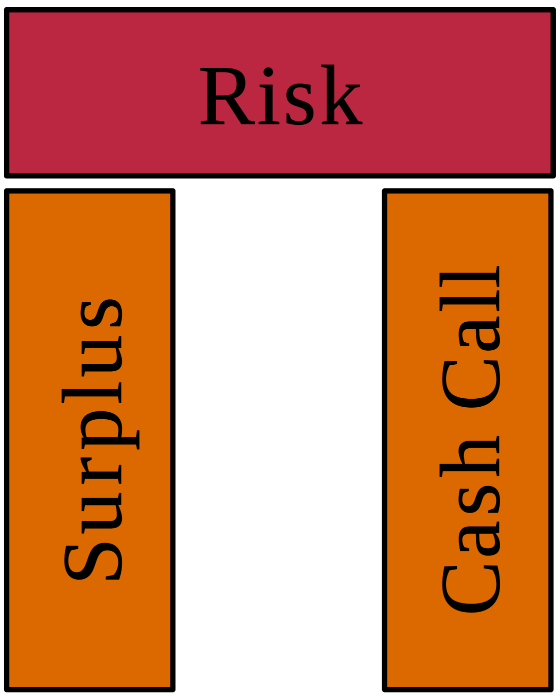
Funding your pool for the long-term

RECIPE FOR SUCCESS

SEPTEMBER 12-15, 2017
SOUTH LAKE TAHOE, CA

Initial pooling business model



- Insurance unaffordable or unavailable
- Pooling risks offered greater cost stability versus being without coverage
- Initial "capital" came from retroactive assessment ability
- Surplus levels were small and not that important
- Temporary structure

Financial expectations of pools have matured

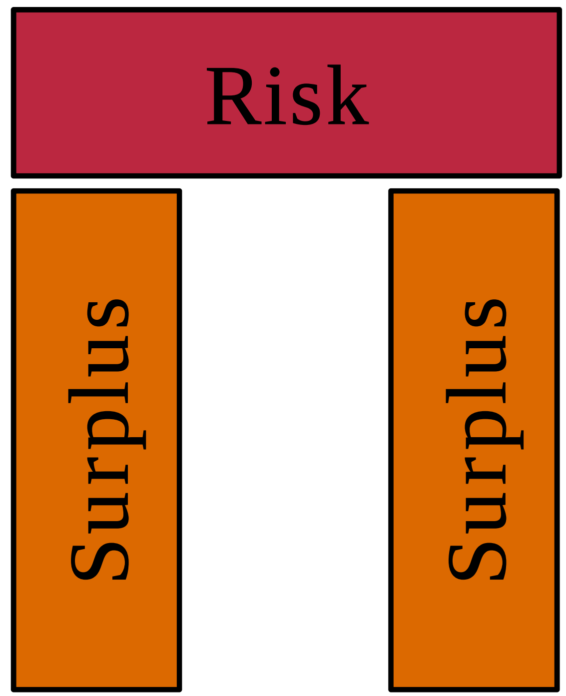
Members now expect:

Stable and low rates

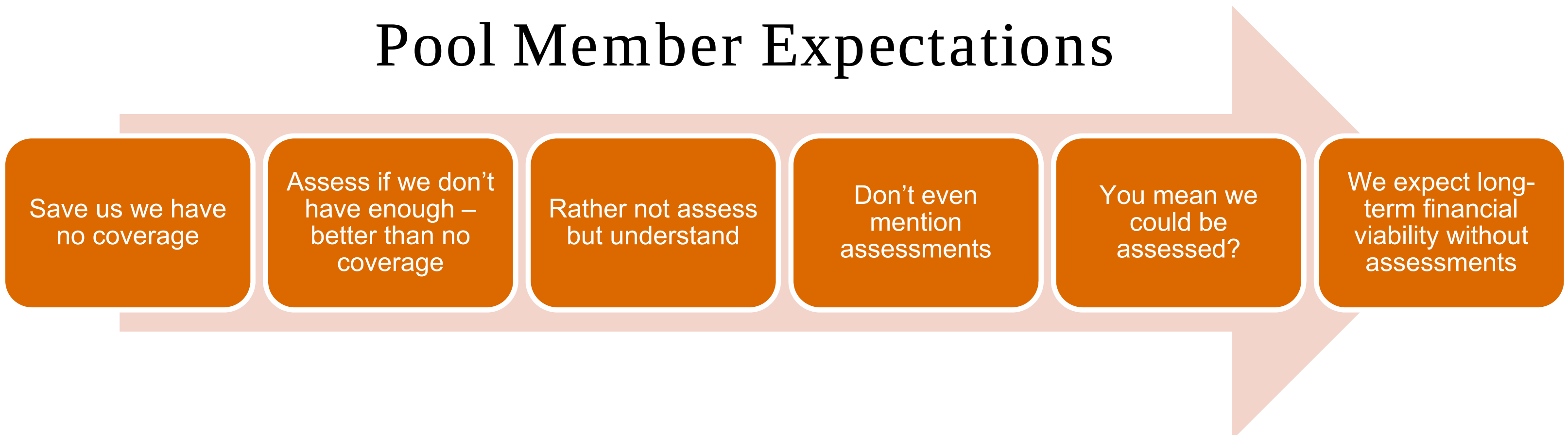
Financial soundness

Customized coverages

- Financial uncertainty fully supported by surplus
- Long-term financial viability
- Permanent Structure



Pool member expectations compared to evolution of funding measures



Pool member expectations compared to evolution of funding measures

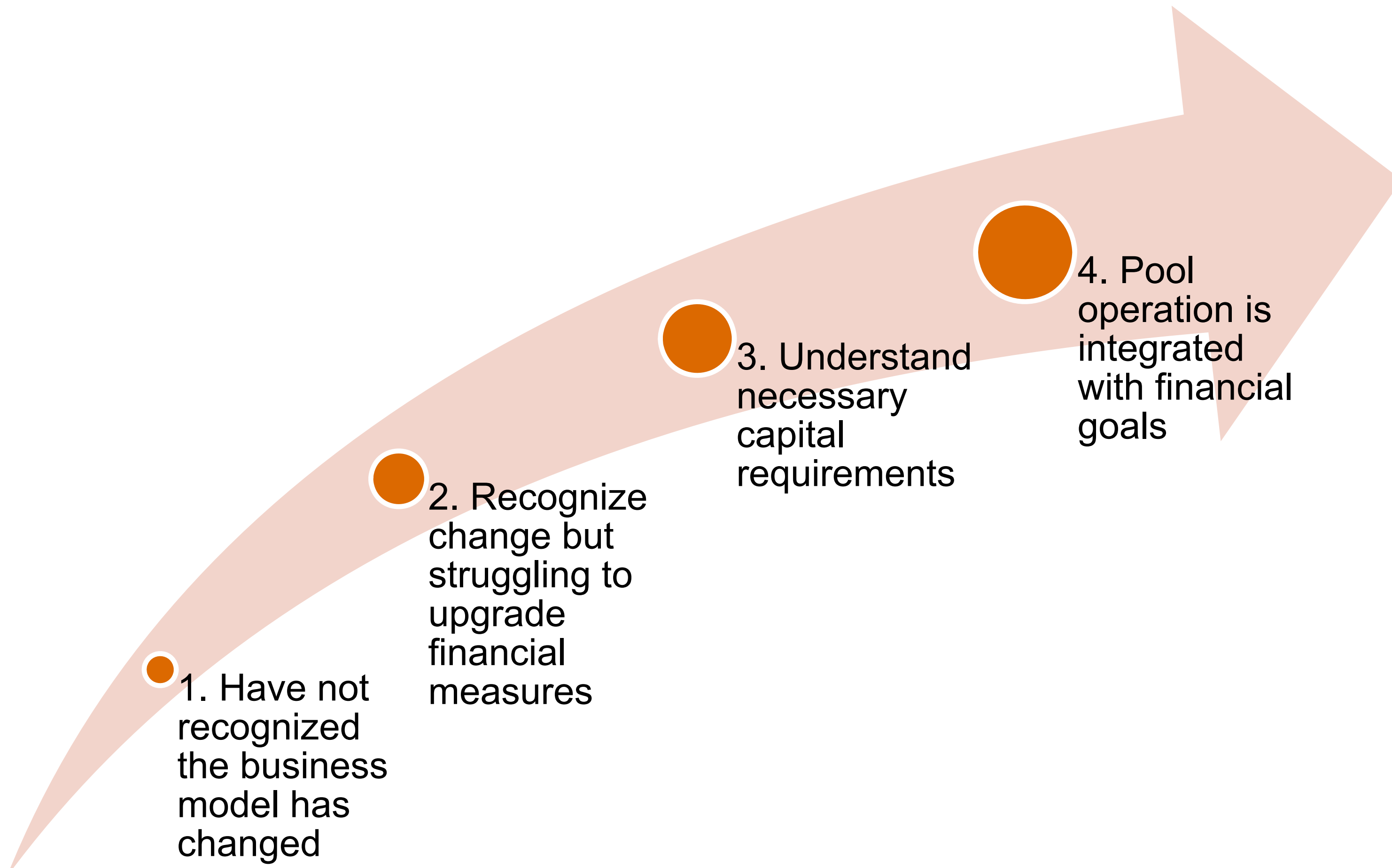
Pool Member Expectations

1. Save us we have no coverage
2. Assess if we don't have enough – better than no coverage
3. Rather not assess but understand
4. Don't even mention assessments
5. You mean we could be assessed?
6. We expect long-term financial viability without assessments

Evolution of Funding Measures

1. Funding adequacy not a priority
2. Funding through premiums, assessments and dividends
3. Setting confidence levels
4. Financial ratio benchmarks
5. Regulatory and rating agency formulas
6. Pool specific capital based models

Where are pools with regard to managing these trends?

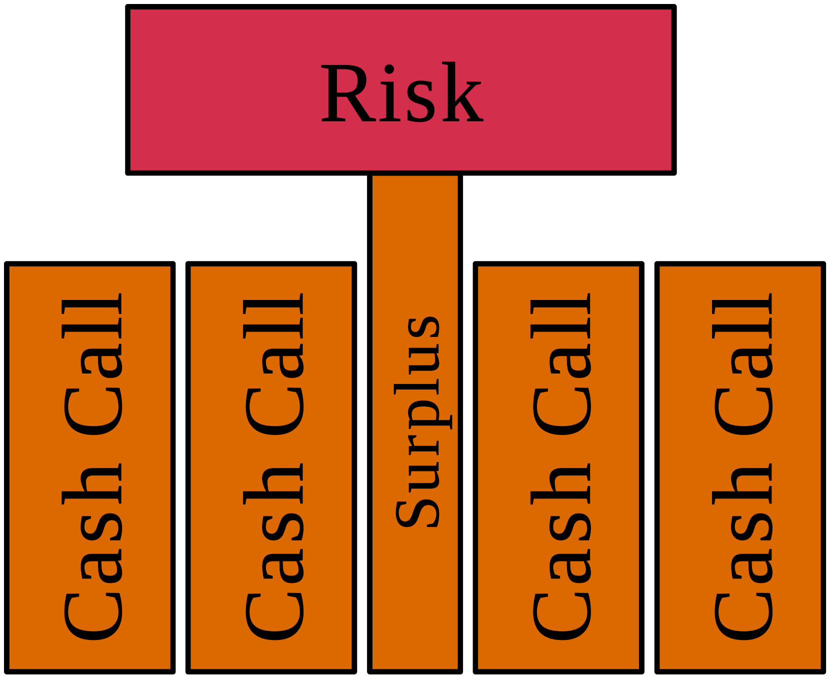


Stage 1: Have not recognized the business model has changed

- Minimal effort in assessing capital needs
- "We have not had to assess so why would we plan for an event that has not happened?"

Traditional Pooling

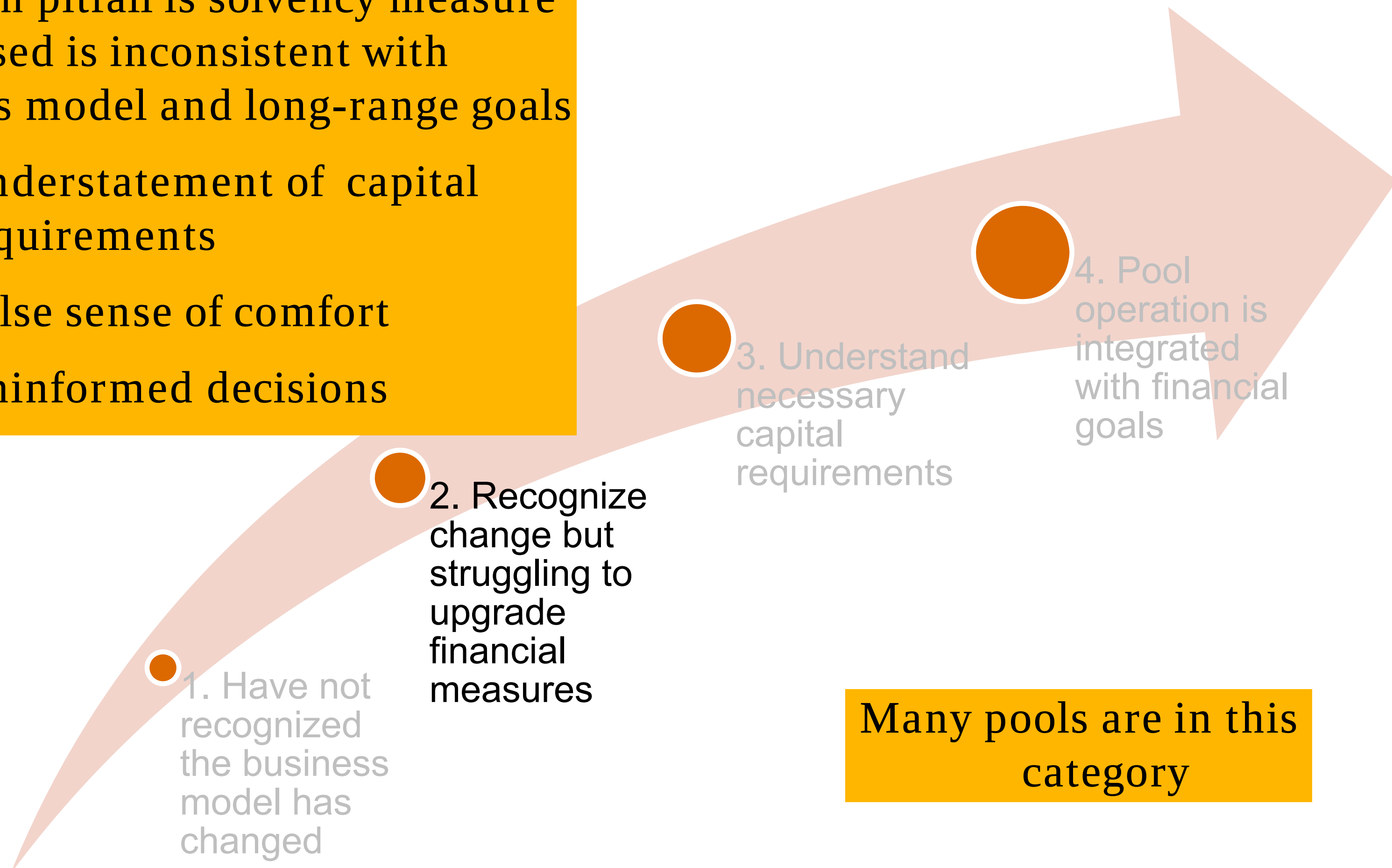
Capital Perspective



Stage 2: Recognize change but struggling to upgrade financial measures

Common pitfall is solvency measure being used is inconsistent with business model and long-range goals

- Understatement of capital requirements
- False sense of comfort
- Uninformed decisions



Many pools are in this category

Confidence Levels

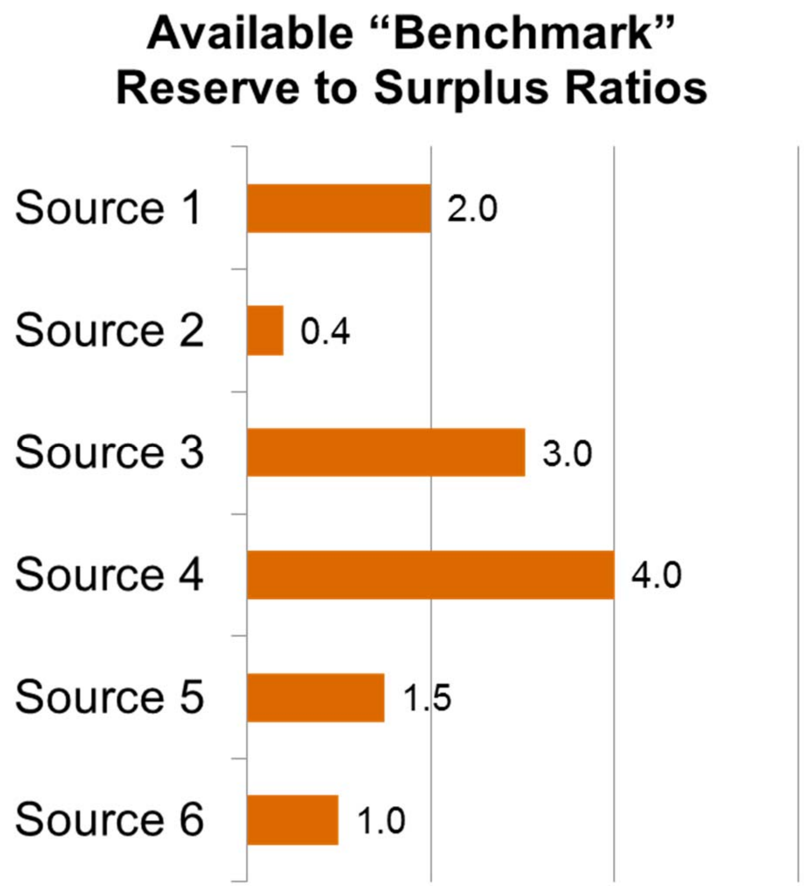
- Developed in the late 1980’s/early 1990’s
- Pools were operating with much lower financial/capital expectations
- Not used outside the pooling community – why?
- 90% confidence level funding means 10% chance of funding shortfall
  - o conservative?
  - o consistent with long-term financial goals?

How a measure is presented impacts the user’s assessment

- More support for airport-safety measure expected to save 98% of 150 lives at risk versus a measure expected to save 150 lives

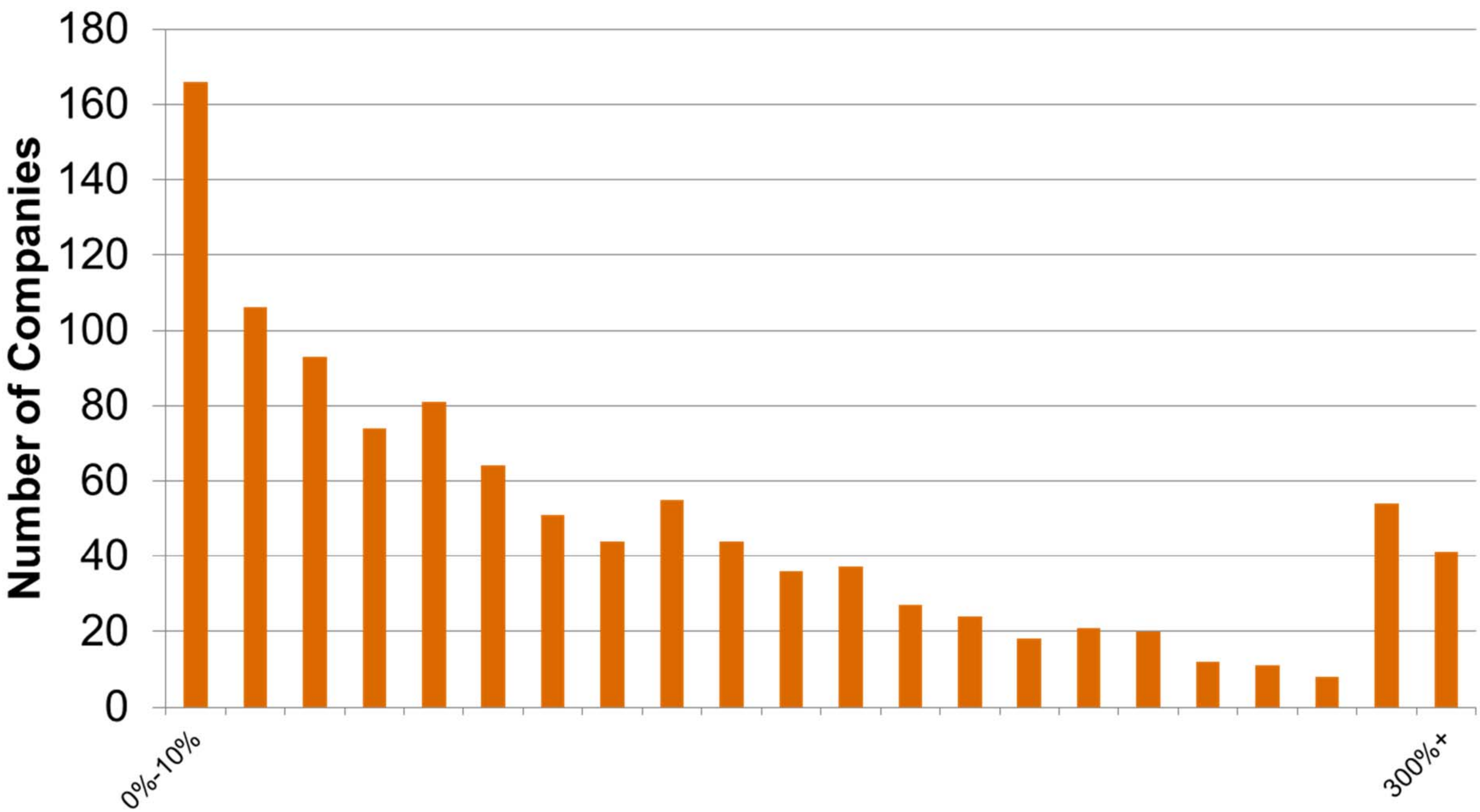
Financial Ratios

- Benchmark value
  - What is the source?
  - What is the context?
- Are pools comparable to insurance industry?
- Pool to pool - value of comparing within an unregulated and unrated industry?
- Which benchmark value to use?



Universal set of ratios to determine optimal capital targets does not and cannot exist

Insurer reserve to surplus ratios



Source: Reserve to Surplus Ratios from Statutory Filings

Risk Based Capital Formula
(National Association of Insurance Commissioners)

- Regulatory Tool
  - Minimum (not a target)
- Developed for a specific context
- Not "capital based on risk"
- Calibrated to insurance companies

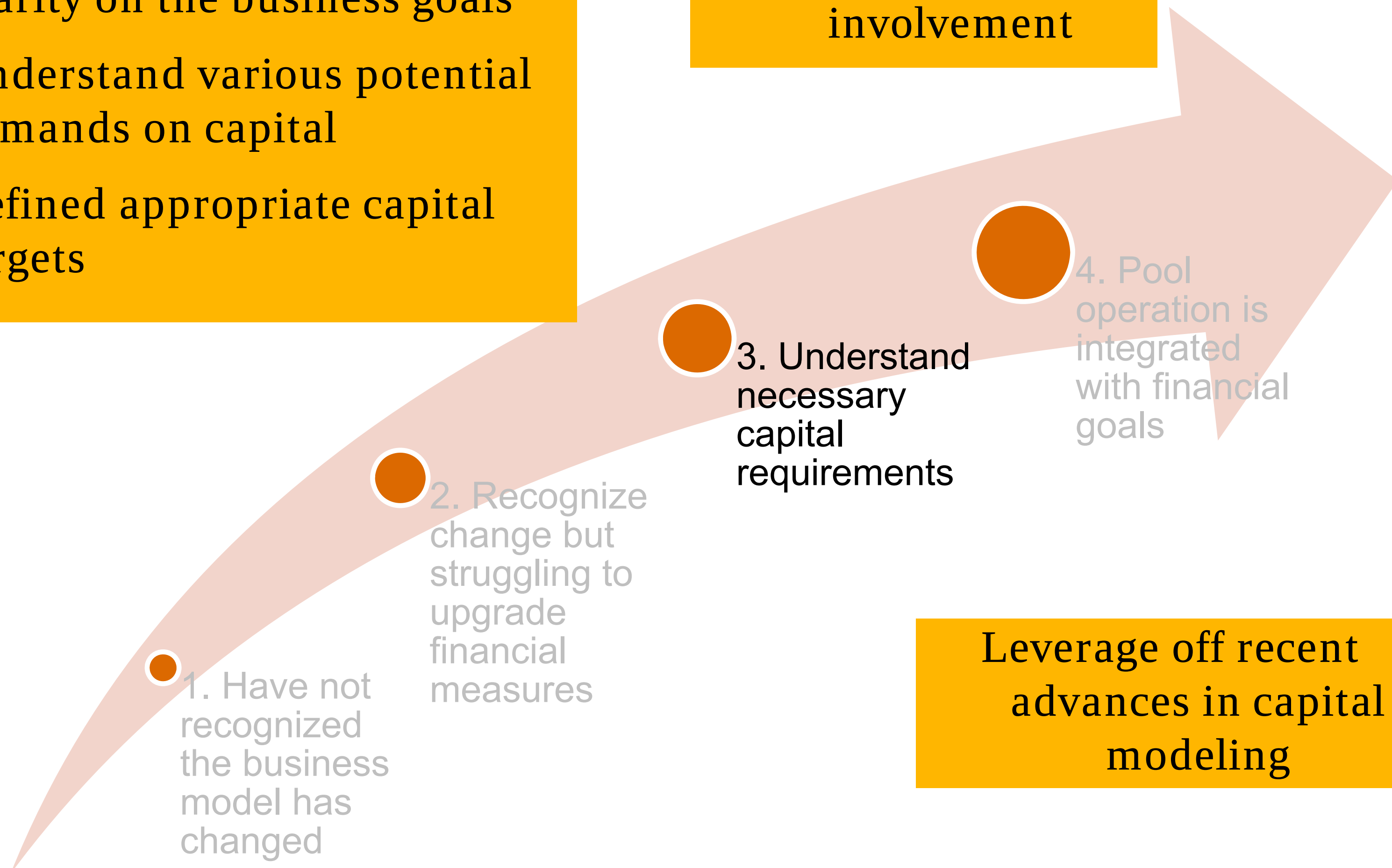
"…will not compute the precise amount of capital an insurer needs to maintain in a competitive, dynamic and uncertain marketplace."

Regulation is developed in the context of having sufficient resources left in a troubled company to rehabilitate or liquidate

Stage 3: Understand necessary capital requirements

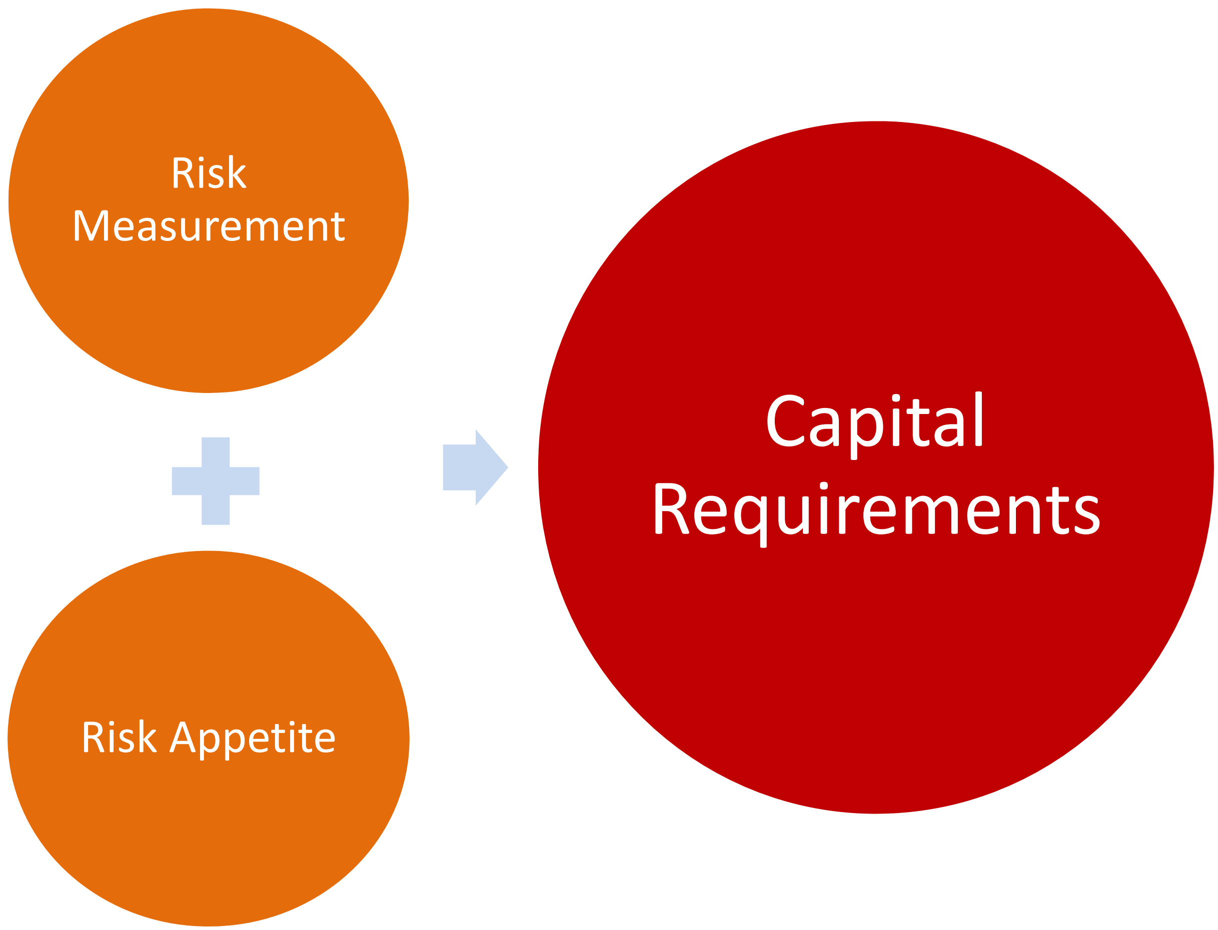
- Clarity on the business goals
- Understand various potential demands on capital
- Defined appropriate capital targets

Trustee/Owner involvement



Leverage off recent advances in capital modeling

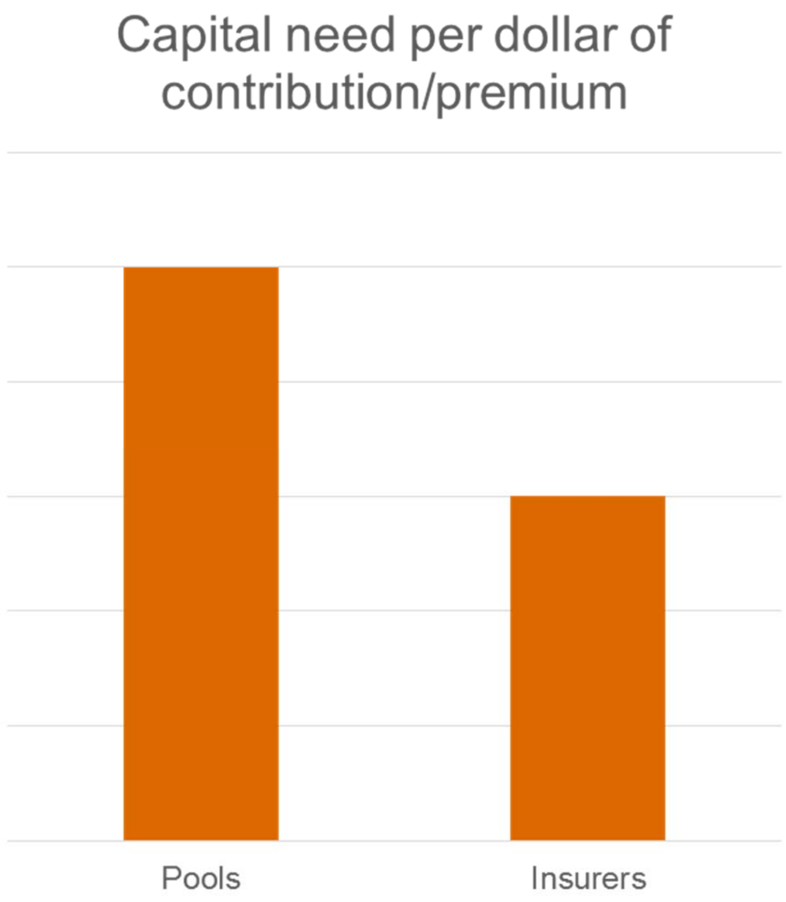
Determining capital targets using capital modeling



Financial Uncertainties - Demands on Capital

Reserving	• Actual unpaid claims may be higher than current estimates
Underwriting	• Next year's losses may come in higher than projected
Asset/Credit	• Interest rates may go up which results in bond holdings decreasing in value • Excess carrier may default
Operational	• Next year's administrative budget may be exceeded due to an unforeseen event

Key observation from risk measurement: Pools generate significant financial uncertainty



Underlying Reasons

1. Smaller
2. Risk concentration
3. Risk taking "independence" culture

Implication for using "insurance industry" measures

Context for risk appetite

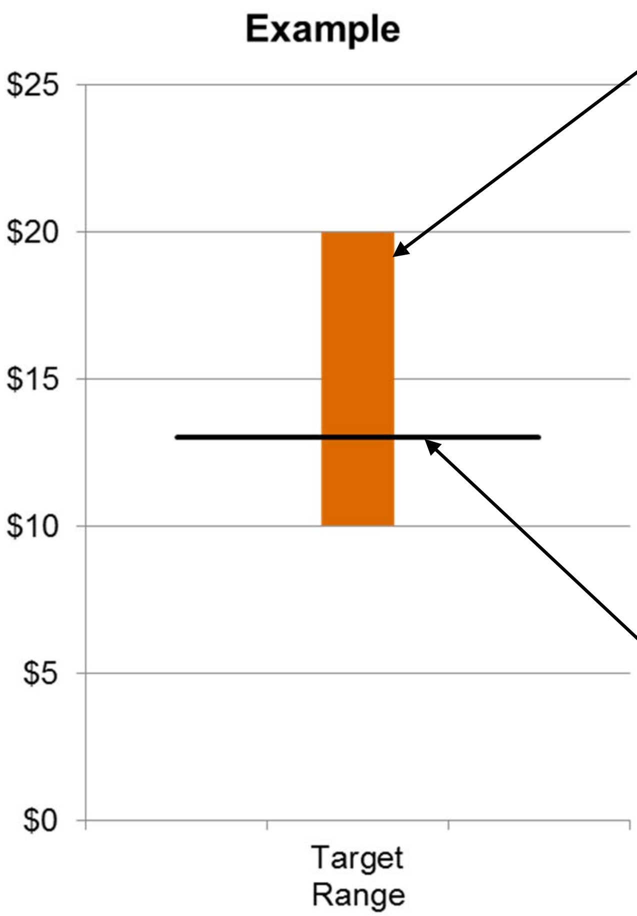
What is the insurance industry context where a cash call is not an option?

Rating Agencies	• Secure rating - roughly around 1-in-250, though not specified by agencies
Global Insurance Regulation	• European and other developed countries set the "target" capital level at 1-in-200

Upon closer examination, pools may want to hold even more capital than the "insurer" guidelines

- Ability to "manage" book?
- Restrictions on rate actions?
- Ability to replenish capital?
- Members rely on other services

Outcome of Process



Target Capital Range Defined

- Target range is based on the comprehensive measurement of the financial uncertainties and management/board's risk appetite

Long-term Planning

- Pools recognize they are becoming permanent institutions
- If a pool plans on being around for 50+ years, planning to withstand a 1-in-100 year financial storm is not conservative

Improved Governance

- Board has given management parameters to work within (maintain surplus in range)
- Rate, retention, dividend and investment decisions can be measured against the board guidance

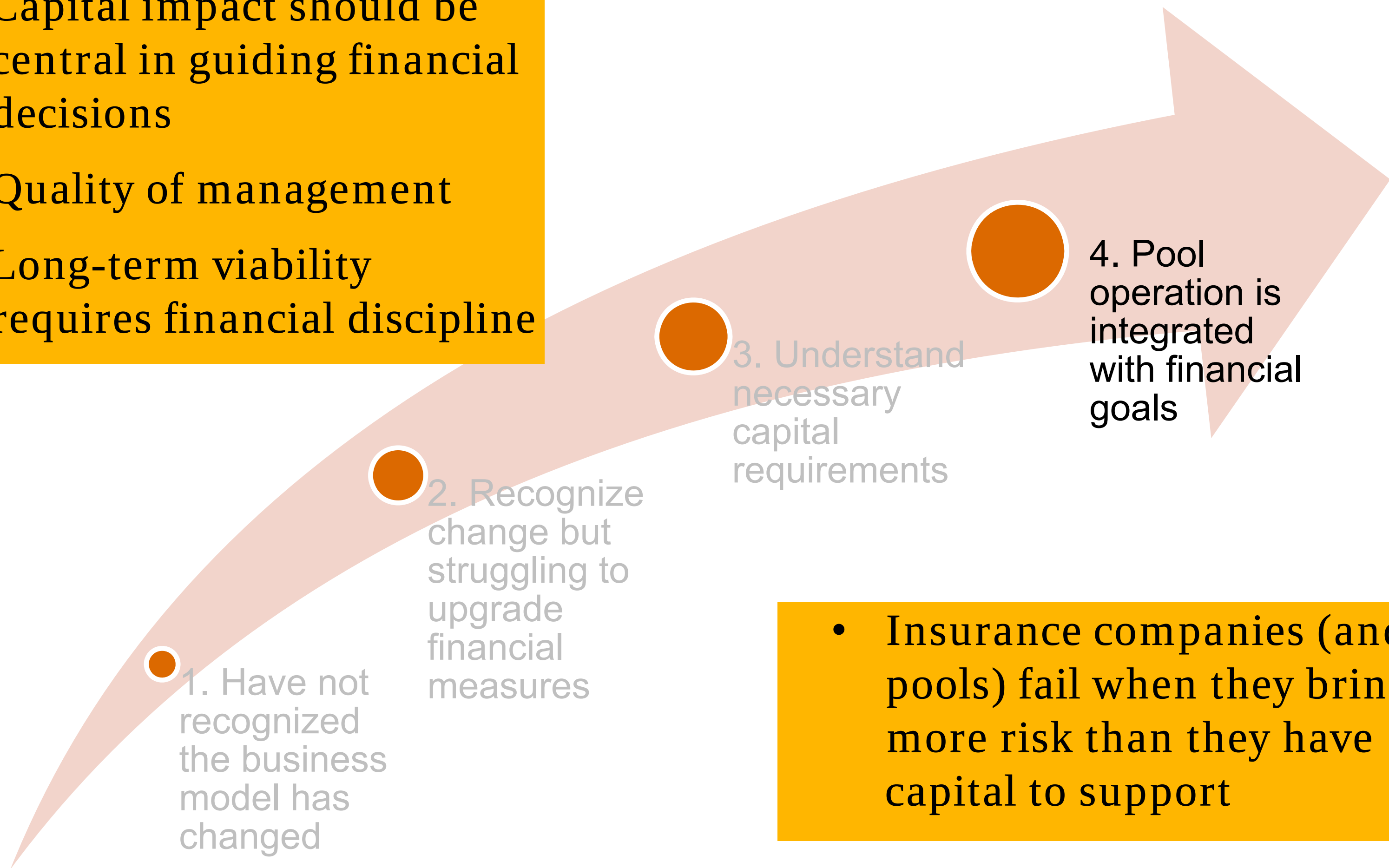
Comparison of Funding Approaches

"We have extra money for dividends"

"We are funded toward the low end of our comfort zone"

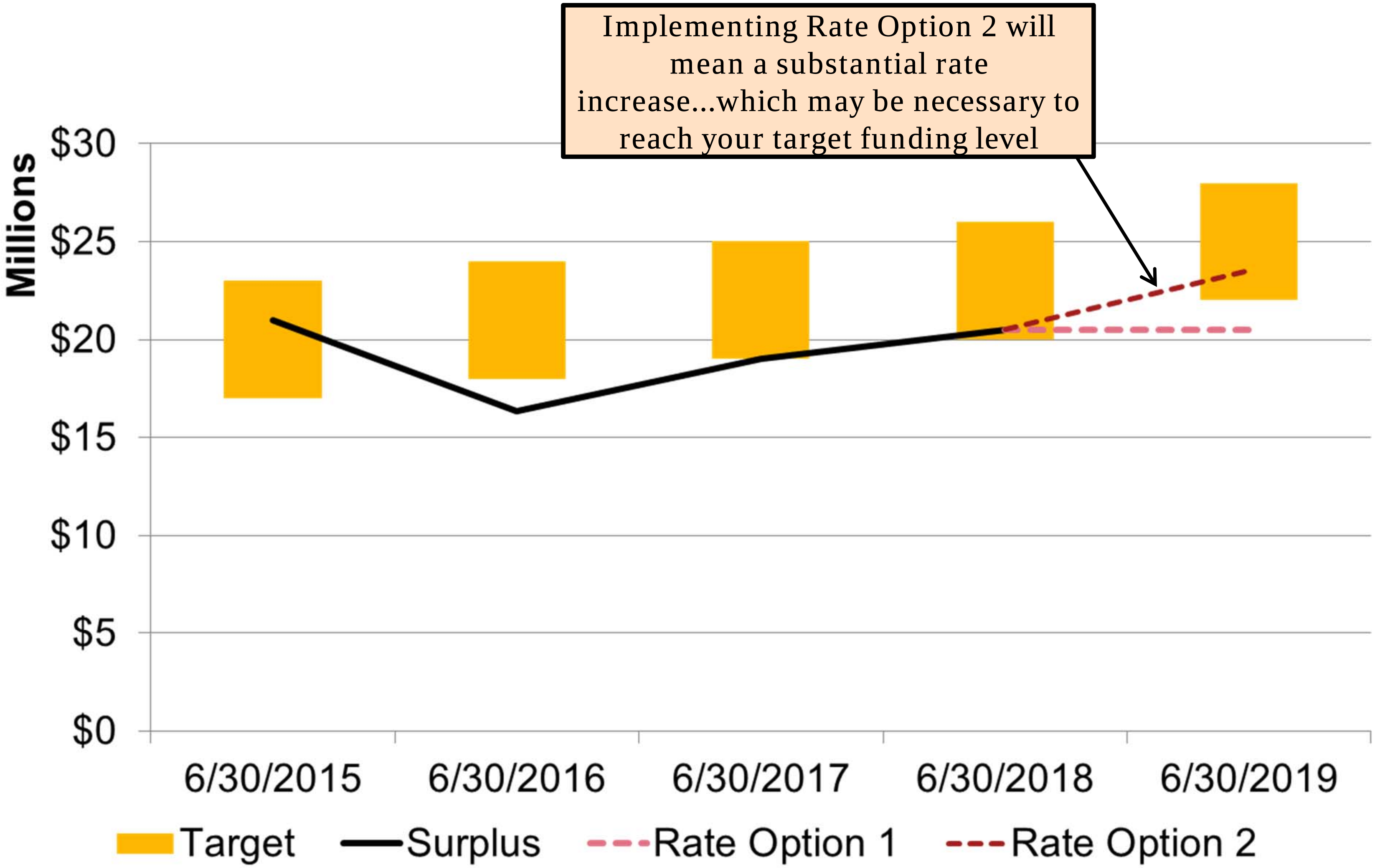
Stage 4: Pool operation is integrated with financial goals

- Capital impact should be central in guiding financial decisions
- Quality of management
- Long-term viability requires financial discipline

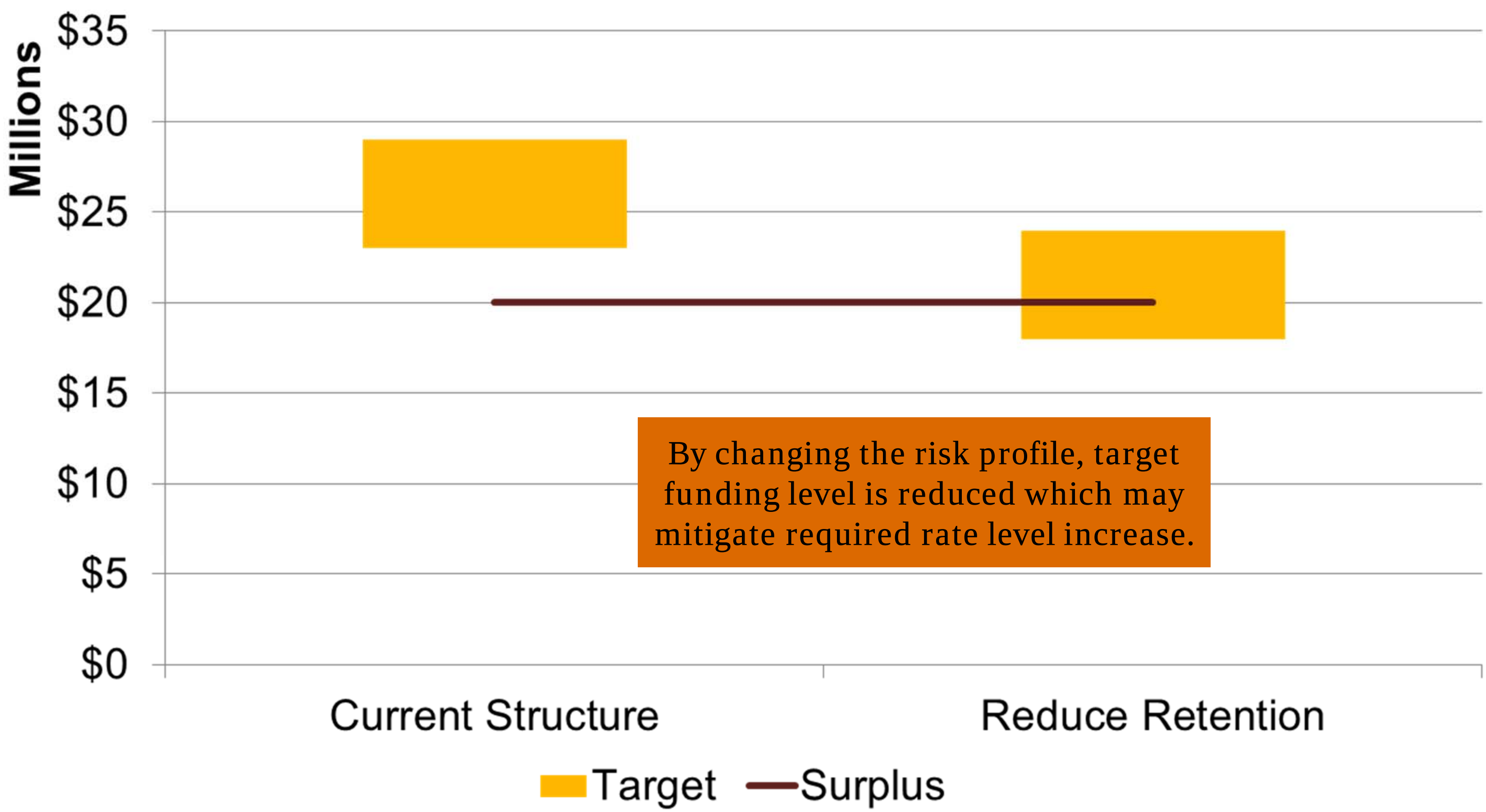


- Insurance companies (and pools) fail when they bring on more risk than they have capital to support

Impact of Rate Level Decision



Impact of Changing the Risk Profile of Pool



Long-term planning checklist

What is our business model?	• Is a retroactive assessment a viable business option for our pool? • If not, proper capitalization is critical
Do we understand our capital needs?	• Have we measured all our financial uncertainties in determining our capital needs? • Is our capital adequacy measure consistent with our long-term goals?
Are we making proper risk and capital decisions?	• Do we understand how our capital needs will change with different financial decisions? • Are we making decisions with long-term capital adequacy in mind?

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