YOUR NOTES

SIGMA TALK

Prospective Client: Questions. Research. Documentation.

Question 1: Loss Sensitive Programs

What are the provisions of your current large deductible, self-insured, or loss sensitive programs? The key items we would want to document for each program (if applicable) include effective and expiration dates, per occurrence retentions including the treatment of loss adjustment expenses, aggregate limit, policy limit, and any other parameters such as those used in the calculation for a retrospectively rated policy.

Do you have the policies or supporting documents showing the provisions for large deductible, self-insured, or loss sensitive programs for prior periods as well? Particularly those with any open claims. The parameters for the past programs are central to estimating any retained liability for prior programs.

SIGMA Thoughts

For a current client, you typically have all the information necessary to document the current and past programs during the period of your involvement. For a new client, it is important to document the past programs. We frequently see projects where past programs, particularly those involving a different broker, are not well documented.

At times, unexpected liabilities have resulted when a past program was not properly understood and documented. It is important to research and document programs that were in place prior to your involvement.

Goals

It is important when engaging a new client to have good documentation of prior programs, particularly if a balance sheet liability needs to be carried for prior liabilities or collateral is involved. Assisting the client with the calculation of that liability or the negotiation of related collateral will be an important part of supporting the client going forward.

Be thorough in documenting all of your client's current programs and historical programs. When you discuss this item with the client, probe for potentially missing information from past years. Also, verify that they understand the specifics of the current program.

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Question 2:

Loss Sensitive Programs - Amount of Loss Retained

Once we have all the policies and/or the parameters for prior programs we will document the risk retained by you under each program. We will pay special attention to any concerns about liabilities from past years. Do you currently have a balance sheet or related liability for the retained losses of the current and prior insurance programs?

SIGMA Thoughts

Given some of the more complex programs available, corridor deductibles and retrospective programs for example, it is important to clearly state and document the losses that are retained by the client. This can be done with specific examples or graphics.

Goals

It is important that you communicate and document each client's retentions and other program parameters so that any team member can refer to this documentation when the topic comes up. You do not want someone to misrepresent or misstate the retention or other program parameters. Also, it is good to communicate directly with the client and have them acknowledge their understanding of the retention.

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Question 3: Maximum Loss Retention

Often, the program parameters, such as the per occurrence retentions, are selected based on the cost savings in the premium paid. Particularly in the case of multiple retention options, it is important to quantify the retained losses and compare that to the premium savings.

Has an analysis of the estimated retained losses at various retentions been completed recently?

Would you like to better understand this process and how it might add value to efforts to minimize total insurance costs in the long run?

Given that you have a portion of losses that your organization retains, have you considered the potential variability in those losses and how this variability might impact your balance sheet and income statement?

SIGMA Thoughts

Frequently, an insurance program with a significant retained loss portion is selected primarily to achieve a reduction in premiums. An important part of the decision is to consider the losses retained versus the reduction in premiums. It is important to consider both the expected retained losses and the variability in the retained losses as well.

An independent estimate of the losses to be retained should be considered, not the insurance company's estimate. For smaller retention amounts, in house analytical tools may suffice. However, for larger retention amounts for clients with sufficient losses, an independent actuarial loss projection is more appropriate.

Often clients fail to recognize the potential for variability in their retained losses. It is often assumed that actual ultimate retained losses will end up close to the initial loss pick. In the case of larger per occurrence retentions, significant variability in the retained loss amount is possible.

Clients should have a strategy for dealing with and monitoring this variability. Losses should be monitored over time through periodic analysis. In some cases, an annual or semi-annual analysis should suffice. In other cases, a quarterly update of the loss estimates may be more appropriate.

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Question 3: Maximum Loss Retention

Goals

If the decision to purchase a particular loss sensitive/large deductible program has historically been made without an independent actuarial loss projection, this is opportunity to explain the impact of the program parameters and possibly consider alternative options as well.

This will also give you the opportunity to discuss potential variability in loss picks (whether done with an in-house tool or by an independent actuary) and the potential need for a more in-depth analysis.

Unpleasant surprises from adverse retained loss experience are never welcome. They typically lead to questions from the client about the retention amount and the estimated funding. Some (documented) measure of the potential variability is useful to explain the possible variation in losses and recover from any relationship damage that might occur due to a year of adverse loss experience.

Large deductible/large retention programs work as an effective risk management/ cost containment strategy, but too often the downside of retaining risk is not fully discussed. It is good to discuss the downside and potential risks as part of this conversation.

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Question 4: State and Regulatory Requirements

Are you a “qualified” self-insured or are you considering becoming a “qualified” self-insured in any state?

SIGMA Thoughts

Almost every state has instituted some level of review for qualified self-insureds in their state. This typically includes an independent actuarial review with a frequency of at least tri- annually. In many cases it has become an annual requirement. States have been impacted by financially distressed self-insureds in recent years.

There are additional requirements in certain states. For example, some states require an actuary to sign off that a self-insured group has purchased a reasonable aggregate limit in addition to the per occurrence limit.

Goals

Many clients are choosing to self-insure in certain states. This typically is in the form of a self-insured retention (SIR). This eliminates the collateral requirements of the carriers; however, the states are instituting their own collateral requirements. Actuarial resources will be needed in most cases to satisfy the state’s self-insurance requirements. The reports typically have to be certified by a Member of the American of Actuaries (MAAA) or an Associate or Fellow of the Casualty Actuarial Society (ACAS, FCAS).

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Question 5: Collateral

Do you feel comfortable with current collateral requirements and understand how those will be adjusted going forward? Do you have documentation of all collateral related contracts?

How have your collateral requirements and collateral negotiations been over the past few years?

SIGMA Thoughts

In recent years, with tightening credit markets and other financial strains on companies, collateral requirements have become an area of focus for most companies.

Ask for historical collateral requirements. Look for a collateral worksheet for each year and a collateral agreement that outlines all the parameters of the collateral calculation(s). At the very least there should be an "invoice" and some perception of the client's CFO and the risk manager's satisfaction with the current figure. Some risk managers are satisfied with their collateral requirements but need assistance explaining the requirements and their calculation to the CFO and CEO.

Actuaries are becoming more involved in collateral discussions and negotiations from all sides. The carrier is likely to have an actuary involved in the collateral calculations and related negotiations. Doesn't the client want an actuary on their side too?

Goals

A key goal is to have all collateral agreements thoroughly documented including the provisions related to how and when collateral held will be adjusted.

Additionally, it is important to be proactive and negotiate the provisions of the collateral agreements upfront, including the provisions related to any loss development factors and risk margin, as well as provisions related to the timing of collateral adjustments.

The collateral required can be minimized by properly understanding and managing all related contracts. Actuaries can play an important role in negotiating lower collateral requirements.

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Question 6:

Individual larger losses and/or total retained losses

Do you have any individual losses > $100,000 OR total retained losses > $500,000 for a single coverage in the past five years? If so, it may be time to consider an actuarial analysis, if you have not already. Do you currently have an independent actuarial analysis completed for any coverage(s)?

Would you be interested in learning more about the purpose and benefit of an actuarial analysis?

SIGMA Thoughts

There is no exact threshold that determines when an actuarial analysis is "necessary". The term usually used by accountants and actuaries is materiality - is the amount material versus the total balance sheet and income statement? If a client has had a larger loss or total retained losses over $500,000 for a particular coverage in the past five years it should be at least considered whether an actuarial analysis is appropriate, particularly for balance sheet purposes.

Goals

For clients with this level of retained losses it is appropriate to ask how the company is setting the estimated required reserves (i.e. liabilities) related to the historical retained exposures. It is also worth noting that this balance sheet exposure also relates to the collateral held, since insurance carriers are typically holding collateral on account of the unpaid retained liabilities as well.

It may be that the company decides that an actuarial analysis is not necessary in their specific case. However, at this level of retained losses it is at least appropriate to make the client aware that their retained losses have reached a level where the benefits and need for an actuarial analysis should be considered.

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Question 7: Tail Liability

Do you currently have any insurance coverages that are covered on a claims-made basis? Are you aware of the tail liability related to insurance on a claims-made basis? The term tail liability is loosely used in many different insurance situations. The definition of the tail liability here is the tail exposure for a claims-made program related to claims that have occurred but are not reported. Unless an extended reporting endorsement has been purchased, a balance sheet liability is typically required for this unlimited exposure.

From an accounting perspective are you carrying a reserve for the tail liability, as described above, for any coverage? If so, how has that tail liability reserve been determined?

SIGMA Thoughts

Professional liability insurance is typically written on a claims-made basis. This insurance covers claims on a report date basis, and not an accident date basis. There are other types of insurance that are written on a claims-made basis, but professional liability is definitely the most common. Currently, it is quite rare to find medical professional liability coverage on an occurrence basis.

The claims-made coverage is sometimes first dollar but in other cases the claims-made coverage includes a per-occurrence retention or deductible. In either case, there is a tail liability that is not covered by the insurance unless a specific extended reporting endorsement is purchased. It is important to consider this tail liability on the balance sheet.

Clients' and auditors' understanding of the impact and existence of this tail liability varies. In recent years, more auditors have become aware of the need for this specific item on the balance sheet for claims-made insureds.

Goals

It is important to recognize the tail liability that accompanies claims-made coverage, even when the claims-made coverage is first dollar. It is not possible here to discuss the complete accounting reasons for the tail liability, but if the amount of the tail liability is material, it should be a liability on the balance sheet.

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Question 8: Public Company or any Public Debt

Is your company a publicly traded company? Are you considering going public in the near future?

If the company is a private company, has it issued any significant public debt (eg. corporate bonds)?

SIGMA Thoughts

In the last decade, publicly traded companies have become subject to stricter audit and reporting standards. Beginning with the advent of the Sarbanes-Oxley Act of 2002 (SOX), auditing firms, particularly large national auditing firms, have required a credentialed actuary to provide an actuarial report, at least annually, related to material self-insured liabilities on a company's balance sheet.

Also, since the passage of SOX, auditors have applied many of the principals of SOX to clients that are not publicly traded. For example, even though a company may be privately held, by issuing debt, such as corporate bonds, there will likely be more stringent audit requirements.

Goals

Clients who are publicly traded, and others, will need a credentialed actuary, at least annually, to provide an analysis supporting the carried liabilities related to retained losses. It is important to have actuarial resources available to provide these analyses where needed.

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Question 9: Public Entity

As a public entity, do you fund the retained losses for both the current period and historical periods? If so, how is that amount calculated and by whom?

SIGMA Thoughts

The Governmental Accounting Standards Board (GASB) provides accounting and financial reporting standards for state and local governments as well as public entity risk pools. Statements numbers 10 and 30 (GASB 10 and GASB 30) particularly relate to the Accounting and Financial Reporting for Risk Financing and Related Insurance Issues.

Included within GASB 10 and GASB 30 are guidance related to estimating the ultimate liability for unpaid claims costs including IBNR.

Goals

Pronouncements of the GASB typically apply to the financial reports of all state and local governmental entities. Actuarial analysis can play an important part in satisfying the demands of the GASB statements such as those mentioned above.

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Question 10: Loss Allocations

Are you allocating insurance costs internally? These insurance cost may include retained losses, excess insurance cost, and other internal and external risk management costs.

If so, what process is used for each coverage and/or allocation? Would you like to develop an objective, analytical, allocation approach for certain coverages?

SIGMA Thoughts

Allocating the cost of coverages such as workers compensation, general liability, and auto liability can play an important role in controlling the total cost of insurance. When departments bear a cost that is related to their actual exposure and historical experience, there is more incentive to control losses.

It is important to create a balance in the allocation process. Large losses should be capped at a level appropriate for the individual risk. It is important for the allocation process to reflect recent historical experience and any significant exposure changes.

Goals

An allocation process should not be overly complex. However, it is important to design an allocation formula/process that will create an incentive for loss control and risk management. Actuarial reports may include an allocation of costs related to the retained losses included in the report.

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Question 11: Acquisition or Divestitures

Related to any acquisitions and/or divestitures you made during the past year, have you considered the impact on premium and retained losses? Do you have any pending or anticipated acquisitions or divestitures in the coming year?

SIGMA Thoughts

When an acquisition or divestiture occurs it is important to properly quantify the impact of any retained liabilities involved. When an acquisition includes the assumption of a company's prior retained liabilities an actuarial analysis is prudent as an independent assessment of the adequacy of the carried amount related to those liabilities.

It is also important to document the particular parameters of the policies for those periods in order to understand the losses being retained.

Additionally, when an acquisition or divestiture occurs, it is important for the projection of future losses to reflect the impact. The loss experience of the acquired or divested unit may be quite different from the rest of the company, and the projection should reflect that. This could have serious implications for collateral, reserves, and premium.

Goals

Before any acquisition or divestiture is made it is important to make sure that the impact of any retained insurance liabilities is properly reflected in the transaction price and/or terms and conditions. This is important from both the buyer's and seller's perspectives.

Also, it is important that the projected losses reflect the impact of any acquisition or divestiture. For example, a company divests a unit with some of the highest loss rates in the company. An actuarial analysis with this unit excluded can aid in quantifying the reduction in the projected loss rate after this divestiture.

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Question 12:
New Risk Management or Loss Control Initiatives

How long have you been in your current position (risk manager, CFO, etc.) with the company? Have you initiated any new risk management or loss control initiatives/ programs in recent years? Have you measured the impact of these initiatives/ programs?

SIGMA Thoughts

How do you measure whether a new program is working? An actuarial analysis can be one way to measure whether the initiative is having an impact. Is the frequency per exposure unit dropping? Frequency is one of the earliest indicators of improvement. Our actuarial analyses typically contain a frequency estimate by accident year. This will show the trend over time.

Severity improvement takes longer to "show up" since losses may develop over time. A loss projection is based on historical loss rates trended to the same point in time. This makes for easy comparison of the trend over time as well.

There is more to an actuarial analysis than just the reserve estimate and projected losses. Other tables within the report are helpful for self-benchmarking and marking progress over time.

Goals

There are many ways companies try to measure the impact of a new risk management or loss control initiative. An actuarial analysis can be an objective way to measure the impact of an initiative over time. It is also important that any such initiative or programs are discussed with the actuary so that the impact on the estimated required reserves and loss projection can be fully considered.

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Question 13: Captive

Do you currently have or are you currently involved with a captive insurance company? Have you previously considered or been involved in a captive? Are you considering a captive in the future?

SIGMA Thoughts

Many companies are in involved with a captive in some way or at the very least they are considering a captive. Of course, there are many types of captives including single parent captives, group captives, association captives, agency captives, and rent-a-captives.

An actuarial analysis is an important part of the process when considering forming or joining a captive. For example, when considering forming a single parent captive, clients will typical utilize an independent captive management firm and/or the internal captive management arm of their existing broker. The captive management firm will more often than not require an actuarial projection as part of a captive feasibility study. The captive regulators will typical require an actuarial projection as well.

Also, most captives, particularly domestic captives require an annual statement of actuarial opinion and a supporting actuarial analysis from a credentialed actuary.

Goals

It is important to let clients know that you have the resources available should they want to consider a captive. SIGMA can provide the actuarial support needed when considering a captive and related to captive management. Captives are certainly not for every client, but it is important to make sure you can offer your client these services, should they need or want them.

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Question 14: Mass Tort - Asbestos/Mold

Does your organization have any significant mass tort liabilities such as asbestos, mold, hearing loss, etc.? Whether they are insured and/or uninsured?

SIGMA Thoughts

It has been SIGMA's experience in recent history that if historical losses are probable and the amount of that loss can be reasonably estimated then a liability should be established. Asbestos and mold are examples of coverages where some companies may not have historically carried a specific balance sheet liability but probably should.

Goals

It is important to consider these significant historical exposures of your clients. They may have minimal or no insurance coverage for these mass torts or they may be covered under historical liability policies.

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