RISK 66

Collateral Requirements: SIGMA's Analysis

STEP 1. Negotiating the Terms

1. During the negotiation period, the insured should expect an insurance company to consider: the insured's credit worthiness, at least five years of their historical losses and exposures, and a calculation of their expected losses.

2. To best influence the negotiated collateral, the insured should provide: their most recent audited and interim financials, a brief overview of trends and expectations, and enough time for the insurer to become familiar with their credit profile. Full loss history, complete explanations of large losses, and an independent expected loss computation are extremely helpful to this process.

3. The insured should also read and understand the rating plan documents, specifically the ways in which collateral is adjusted and calculated. While they aren't guaranteed, doing so could lead to modifications from the standard document wording, especially if insurers find reason to do so.

STEP 2. Annual Collateral Review

1. The insured, broker, and claims adjusters should meet periodically to review large claims and determine a strategy for closing each.

2. Ninety days prior to renewal, the broker should prepare a report for the insurer which:

a. Shows the results of the most recent claims review

b. Summarizes the loss experience in a clear, meaningful way

c. Includes ultimate loss projections for each policy year

d. Includes a projection of a reasonable collateral amount

3. No later than forty-five days prior to renewal, up-to-date financial information and expectations should be reviewed so that each party has a chance to predict and expand on areas that the insurer may have questions on.

4. Following these steps, applicable parties should meet with the insurer to present specific concerns and desired outcomes as well as supply answers to any questions.

STEP 3. Computing Collateral Requirements

A typical insurance company's process for computing collateral requirements follows these steps:

a. Total ultimate losses for any and all historical deductible years are calculated by the insurance company's actuaries.

b. Total claim payments made to date are then subtracted from the ultimate losses.

c. An ultimate loss estimate for the new policy period is added.

d. Adjustments for credit rating (+/-) are made.

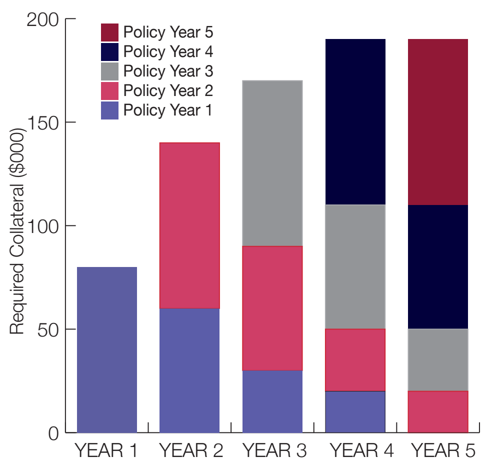
So, the formula looks like this:

COLLATERAL =
\+ Ultimate Losses
– Paid Claims
\+ Loss Pick
\+ / – Credit Rating Adjustment

In the past, SIGMA has been very successful in negotiating adjustments to this formula to account for losses paid in the first year. SIGMA can also evaluate, and perhaps influence, underlying assumptions behind the terms in the formula.

Contact SIGMA for more information.

STEP 4. How Collateral Builds



When starting a large deductible program, the insured is often caught off guard by the growth of collateral burden over the first few years. Understanding and anticipating how these burdens build and eventually reach a "steady-state" is an important process that SIGMA can assist with upon request.

STEP 5. Discussion

Getting involved on the front end of a deductible policy and making sure the collateral mechanism is understood and negotiated, if possible, is critical. As the insured renews and continues with the deductible plan, there should be a continued effort to minimize collateral requirements through good analysis and information flow to the insurance provider.

An independent actuary can provide the necessary analytics to verify collateral requirements are not excessive and to help negotiate lower levels with the insurance company, when appropriate. By obtaining a loss projection, reserve analysis, confidence interval, and cash flow analysis, the client's CFO will have sufficient information to meet all financial planning and decision making demands.

Special thanks to Steve Coombs, CPCU, ARM, for his contributions to this piece.
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