Collateral Program *in California called* GAME CHANGER

Marsh helps free up credit for small SIGs, improve workers' comp efficiency

by Bruce Shutan

An innovative new program in California is being heralded for dramatically easing the business challenges associated with managing workers' comp for self-insured groups of small employers.

"What's revolutionary is that we're accessing a different source of capital, which has created a significantly improved solution that was previously just not available to the groups in any form," explains Quentin Hills, managing director at Marsh Risk & Insurance Services and creator of a new collateral program for California SIGs.

Although pioneered last year for five small groups of self-insured employers in California, which he declined to identify, the program is equally applicable anywhere SIGs are required to meet higher collateral requirements. Hills also is in talks with a group in New York, as well as a self-insured company, about pursuing this same solution.

California SIGs are required to post collateral to state regulators within any given 12-month period in the form of a letter of credit, surety bond or cash on an individual basis. That process has become increasingly cumbersome in the face of new capital charges in the banking market and higher charges on the surety side under the Dodd-Frank Act.

Hills says groups are often having to post anywhere from 60% to 100% of additional security or cash behind that action, which seriously restricts or drains liquidity. However, Marsh's program allows them to post just 25% collateral to create this facility and pay an annual fee to cover the cost of that structure.

"They're going to free up 75% of that cash collateral they've got sitting behind their L/C or surety bond, which can be used for working capital within the group," he explains, including helping manage workers' comp. "Banks and sureties don't want to take on the credit risk of the SIG." Marsh, in effect, has removed that risk from bank balance sheets and instead taken it into the insurance or reinsurance markets, while providing security or collateral that is acceptable to the state regulator.

The effort took shape about a month or two after the start of California's annual posting cycle for self-insurance, which runs from July 1 to June 30. "We were able to get a six-month transaction done in December," Hills reports, "and now over the last couple of months, we've been talking about deepening that structure across many more groups." The facility's size is expected to more than double this year.

California's Collateral Crackdown

The Marsh program is "a game saver" for SIGs that now have "another option to allow them to navigate the very challenging California marketplace, whose collateral demands are probably the largest in the country," notes Duke Niedringhaus, an insurance broker with JW Terrill Inc. who chairs SIIA's Workers' Comp Committee.

Citing New York and Minnesota as states where small SIGs can use a helping hand accessing capital beyond traditional sources, he hopes Marsh's program migrates to states with low-end collateral requirements.

California regulators have always taken a conservative stance on how much collateral they want from SIGs, according to Niedringhaus. "Despite having enormous liabilities," he explains, "there are a couple states that might require $250,000 or $500,000 of collateral, whereas a lot of these California self-insured groups might be talking $10 million to $50 million of collateral."

What's particularly noteworthy about this program is that it offers a financial product that doesn't assume "every single member is going to become financially insolvent," Niedringhaus explains, "and when you can spread out that risk financially, it makes it a little bit more palatable for an insurance company to look at that in a different light."

He says the program can benefit certain classes of business more than others, such as agriculture, which can use "every option available to them to try to control those workers comp' costs." Size also matters. Many small and midsize employers that tap the program will have an ability to continue the option of self-insuring workers' comp in a group setting, he adds.

A Better Mousetrap

Jeff Pettegrew, executive director of the California Self-Insurers' Security Fund (SISF), describes Marsh's collateral program as "an exciting direction" for security funds with self-insureds. "I think it's kind of an ingenious model that they've come up with," he says, "because the payment stream is way down the road. There's a retention, if you will, like a lot of insurance policies, and the protection comes down the road, so they can price this pretty competitively, and they know when the losses occur and don't have to fund them for years to come."

SISF uses the program for protection in certain categories of alternative security program participants. Pettegrew says "it's the first time that we've been able to find an alternative insurance market versus credit default swaps that really don't

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fit out model." The former solution is designed as an instrument for bond holders or investors in the event of a bankruptcy filing.

"In our case," he explains, "a default is not the same as bankruptcy. So the instrument that we have now is really tailored to not so much bankruptcy, it really has to do with default, and it has to do with workers' comp losses and so forth." There's an understanding about the coverage and how it's applied, without any guessing associated with the credit default swap mechanism.

Hills has a long-standing association with SISF, whose innovative Alternative Security Program is the first of its kind for any of the nation's state self-insurance security/guarantee funds. When that program began on July 1, 2003, about 350 companies were required to individually post about $4.8 billion worth of letters of credit, surety and cash – an amount that's now $7.4 billion.

"That was chewing up their credit capacity," recalls Hills, whose firm has worked closely with specialist insurance markets over the past decade to restructure how security or collateral is posted for individual companies in California. "It was inefficient from quite a number of different reasons."

So rather than pay annual fees to banks and surety companies, each of the 350 employers pays the SISF, which arranges and guarantees collateral deposit requirements on their behalf based on credit standards. Those that do not meet these standards must directly post their collateral security deposits with the Office of Self Insurance Plans.

Embracing Creative Solutions

Hills says regulators and fund trustees alike are "very comfortable looking at new creative solutions that are prudent and meet their objectives."

It's also worth noting that the collateral program is more efficient for state regulators who receive a single letter of credit that addresses all security requirements for a group rather than having to post various forms of security, according to Tom Hebson, VP of product development and government relations for Safety National, the excess workers' comp market leader.

Knowing California SIGs face an uphill battle in trying to secure credit or capital, Marsh is able to bundle up their collateral requirements and access wholesale financial markets that previously weren't available to them. The hope is that some capital from the banking markets, pension funds and other alternative capital providers will

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consider the collateral program a sound return for the risk that's being taken, which in turn, will create more capacity.

"At this stage," Hills says, "our main goal this year is just to broaden and deepen participation from those five groups to around 10-12, get that version 2.0 in place, and then we'll look to version 3.0. And a lot of this depends on what's possible within the legislative framework as to what we can legally provide that the regulator will accept."

Once a SIG conducts an annual actuarial study to determine the extent of its workers' comp liabilities, it will then know the amount of collateral that has to be posted. Under the collateral program, a letter of credit is then drafted based on that number. Hills says that while this solution has no direct impact per se on claims management, it enables SIGs to be much more effective by freeing up cash.

Since workers' comp represents "a significant portion" of exposure in California, Pettegrew says any tool that can SIGs squeeze more out of dollars devoted to addressing work-related injuries makes good business sense. "And to that degree," he adds, "it strengthens the workers' comp program because it offers for the first time an alternative, which no one's really thought of or designed prior to this."

Having access to a collateral alternative enables SIGs to "pay a premium or combination of premium and some collateral into a program that is less cost intensive than it would be if they had to do the whole collateral piece," according to Hebson.

Perhaps the most important point of all about the program is that it supports self-insurance, which he says "is probably the most efficient way to cover your exposures if you have all the other pieces in place." ■

Bruce Shutan is a Los Angeles freelance writer who has closely covered the employee benefits industry for 26 years.

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