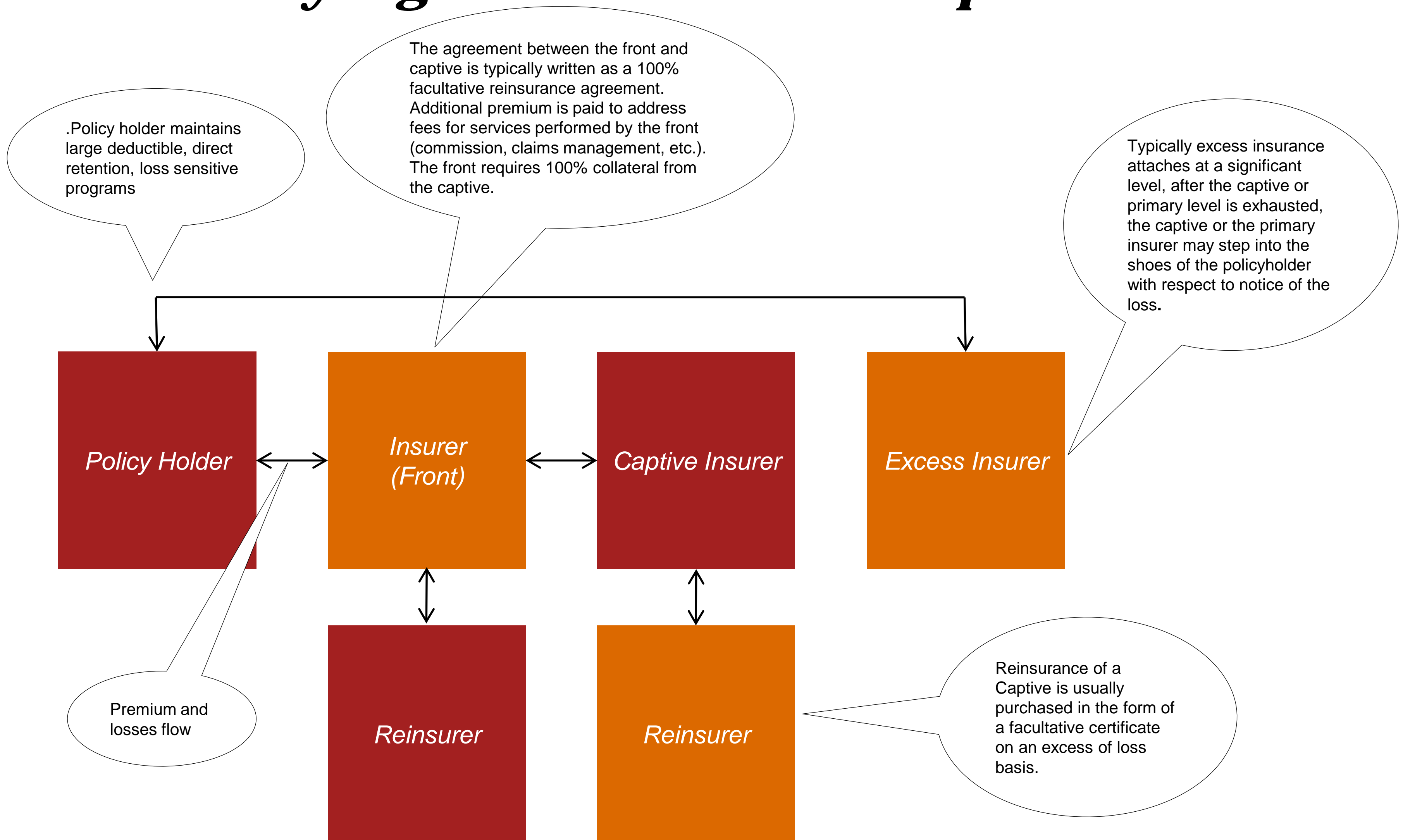
Risk Management:

- Removed from direct line, taking a reactionary approach
- Lack robust assessment processes

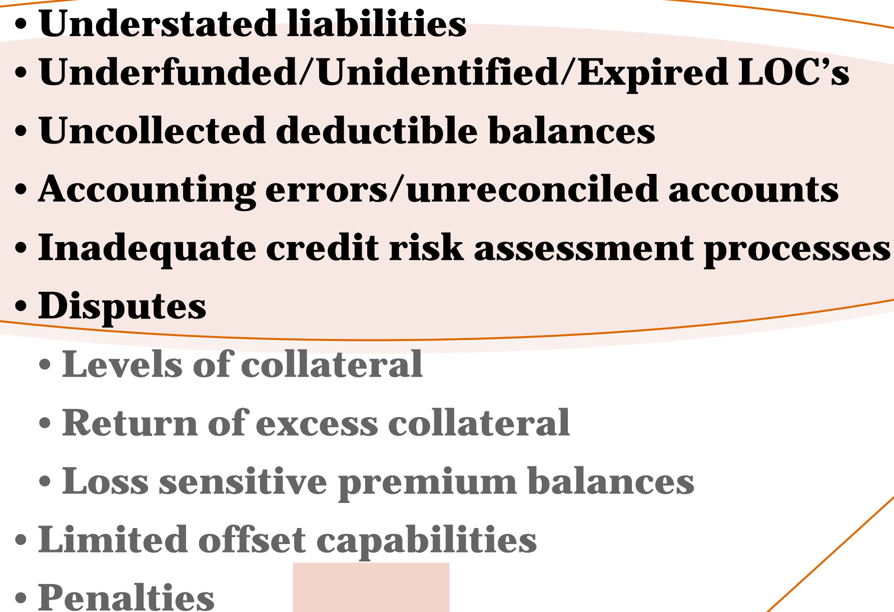
A case study

See nothing, book nothing

Case study – global P&C insurer exposure base



Case study – In run-off, under Supervision, goal to Novate



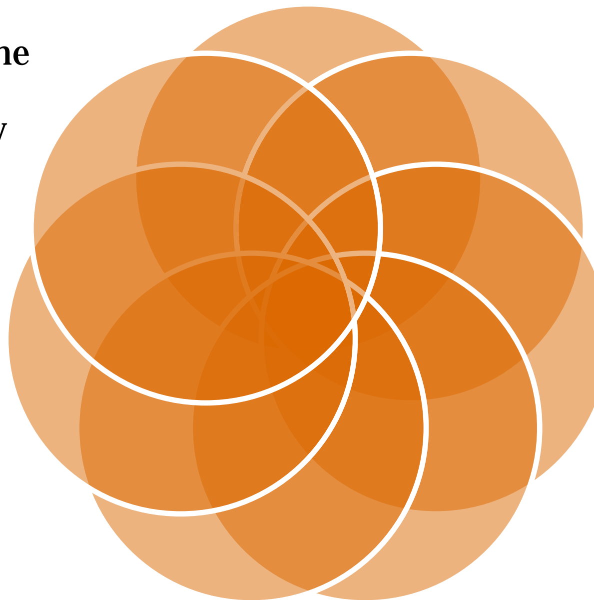
Reduced Surplus and Liquidity

Case study – The Perfect Storm

Aggressive pricing of Workers Compensation and Program business

Significant use of Large Deductible Programs while failing to pursue deductible obligations, appropriate loss funding, LOC draw downs, and/or collateral replenishment

Insured controlled claims management and reserving within the deductible layer without formalized consistent reporting to the Company



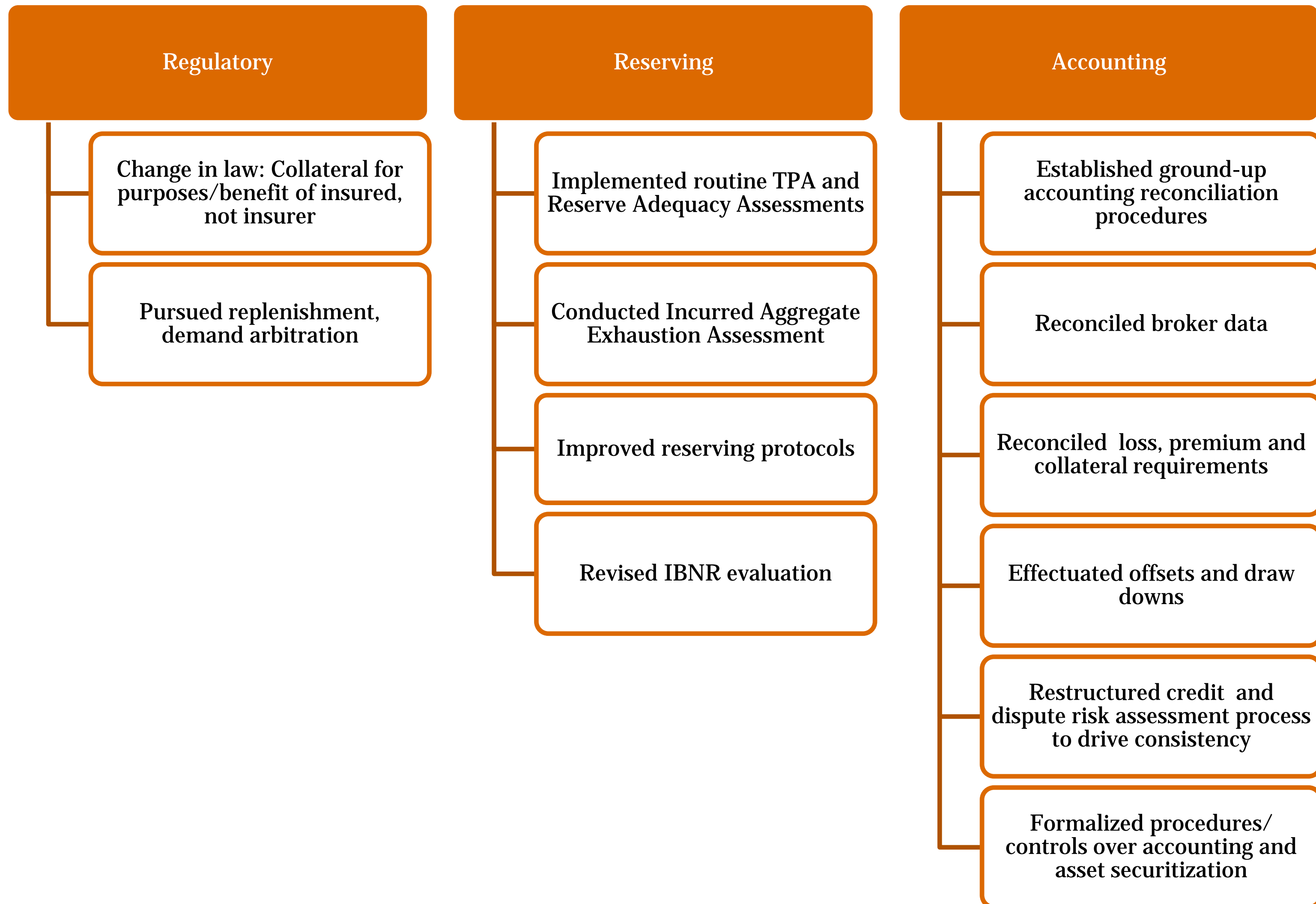
Heavy reliance on Third Party Administrators (TPA's) without oversight protocols, or key performance indicators

Common use of aggregate deductibles with no standardized means to process or track balances

Inadequate controls around the negotiation of pricing, collateral requirements and credit worthiness assessment

Heavy reliance on loss sensitive arrangements without an adequate accounting system

Case study – solution "The 12 step program"



Accounting rules and proposed changes

Current accounting rules

Statutory Accounting Principles, as defined in SSAP 65, requires the financial statement treatment for P&C reserves to be net of the large deductible, unless the deductible is deemed to be uncollectible.

The deductible is accounted for from policy inception onward, and the sums attributable to the deductible layer are treated as a credit risk.

Annual Statement Note 31 requires the reporting of value of the deductible credit for unpaid claims and billed deductible amounts on paid losses.

Changes regulators are considering

- Revise Note 31 to clearly encompass and delineate IBNR
- Change accounting rules for deductible reserves
  - Require booking reserve gross of deductible
  - Establish an offsetting asset or contra code, representing the deductible obligation
  - Treat similar to the booking of reinsurance
- Risk-based capital (RBC) charges
  - Reflect risk associated with unsecured or undersecured losses
  - Account for the potential of adverse development that exceeds collateral
  - Acknowledge credit risk associated with the collateral
- Retrospective rating plans
  - Align loss sensitive plans to revised accounting protocols for deductibles

Legislation to further define policyholder financial strength requirements and limit the amount of retained risk relative to its capacity, collateral and loss funding protocols.

Regulation increasing reserving requirements, financial stress testing, and restrictions on underwriters.

"Special Exam" if carrier is "at risk".

Enhanced guaranty fund language to ensure the deductible is secured for the benefit of the policyholder.

Impact of changes on direct insurer functions

Underwriting

- Face greater internal scrutiny when placing business
- Revise definitions of acceptable levels of collateral
- Increased pressure to negotiate for collateral levels consistent with IBNR needs
- Narrow options for funding vehicles
- Enhance controls around acceptable amounts and forms of collateral and associated quality assurance initiatives
- Improve evaluation methodologies of client credit worthiness
- Heighten the scrutiny of collateral level requirements by policyholders and brokers

Impact of changes on direct insurer functions
(Continued…)

Accounting

- Modify accounting systems and protocols to allow for offsetting entries to gross values by the deductible held and other regulatory driven changes
- Revise reinsurance cession logic to cede net of deductible
- Enhance procedures and controls to ensure reconciliations and replenishment consistent with the calculations and intervals defined in the contract
- Increase controls around establishing credit risk and write-offs
- Expand focus on replenishment and collections

Impact of changes on insurer functions

(Continued...)

Claims Management

- Manually adjust all reserves to be gross of deductible
- Revise accounting and reinsurance reporting systems and processes to account for the deductible
- Increase in claims counts and assessment activities
- Greater scrutiny over reserve adequacy
- Improve assessment processes and oversight of TPA reserving
- Formalize processes around monitoring deductibles, associated aggregates, and rate of exhaustion so as to not overstate the deductible asset

Impact of changes on insurer functions
(Continued…)

Actuarial

- **Modify pricing tools to consider credit risk**
- **Increase use of actuaries in the process of pricing and collateralizing individual insured programs**
- **Increase involvement in the assessment of credit risk**
- **Produce IBNR analysis for the amounts under the deductibles in the aggregate**
- **Establish IBNR on a “by account “basis**

Impact of changes on insurer functions

(Continued…)

Financial Reporting

- **Revised processes, procedures and controls with respect to financial reporting**
- **Increased statutory reporting requirements**
- **Heightened sensitivity over penalties**

Perspectives from other key stakeholders

Policy holder	Increased regulation over deductible collateralization. Greater underwriting scrutiny with respect to credit worthiness. Increased collateralization requirement and/or less ability to negotiate a reduced collateral value based upon negotiating an IBNR valuation. Decreased access to large deductible programs.
Reinsurers	Heightened scrutiny over cessions to validate they are net of deductible/retention.
Regulators	The need to monitor the collateral maintained by insureds with insurers through increased oversight to assess the value and appropriate securitization .
Guaranty funds	Greater certainty that available collateral will meet long term needs in case of failing insured. Improved transparency.
Carriers investor	Increased assessment will be required to ensure long term collateral needs will be met in order to avoid solvency issues, or decreases in shareholder value. Improved transparency.
Rating agencies	Increased focus on underwriting assessment process, collateral requirements and securitization to support financial statements. Greater certainty that available collateral will meet long term needs in case of failing insured. Improved transparency.
Outside auditors	Increased focus on assessing appropriateness of collateral and gross up value determination.

Open discussion and Q &A

- **Is a change in regulation required?**
- **Any other suggested revisions?**
- **Other key impacts?**
- **If the definition of a "Mega" Deductible changes from a deductible of $750k to $10M does your opinion change regarding impact to stakeholders or the need for regulation?**

Thank you

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