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CHALLENGES IN COLLATERALIZING LARGE DEDUCTIBLE PROGRAMS

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Executive Summary

A large deductible insurance program often appears to be a reasonable alternative to purchasing traditional insurance. By retaining losses and managing risks through loss control and claims management, some insureds can realize significant cost savings. Along with cost savings, insureds must effectively manage collateral, which is a requirement of large deductible insurance programs to protect the financial risk that insurance carriers may assume when providing programs of this nature. If not managed properly, collateral requirements may at times be as significant in buying decisions as the premium cost for some large deductible casualty programs.

Introduction

A large deductible insurance program often appears to be a reasonable alternative to purchasing traditional insurance.

The term "correction" is being used throughout the insurance industry more frequently these days. After years of rate slashing and expanding policy terms and conditions, the market is showing signs of turning. While the change is most evident in the property sector, many observers foresee steadily rising premiums in many lines of commercial insurance through 2012 and beyond. Now is the time for brokers and insureds to discuss how to best prepare for the consequences of a hard market, which has included limited capacity at sharply higher rates in the past.

Sophisticated insureds with a thorough understanding of their exposures and historical loss experience, if they have not already, may seek more affordable options as opposed to the high cost of traditional insurance coverage. Risk-sharing programs, also known as loss sensitive programs, have provided this alternative for casualty lines for many years. These programs provide a financial incentive for insureds to implement safety and loss control measures. Examples include retrospectively rated premium programs, dividend programs and large deductible programs.

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A large deductible insurance program is designed for medium-to-large commercial insureds, and typically covers casualty lines such as workers' compensation, commercial auto and general liability.

Large deductible programs have surged in popularity as the go-to risk-sharing solution. However, insurers have a statutory requirement to protect their financial strength by maintaining appropriate levels of policyholders' surplus, and large deductible programs can put strain on surplus. Insurers, therefore, require policyholders under large deductible programs to post collateral for their potential future liabilities. Initially, large deductible programs appear to offer nothing but financial benefits for insureds who prudently manage risk. What many fail to consider, however, is the financial commitment that can accrue over time as carriers increase collateral demands to support new policy years.

Large Deductible Program Overview

A large deductible insurance program is designed for medium-to-large commercial insureds, and typically covers casualty lines such as workers' compensation, commercial auto and general liability. Generally, the deductibles vary from between $100,000 to $1 million per claim. The policies are designed so that the insurer assumes full statutory liability for all coverage under the policy terms while the insured assumes a contractual obligation to reimburse the insurer for any claims paid under the deductible.[1]

The two common types of large deductible programs are insurer-funded and policyholder-funded. The insurer-funded program is set up so that the insurer will pay all claims within the deductible and then bill the insured for the reimbursement. The policyholder-funded program allows the insured to fund its own claims within the deductible by providing funds to a third party administrator (TPA) who then administers the claim.[2]

By implementing a large deductible program, an organization is taking a calculated risk that their loss control and claims management efforts are going to meet or exceed their historical loss experience and outperform similar companies in their industry. The expectation is that the insurance premium saved by choosing a higher deductible will exceed that of the claims costs in a given policy year. With this in mind, a company will develop annual operating budgets that project the direct and allocated costs of its expected claims, including excess insurance.[3] However, what often is overlooked in this analysis is the cost of collateral that will be required by either insurer-funded or policyholder-funded large deductible programs.

The Purpose of Collateral

In a typical insurance arrangement, the insurer collects an upfront premium and allocates a specified percentage to future claims, operating expenses and profits. In a large deductible

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program, on the other hand, the insurer requires a much lower premium because the claims costs that fall under the deductible will be reimbursed by the insured.

While responsibility for paying claims ultimately falls to the insured, the insurer nonetheless assumes both the credit risk and the timing risk of reimbursement for claims paid out under the deductible. For this reason, collateral is required by insurance companies to preserve statutory surplus levels required by the states in which they do business, maintain favorable considerations by ratings agencies that evaluate their financial condition and comply with the state law mandates to pay claims regardless as to whether or not reimbursement is forthcoming. While the most common and safest form of collateral provided to insurers are letters of credit (LOCs), cash, surety bonds, trusts, or a combination of the above also are sometimes used.

Collateral Challenges Faced by Insureds

Collateral provided to insurers by companies with large deductible or other risk-sharing programs can have significant and, potentially, unforeseen financial consequences if overlooked or misunderstood. Insurers' collateral demands increase over time as they continue to hold collateral to support prior years' open or unrealized casualty claims while requiring additional collateral at each new policy year. Policyholders may be required to post collateral for as much as ten prior policy years' liabilities. Companies may be able to negotiate with their insurer to reduce the prior years' collateral requirements but, if they change insurers, it becomes more difficult to negotiate the collateral requirements for past liabilities with the prior insurance carriers.[4]

Unless a company is flush with cash, having to post increasing amounts of collateral can limit borrowing capacity, potentially diminishing cash flow to maintain current operations or inhibiting the company's ability to make investments that will generate future growth. In these instances, by being over-leveraged, the cost of collateral in some cases may outweigh the benefit of premium savings compared to a standard casualty insurance program.

The collateral required by the carrier is based on an insured's expected losses and, as previously mentioned, will increase over time to support new policy years. Since collateral requirements can deprive an insured of credit that could otherwise be used for corporate growth, it is important to produce an accurate estimate of an insured's future losses, called a "loss pick". If the loss pick is too high, the collateral demands will be more than is actually necessary and, therefore, unnecessarily impact borrowing capacity. If set too low, the initial cost will be lower but the insured will be faced with unexpected future expenses.[5]

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Collateral demands are not equal for every insured, and will vary based on the financial health of an organization. Similar to how banks provide their best interest rates to individuals with the best credit, insurers offer the best collateral terms to the companies with the best balance sheets, even if companies have identical expected losses.[6] For that reason, highly-leveraged companies, or with other balance sheet or income statement issues, may find that the collateral demands are so high that it makes more sense to pay the premium of a standard insurance program.

Companies with less-than-stellar balance sheets not only may have higher collateral requirements, but they may also have higher LOC costs with their bank. Banks, which have been more conservative with credit since the start of financial crisis in 2007, reserve their best LOC terms and fees for organizations in the best financial health. While many seem to be loosening their belts slightly as of late, it still is not uncommon for banks to increase their letters of credit fees, creating another collateral challenge for insureds to overcome.

What Should Policyholders Do?

Tying up an unexpected amount of credit to cover insurer collateral demands is not a situation that most risk managers want to have to explain to executive management, especially for growth-oriented companies. It is with this in mind that they should consider a couple of key questions before making the move to a high deductible program. How much collateral am I going to have to post? And, what will it ultimately cost the organization to not have access to that credit each year?[7] If an insured feels comfortable with the answers to these questions and moves forward with a high deductible program, there are steps that can be taken after the inception of the policy to favorably impact an insurer's collateral requirements.

While the need for collateral by insurers is legitimate, it is just as legitimate for insureds to proactively monitor how much collateral is being required.[8] Since collateral demands will increase each year until claims level off, insureds should have an understanding of exactly how carriers determine the amount required as liabilities accumulate. Transparency by the insurance carrier is essential.

To maintain accurate loss picks, it is important that an insured (with the assistance of its broker) conduct frequent and comprehensive reviews of its operations in an effort to determine whether changes have occurred that will make historical loss levels less relevant to future loss picks. For example, if there has been a significant round of layoffs, the anticipated level of workers' compensation claims will be reduced. Other examples include technological improvements, which reduce workforce risk and commitments made by the insured to focus on

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and improve loss control. The broker should then communicate the changes to the insurance carrier so that the loss pick is accurate and, therefore, collateral demands can be reduced (or at least be representative of current conditions).[9]

Another factor that should be taken into consideration regarding the loss pick is the steps that a company takes to limit the severity of losses after they occur. If claims are not managed correctly, the carrier will often pay out more in benefits over the life of the claim. Insureds who get involved in the claims process early are proven more likely to limit the claim from getting out of control.[10] Brokers should be certain that insurers are fully aware of all post-loss activities that will help to contain loss costs.

It is important to work with insurers who will not simply stack loss picks as new policy years are added. Instead, progressive insurers will take a more holistic approach and adjust collateral requirements based on actual incurred losses and actuarial forecasts of future loss development. By melding both the historical and forward-looking data, insurers can set a more accurate loss pick that will, often, reduce collateral demands.

Conclusion

As large deductible insurance programs gain in popularity, insureds considering the use of them must have a thorough understanding of both the benefits and challenges. Some insureds, by retaining losses and proactively managing risk, can see significant cost savings. Others, however, find themselves struggling with the financial demands placed upon them in trying to meet the collateral requirements of their insurer. This does not have to be the case as collateral can be managed by the willing. A combination of a proactive insured, experienced broker and a progressive insurer can help turn a challenging situation into a positive one, creating a win-win situation for all. ■

Notes:

1. *Constance B. Foster, Esq., "Insurance Insolvencies and Large Deductible Insurance Programs" http://www.forc.org/pdfs/vol16-ed2-art2.pdf*
2. *Constance B. Foster, Esq., "Insurance Insolvencies and Large Deductible Insurance Programs" http://www.forc.org/pdfs/vol16-ed2-art2.pdf*
3. *Jeff Pettegrew, insurancethoughtleadership.com, "Self-Insured Retention vs. Collateral", (June 2011), http://www.insurancethoughtleadership.com/index.php/site/safety-risk-control/self-insured-retention-vs.-collateral-what-is-the-true-cost-of-risk/#axzz1t9ZQx9wZ*
4. *Willis, "Construction Insurance Property & Casualty Market Update", (February 2007) http://www.willis.com/documents/publications/Industries/construction/Construction_PC_Market_Update0207Final.pdf*
5. *Mark Gordon, Pietragallo Gordon Alfano Bosick & Raspanti, LLP; Pamela Ferrandino, Willis, "Collateral Wars" (Fall 2009)*
6. *Mark Gordon, Pietragallo Gordon Alfano Bosick & Raspanti, LLP; Pamela Ferrandino, Willis, "Collateral Wars" (Fall 2009)*
7. *Jeff Pettegrew, insurancethoughtleadership.com, "Self-Insured Retention vs. Collateral", (June 2011), http://www.insurancethoughtleadership.com/index.php/site/safety-risk-control/self-insured-retention-vs.-collateral-what-is-the-true-cost-of-risk/#axzz1t9ZQx9wZ*
8. *Mark Gordon, Pietragallo Gordon Alfano Bosick & Raspanti, LLP; Pamela Ferrandino, Willis, "Collateral Wars" (Fall 2009)*
9. *Mark Gordon, Pietragallo Gordon Alfano Bosick & Raspanti, LLP; Pamela Ferrandino, Willis, "Collateral Wars" (Fall 2009)*
10. *Mark Gordon, Pietragallo Gordon Alfano Bosick & Raspanti, LLP; Pamela Ferrandino, Willis, "Collateral Wars" (Fall 2009)*

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