SMALL INSURER FAILURES AND THE MISUSE OF LARGE DEDUCTIBLE POLICIES IN WORKERS COMPENSATION

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Workers Compensation Insurer Insolvencies since 2007

Company	# of WC Claims	Year Prior to Insolvency	Worker Comp Reserves one year prior to insolvency (OOO)
Imperial Casualty & Indemnity Insurance Total	905	2007	17,475
Insurance Corp of NY Total	15	2008	20,334
Lumbermens Mutual* Total	6,968	2010	542,096
Park Avenue Property & Casualty Total	2,039	2007	37,334
Pegasus Insurance Company Total	629	2008	3,381
Red Rock Insurance Company Total	187	2012	29,657
Reinsurance Co. of America Total	158	2007	9,214
Southeastern U.S. Insurance Inc. Total	1,054	2007	35,110
Southern Eagle Insurance Company Total	458	2009	8,450
The Insurance Company of NY Total	14		
Ullico Casualty Company Total	7,812	2010	73,361
Valor Insurance Company Total	-		
Grand Total	**27,526**		

$1,167,125,730

Were Credit Problems Mentioned in SAO?

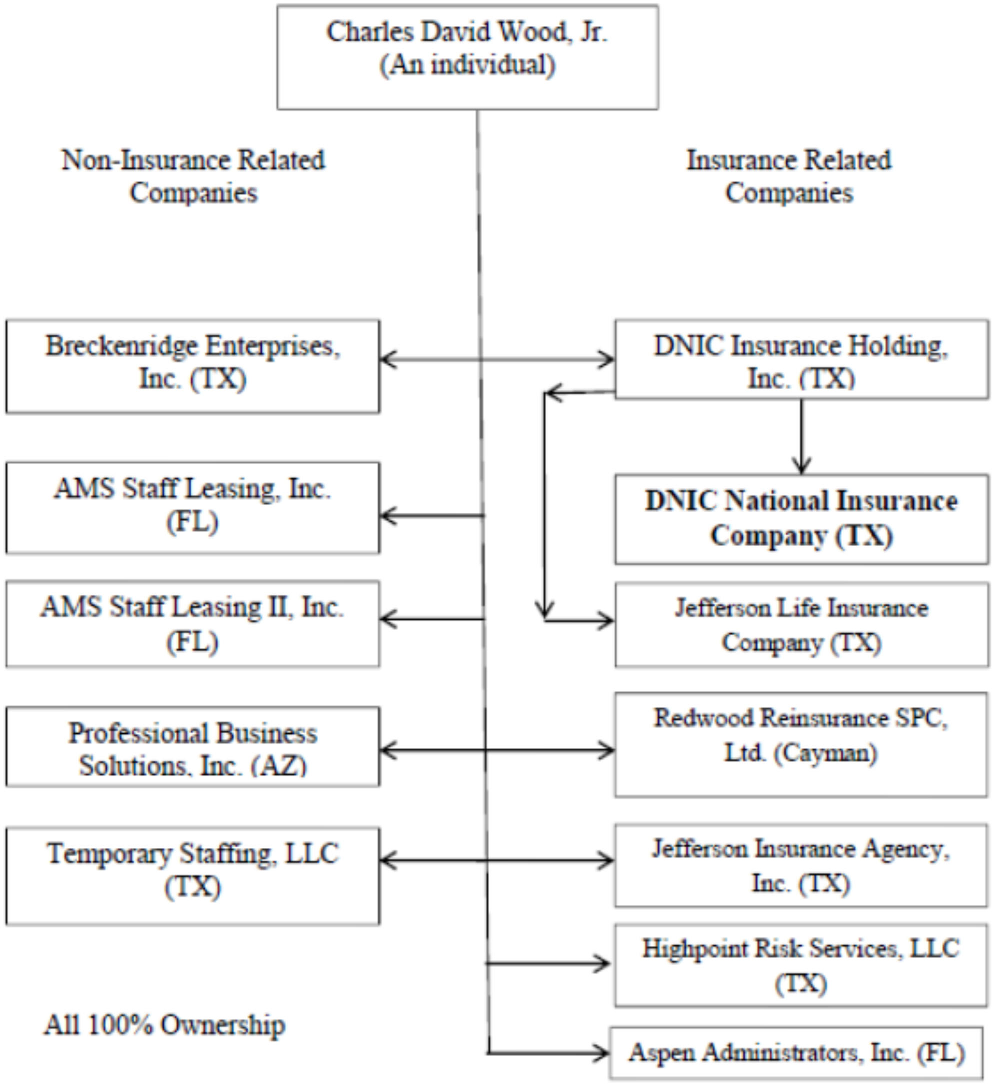
- 2 years before surplus dropped below zero. 50 percent of actuaries commented on credit risk of insureds
- 1 year before 60 percent commented on risk
- Year placed in receivership only 50 percent commented on credit risk of insureds

Company	Year 0 > SP	Detected Credit risk?
1	x-2 yr	No
	x-1	Yes
	x	No
2	x-2 yr	No
	x-1	No
	x	No
3	x-2 yr	Yes
	x-1	Yes
4	x-2 yr	No
	x-1	No
	x	No
5	x-2 yr	Yes
	x-1	Yes
	x	Yes
6	x-2 yr	No
	x-1	No
	x	No
7	x-2 yr	Yes
	x-1	Yes
	x	Yes
8	x-2 yr	Yes
	x-1	No
9	x-2 yr	No
	x-1	No
10	x-2 yr	Yes
	x-1	Yes
	x	Yes

YOU MIGHT ASSUME

- Insurers control the data the actuaries use to set reserves
- All insurers keep secure collateral for large deductible policies
- Businesses under a PEO are diverse and uncorrelated

Exhibit 1- Chart of Dallas National Insurance Company and Related Companies



- ONE MGA
- Guaranty Fund Exposure **$96,465,065.79**

- PEO “Collateral” **$28,979,319.96**
    - “Collateral” is held by a program manager and is in dispute and may not be segregated

- ***Estimated Shortfall*** ***<u>$67,485,745.83</u>***

- *Note: numbers not final, include estimates and projections, and subject to revision.*

CHECK YOUR ASSUMPTIONS!

- Insurer are not always responsible from first dollar to ultimate benefits level
- Employers may handle the claims. Insurers may not have even have access to claims data. Instead are just given reports.
- Agreements may exist between insurers and employers regarding handling of claims by TPAs and may be different than policy terms and conditions (side agreements)
- Insurer may be controlled or affiliated with a PEO
- Laws may allow collateral to become assets of the estate
- Collateral may not be secure (like letters of credit)

Variable Predictability Measure

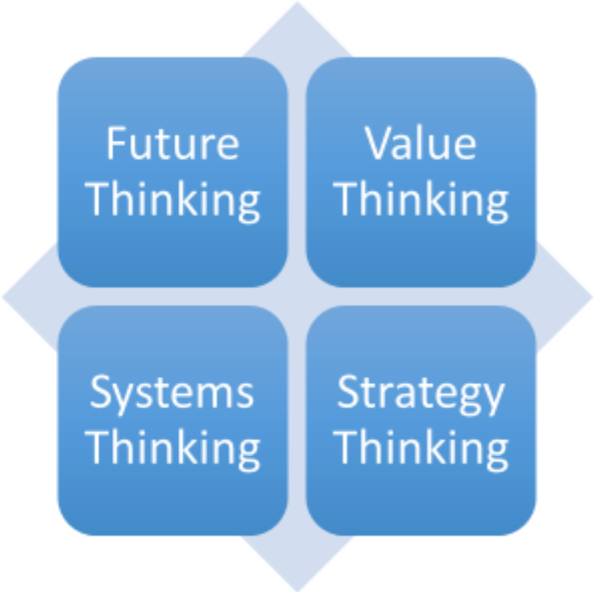
(The higher the value the more accurate the variable is in predicting WC insurer insolvency)

NPW Growth Rate	**9.8**
Loss and LAE Reserve Growth Rate	**8.2**
DPW	6.0
WC Loss and LAE Reserve Growth Rate	5.9
Percentage of Premium Revenue from MGAs	5.8
NPW	3.4
WC DPW	3.0
Exp. Ratio	2.3
Combined Ratio	1.65
WC NPW	0.2

RECOMMENDATIONS FOR LARGE DEDUCTIBLE PROGRAMS WITH SMALL TO MEDIUM INSURERS (I.E. < ORSA THRESHOLD)

1) Sufficient collateral must exist for insurer to pay the claims should the employer become bankrupt (i.e. LOC)
2) The insurer must have access to the collateral (rather than just the MGA)
3) PEO should not own or control the insurer
4) Insurer must control the claims reserving and payment process
5) No side agreements permitted which would make LD Policy tantamount to self-insurance
6) Better disclosure of "risks of material adverse deviation" based on credit risk (auditors and actuaries need to work this out)

RESERVING IN THE FUTURE



RECENT ILLINOIS LARGE DEDUCTIBLE LEGISLATION

Illinois SB 1805

- Applies only to insurers who (1) have *less than $200 million in surplus* and (2) have *lower than an A- rating* from A.M. Best.
- "Large Deductible" is defined as any combination of "policies, endorsements, contracts, or security agreements which provide for the policyholder to bear the risk of loss of $100,000 or more per claim…"

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Illinois SB 1805

- Requires “full collateralization” of a policyholders obligations under an LD agreement by:
  - A surety bond (subject to the issuer meeting financial requirements), or
  - An irrevocable letter of credit from a federally-insured bank in Illinois, or
  - Cash or securities held in trust by the insurer or a third party expressly pledged as security

Illinois SB 1805

- Effectively requires a LD policyholder to have annual audited financial statements
- Limits the size of the per-claim deductible amount to no greater than 20% of the total net worth of the policyholder at each policy inception
  - Specifies the use of financial statements as of the most recently available fiscal year end

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