Taming the Wild Burning Cost and the Collateral Sleeping Giant

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“Taming the Collateral Sleeping Giant”
Insurer Collateral Requirements for Large Retention Programs

What are we covering?

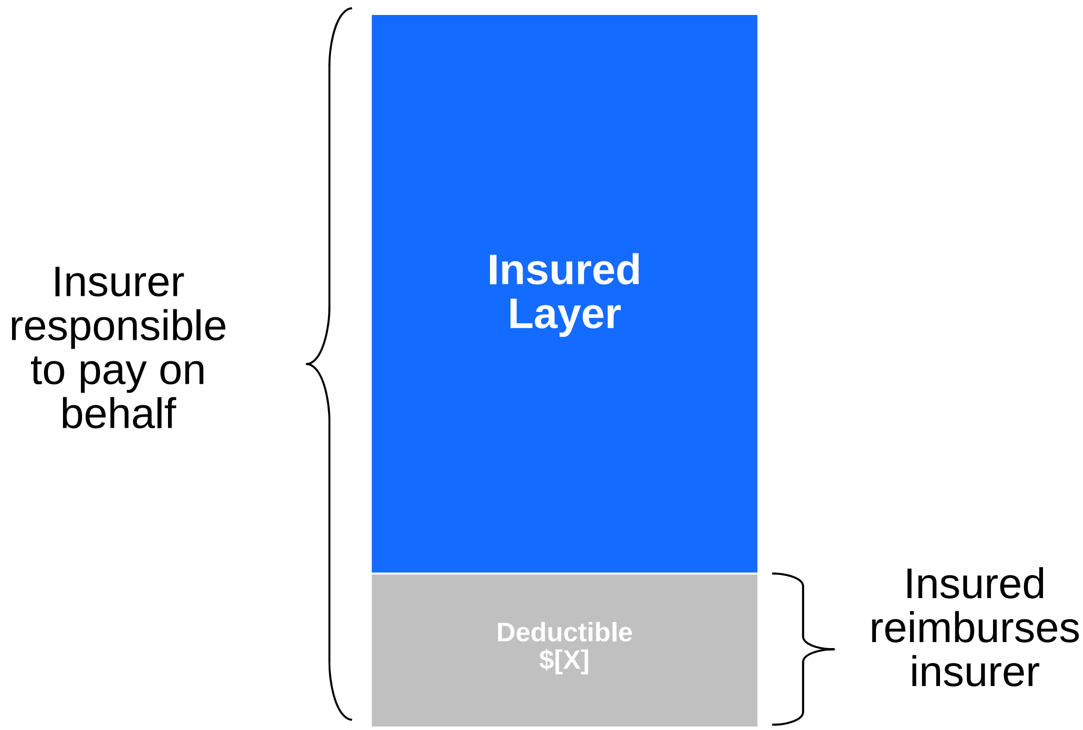
1. Overview – why do insurers require collateral
2. How are collateral requirements determined?
3. Types of collateral and differences in security
4. “Players” in collateral setting – underwriters, actuaries, credit officers
5. Current economic environment – how has it changed collateral environment
6. Current developments in the market affecting collateral requirements
7. Additional considerations & Anecdotes

1 Why do insurers require collateral?

Why do Insurers Require Collateral?

- Credit exposure
  – Ratings
- GAAP / Statutory requirements
  – Surplus requirements
    - Large deductibles strain surplus

Deductible (or Retro) Program



Why do Insurers Require Collateral?

Collateralizing Large Deductibles or other loss sensitive programs where insurer pays on behalf of insured

1

Compelling reasons to institute these programs

- Cost control / savings

2

Insurer assumes full statutory liability for all coverage

3

Insured assumes contractual obligation to reimburse the insurer

4

Carrier has both credit *and* timing risk associated with obligations

5

Creates need to collateralize obligation

- Over time, collateral requirement becomes significant
- Significant buying decision factor

2 How are collateral requirements determined?

Collateral Requirement Drivers

1

Program Structure

- Program elements affect the determination differently

2

Actuarial / loss analysis

- Starting point
- Accuracy of data

3

Credit Review

- Company Review including financial analysis
- Paid Loss Credits

4

Collateral Type

- Five types

5

Underwriting Information

- Accuracy
- Quality

Collateral Requirement Drivers

Program Structure

- Retention Level
- Combination of lines of business
- Large Deductible
- Retrospective Programs – Paid versus Incurred Loss Retro
- Captive
- SIR – any collateral to be considered?

Actuarial Analysis

- Determination of unpaid amounts
- Estimation of amounts paid in future periods for purposes of paid loss credits
- Considerations: any different than in any other estimate of unpaid amounts?
  - Tail, volatility
  - Exposure changes over period of collateralization

Credit Review

- **Company Review including financial analysis**
- **Paid Loss Credits**
- Credit rating models usually carrier-specific
  - Based on Moody's and S&P models
  - Different credit scales by carrier, e.g. A-G, A-F, 1-9, 1-6, etc.
- Financial review
  - Leverage, coverage ratio
  - Liquidity
  - Public/private/size
- Other considerations / judgmental factors
  - Performance
    - weathering of storm
    - comparables
    - management team
    - outlook
  - Industry
    - competitive position
    - stability, defensibility
    - outlook
  - Ownership structure; who owns the insured (international, venture capital co, etc.)

Collateral Requirement Drivers

An actuarial analysis is the starting point for determining collateral requirements, however the desire to deviate will be based on the following

Creditworthiness

- Creditworthiness of insured, as determined by review of company

Risk Appetite

- Insurer's overall risk appetite and view of credit risk within their risk matrix

Other factors

- Other factors such quality of underwriting information

Competition

- Different carriers exhibit notably different levels of conservatism in regards to collateral
  – Competitive factor

Insurers will consider the combination of some of these factors along with results from an actuarial analysis

Collateral Requirement Drivers

Insurer Credit Rating Example (with Paid Loss Credits)

Level	S&P Rating	Paid Loss Credit Guideline
1	AAA to AA	36 months
2	AA- to A	30 months
3	A to A-	18 months
4	A- to BBB	18 months prospective/12 historical
5	BBB to BBB-	12 months Investment Grade
6	BBB- to BB+	12 months prospective/9 historical
7	BB+ to BB	9 months
8a	BB to BB-	9 months prospective/6 historical
8b	BB- to B+	6 months
8c	B+ to B	0
9	B - & below	Surcharged

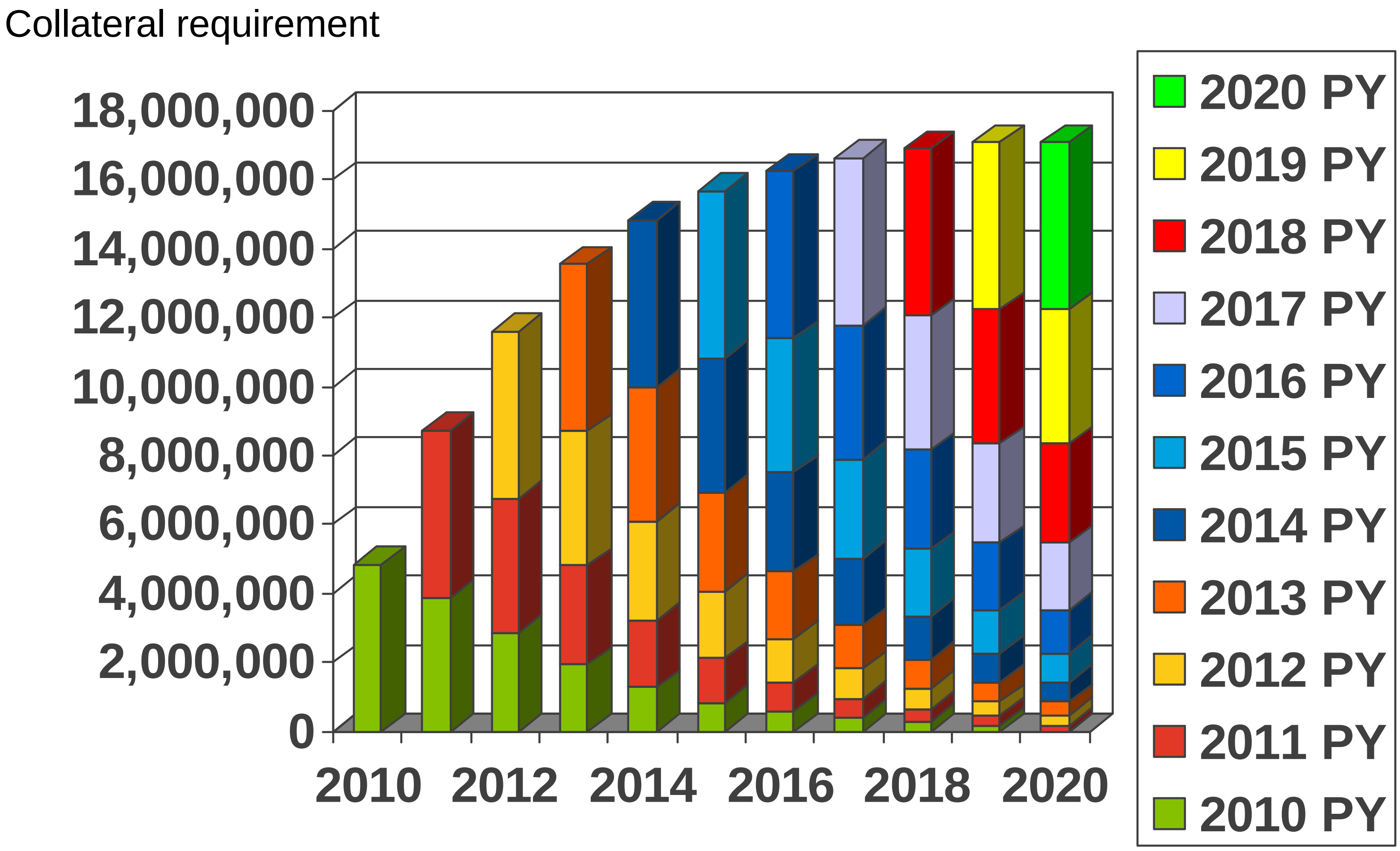
Collateral Requirement Drivers

- Paid Loss Credits
  – Based on loss pick and projection of payment pattern to establish expected values paid over future periods

  – Essence of credit: credit collateral requirement for amount of expected payments over a future period of time

  – Variety of approaches – paid loss credit for:
    - Expected payments for current policy period only
    - Expected payments for current and prior policy periods
    - Amounts of time vary – common ranging from 9 to 36 months

Collateral Stacking



3 Types of collateral and differences in security

Types of Collateral - Acceptable Collateral Forms

Bankruptcy Treatment

	Safety Rating
Letter of Credit	
Trust	
Cash/Pledge	
Surety	
Buy-down	

Type of collateral and security

- Forms of collateral
  1. LOCs
     - Tri party – bank, insured, carrier
     - Preferable for carrier - tied directly to holder
  2. Trust
     - Usually funded with cash or high end bonds
     - Some consider “safe”, but in bankruptcy still must prove belongs to holder
     - Trust agreement – funds frozen for a period of time, so slightly safer than cash
     - Mark to market – asset values fluctuate; may require >100% of credit requirement
  3. Cash
     - different forms of cash – depletes, or sits in trust, or prefunded; give credit for interest earned
     - Not bankruptcy “remote”
  4. Surety bond
  5. Buy-down
     - fee to forgo some of collateral requirement

4 “Players” in collateral setting

Players in Collateral Setting Exercise

- Actuaries, Underwriters, Credit – considerations and interaction with the process
  - **Actuaries**
    - When are they pulled into the process? Rule based? If not, what is motivation? Any biases in when engaged?
    - Different approach / perspective than when estimating unpaid liabilities for reserving?
  - **Underwriters**
    - Collateral requirements often as important as risk transfer pricing – competitive factor?
    - Accuracy and quality of underwriting information
  - **Credit officers / analysts**
    - Are standards being applied consistently?
    - Many factors judgmental

5 Current economic environment and impact on collateral environment

Current Economic Environment and impact on Collateral

- Bank capital
- Insurer credit appetite
- Cash availability
- Cost of collateral vs
  - IRR
  - cost of capital

6 Current market and collateral requirements

Developments in Market affecting Collateral

- Market hardening
  – More incentive for loss sensitive programs
- Large deductible programs requiring little or no collateral
  – buy-back format
- Other

7 Additional considerations and anecdotes

Other Considerations

Changes when insured goes off-risk with carrier

Anecdotes & “Scary” stories

SIRs don’t require collateral, right?

Property as collateral?

Others? Audience anecdotes welcome!

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