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Communication is Key to Successful Collateral Negotiations

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Collateral negotiations can often be contentious. While collateral is required for a variety of insurance programs, opinions of how much collateral is necessary can differ significantly. These differences are borne out of different perspectives and motives between parties involved in the negotiation. An objective discussion between the actuaries behind the loss projections on both sides of the negotiation can help find valuable middle ground.

Ultimately, collateral is protection against financial risk of a Risk Bearing Entity (RBE) defaulting on payments for future retained losses. There are several various types of RBEs, such as large deductible policy holders, self-insureds or fronted captives. Each of these RBEs is ultimately responsible for the retained losses they cover. However, if the RBE has a Policy Issuing Carrier (PIC) and the RBE is unable to meet their claims obligations, the PIC must act as a backstop and is responsible for all claims payments. The PIC offsets this credit risk through the requirement of collateral.

The credit risk to the PIC is the most obvious concern, but they also need collateral to meet statutory requirements since an RBE will not typically qualify as an admitted reinsurer. Rating agencies also have concerns regarding the amount of collateral the PIC is holding as they assess the risk posed to the carrier. Self-insured workers compensation programs without a fronting carrier may also have significant collateral requirements imposed by the state.

KEY POINT

Actuaries talking to actuaries can be the quickest, most efficient way to get to the bottom of the differences between collateral estimates.

This collateral is intended to protect the workers and any guaranty funds that will be used in the event of a self-insured's inability to pay claims.

Collateral can be posted in a number of ways. A letter of credit (LOC) is the most common, but RBEs also use surety bonds, trusts and cash. It is important to recognize that all collateral has a cost and the cost to the company grows as the amount of collateral required grows. An LOC has an

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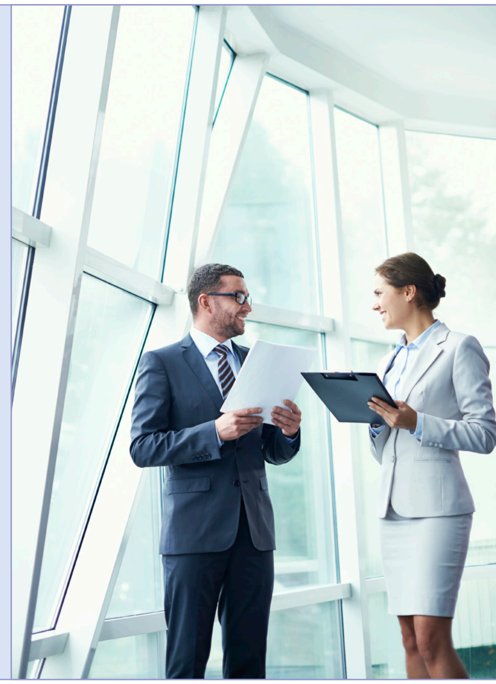
The Independent Actuary's Role

In any negotiation, there can be a question about whether the consultant or company expert is an advocate or an independent voice. As consulting actuaries, we pride ourselves on our independence. Part of this independence is borne out of our professional code of conduct. Precept 8 – Control of Work Product of our code of conduct stipulates that an actuary take reasonable steps to ensure their "services are not used to mislead other parties."

As an independent consulting actuary, our objectivity is vital to being able to do our job and to maintain our reputation. Our clients and those who rely upon our work product (auditors, regulators, etc.) need to be able to trust that we perform our work in an unbiased manner. Our independence is also key in a negotiation setting. An estimate from an independent actuary will carry much more weight than that of an advocate.



obvious cost as a bank typically charges a percent of the amount of the LOC annually. The amount of cash posted by the RBE may not have a specific charge associated with it, but it has a clear opportunity cost to the RBE that could be using the cash elsewhere.

The amount of collateral required can be based upon policy limits or a prescribed formula, but it is most commonly determined based upon expected future claim obligations. Along with a review of expected losses, a PIC may also consider the financial strength of the RBE, the type of collateral provided, and the nature of the underlying coverage and program structure. If the underlying coverage includes low frequency, high severity losses, more consideration may be given to requiring collateral equal to a multiple of the per occurrence policy limit. This may also be true if the underlying exposures include losses with long latency periods, such as asbestos or silicosis losses in a workers compensation program.

Why Parties Disagree

It is not uncommon for an RBE and a PIC to disagree on the required collateral amounts for the program. As you would expect, both sides have different motives and points of view. The RBE is motivated by a desire to keep significant insurance costs such as collateral low for its program. The PIC has a focus that is much broader than a single program. They need to have the capital necessary to mitigate credit risk and meet statutory and rating agency requirements.

Beyond motive, the two parties have vastly different points of view regarding the risk involved in the program. An RBE will tend to trust their results—believing in their business plan and their claims process. Favorable loss experience reinforces this viewpoint. If there is unfavorable experience, it may be explained away, or changes may be made to correct any problems and improve the experience going forward.

The PIC will also tend to trust their own (much larger) body of data in order to project the ultimate claims experience of the RBE. The PIC will develop the captive's loss data based on their aggregate experience in the industry. They recognize the RBE's business plan and claims process, but are aware of many other RBEs with similar plans that have had adverse development. PICs often have a much better appreciation of incurred but not reported (IBNR) and the potential for future development due to their size and length of time in business.

Coming to an Agreement – Getting the Actuaries Together

In the collateral negotiation, we have two parties with strikingly different motives and perspectives. Usually, the starting point for the negotiation is the collateral requirement developed by the insurer. For the RBE, the question is how to make the best case to the PIC. There are a number of ways to present your case in the best light, but first and foremost, you have to speak the same language.

For the purposes of determining collateral, the language often spoken is Actuarial. In a typical collateral negotiation, each party will be working from an estimate of unpaid claims liabilities produced by their actuary. Actuarial estimates can differ for a variety of reasons but gaining an understanding of why they are different can be invaluable in the negotiating process.

There are two common barriers in the flow of actuarial information in a collateral negotiation. The first is an inconsistent flow of information. The RBE is often more than willing to provide their actuarial support as they make a case to change their collateral amount. The PIC is not typically arguing for a change and rarely makes their actuarial study available.

The second barrier involves who is doing the speaking. While a significant portion of the negotiation is based on the actuarial studies, the actuaries are not always directly involved in the conversation. The negotiators for both sides are relying on separate actuarial studies with differing results. While they may understand the basics of their study, they may not recognize the key assumptions leading to different results between the studies or where one study may be stronger or weaker than the other.

The simplest solution to both of these barriers is to increase the amount of direct communication between the actuaries. Actuaries talking to actuaries can be the quickest, most efficient way to get to the bottom of the differences between collateral estimates.

Communication between actuaries can take different forms. At the most basic level, it is often accomplished through the sharing of the exhibits supporting the RBE actuary's analysis and related diagnostics. Open dialogue between the actuaries regarding methodologies, key assumptions, RBE specific operational information, etc., can be invaluable. For example, having the RBE actuary's report that shows significantly less IBNR projected in the current year can be valuable, but it may not persuade a skeptical PIC. However, the RBE's actuary explaining that the use of a lower expected loss ratio in the current year is supported by the RBE's historical experience, recent changes in exposure, or industry trends could be enough to make that same PIC more comfortable with the results.

Common Situations in Collateral Negotiations

Getting the actuaries from both sides communicating will go a long way to finding common middle ground, but will not solve every difference. In general, we run into three types of situations when dealing with collateral negotiations.

1. Little or No Historical Data

The first situation is most common early in the life of an RBE's program. There is very little historical data on which to rely. The PIC is not likely to give much credence to the RBE's viewpoint, and the RBE will have very little leverage in negotiations. The lack of leverage is directly related to the lack of data to support the RBE's view. The actuarial analysis at this point is heavily reliant upon industry benchmarks.

Selection of the appropriate benchmarks at this point of an RBE's program life is crucial to understanding the unpaid claims liabilities. Selecting an appropriate benchmark is an underappreciated skill for an actuary that can bring significant value to the RBE. A particularly robust benchmark can even provide a minor degree of leverage for the RBE when negotiating over collateral. The RBE's actuary may have a benchmark based on publically or privately available data that better matches the underlying exposure to the RBE, such as a professional liability development pattern specific to lawyers. Another example would be using the most specific and appropriate pattern available based on the exposure to the RBE. A generic medical professional liability pattern might produce estimates too high if the RBE only insures podiatrists. It might be biased too low if the RBE only insures obstetricians/gynecologists.

2. Limited Historical Loss Development Data

As the RBE's program grows, more development data becomes available, and the amount of leverage the RBE has in collateral negotiations begins to increase. At this point, the historical data is still not fully credible, but loss development factors and other assumptions begin to incorporate the RBE's loss experience along with industry benchmarks. The RBE now has data to rely on, but the question is about how much weight can be given to the RBE's experience.

The answer depends not only on the amount of historical data available but also on the quality of the data and the underlying exposures. Five years of property data can be very credible while five years of workers compensation data will still require the use of benchmarks. The quality of the data refers not only to how clean and available the historical data is but how much has the insurance program changed. If the RBE has regularly changed retention limits and claims administrators, the historical data will be less predictive, diminishing the credibility of the data.

3. Credible Volume of Historical Loss Development Data
Once the RBE has reached a sufficient size and age, the amount of historical data available and knowledge of the program can provide considerable leverage in collateral negotiations. At this point, an actuary will likely rely chiefly on the RBE's experience for significant assumptions, such as the loss development factors.

While the volume of data provides more credibility, it also provides the RBE's actuary more opportunities to support their estimates. When performing a reserve analysis or assisting in collateral negotiations, diagnostic exhibits detailing changes in frequencies, severities, loss ratios, loss costs, etc. can shed light on underlying trends. Exhibits that detail changes in key data elements and estimates between the prior analysis and the current can also be valuable.

Lastly, exhibits that compare loss development over time with prior estimates from prior analyses (sometimes referred to as "report card" exhibits) can be a great way to show the credibility of an analysis. These exhibits can focus on expected development based on the prior assumptions or may be as simple as a bar chart showing estimated ultimate losses and IBNR over time.

Conclusion
Due to its impact on an RBE's profitability, the amount of collateral required can lead to difficult and sometimes contentious negotiations. As actuaries, we regularly work with our clients and others who review our reports (regulators, auditors, etc.) to make sure that our reports are clear and well supported. In a collateral negotiation, it is incumbent on the RBE's actuary to provide the necessary support for the PIC to best understand the RBE's IBNR potential.

Typically, nobody completely wins a collateral negotiation as there will always be differing points of view. However, with the right amount of involvement from their actuary, an RBE can make a much stronger case to the PIC about what their collateral level should be.

ABOUT PINNACLE

Pinnacle Actuarial Resources, Inc. is an independent, full-service actuarial firm that focuses on the property/casualty insurance industry. Our home office is located in Bloomington, Ill., with additional offices in Atlanta, Chicago, Des Moines, Indianapolis and San Francisco.

Our *Commitment Beyond Numbers* philosophy encompasses all of who we are and what we do. It drives us to do whatever it takes to help our clients address their risks, understand the challenges they face and find the right solutions to meet their goals.

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