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Ensure an Intended Outcome

Collateral is traditionally defined as “security pledged for the payment of an obligation.” Yet, when seen in light of reduced operational flexibility for your organization, the collateral requirements necessary to purchase a loss-sensitive insurance plan can also be seen as *collateral damage*, that is, “an unintended or incidental consequence to the intended outcome.”

In the current credit environment, companies purchasing loss-sensitive programs have to be more vigilant than ever when negotiating collateral requirements. The impact of diminished credit capacity is compounded by the increased cost of obtaining credit. Further exacerbating the situation is the increasingly conservative underwriting of insurers in determining collateral requirements.

Achieving the most favorable outcome requires upfront strategic planning and analysis, which are essential preparation for collateral negotiations with insurers. The right decisions regarding form, amount, and adjustment timeframes are indispensable to your program’s overall efficiency. They will also have long-term effects on helping your company meet business objectives, including maintaining your company’s flexibility when it comes time to pursue other strategic opportunities.

While the analysis and use of alternative collateral solutions is not a novel concept, in the context of the current credit climate, the importance of this often-overlooked component of the insurance transaction is magnified. The potential effects on cash flow, liquidity, growth potential and overall health of the corporation are directly influenced by the selection of a collateral instrument and the negotiation of the collateral amount. Although the cyclical nature of the market can determine the availability of various instruments, the most significant factor in selecting an instrument is to ensure long-term consistency with the financial objectives of your organization.

Collateral Solutions

To be sure you are making the most efficient use of the organization’s assets, it is important to have not only a working knowledge of the collateral instruments available, but also to perform a comprehensive cost/benefit analysis of each potential instrument from a short- and long-term perspective. More important still is that this analysis be done in advance of negotiations with the insurers.

Some examples include:

A **Letter of Credit** is the most common form of collateral and the preference of insurers. If your organization is financially sound and operationally stable, the availability and cost of credit lines may be immaterial. For this situation, a letter of credit securing insurers’ obligations may be the path of least resistance and afford the most efficient use of resources. However, for the many industries and individual

companies adversely impacted by the current credit crunch and other macroeconomic factors, letters of credit can be costly to maintain. For example, in some instances, the letter of credit requirement is exacerbated by an additional requirement that the company pledge supporting cash or other assets to secure the letter of credit. This can severely reduce the borrowing capacity and operational flexibility of the organization.

Cash-based Alternatives may be appropriate if your organization is looking to grow through acquisition. Collateralizing via cash-based alternatives may be more advantageous in order to preserve the credit line for operational expenses. Variations are abundant in this category and include Incurred Loss programs and Pre-funded Deductibles, both on a depleting or non-depleting loss basis.

Hybrid Options, in lieu of letters of credit and/or cash-secured programs, include:

- Use of *upfront cash payments* to “buy down” proposed letter of credit requirements.
- *Trust account arrangements* whereby collateral can be in the form of agreed-to financial instruments posted to an interest-bearing trust account. In addition to often lower annual costs versus a letter of credit, a trust establishes a restricted asset on the balance sheet (as opposed to the contingent liability from a letter of credit) and does not impair borrowing capacity.
- Capital markets may provide *competitive “substitution” collateral* for companies with significant outstanding deductible liabilities, without the actuarial conservatism of traditional insurers.

Each instrument will have its potential upside and downside, which must be assessed not only in the context of your organization’s present and future goals, but also with a view towards the current and projected external insurance and capital market conditions. If not continually and proactively assessed, the impact of the collateral component to the organization can produce unforeseen and lasting consequences.

Collateral Negotiations: It’s in the Timing

Any insurer that is providing coverage on a loss-sensitive basis will need to secure its own inherent credit risk. Should your organization be unable to reimburse the insurer for their payments to claimants, the insurer bears the ultimate legal responsibility both within and excess of the program deductible.

Collateralization of *DEDUCTIBLE* losses is necessary and required protection for insurers. However, the amount of collateral required is debatable. Theoretically, collateral should be a function of expected annual losses within the deductible, minus losses that have already been paid. Insurers may also include some multiplier to adjust for volatility and the financial condition of the insured. Often the insured is not privy to this calculation and only receives the final collateral demand.

Not only is the actual collateral calculation opaque for insureds with multiple-year deductible plans with the same insurer, the required collateral is presented as an

aggregate amount with no insight into the individual period's exposure. This allows the incumbent insurer to create an artificial advantage in future marketing exercises, requesting only slight collateral increases for the prospective year as a result of the slow return of collateral from previous periods. Unfortunately, the insurer is typically under no obligation to reduce existing collateral amounts.

So what can you do? The answer lies primarily in when you attempt to negotiate collateral. The insurer only has leverage after coverage is bound. Including collateral requirements as a key negotiation element before and at the time of program renewal can help protect your organization from the deleterious effects of cumulative collateral build-up.

In order to obtain the most advantageous collateral requirement, your team must be proactive in strategically negotiating with the insurers and be able to provide them with an understanding of your organization's unique characteristics (reason for payout patterns, reserving philosophies, financial intricacies, risk management and loss prevention initiatives, etc.). In essence, the goal is to "put the organization's best foot forward." The presentation must be articulated quickly and concisely to the appropriate insurer discipline (actuarial, credit and underwriting). It is imperative that your team commit the internal resources to providing your broker and insurers with the information needed, as well as, access to key personnel.

In Obtaining the Best Result, Your Broker Can Help

Recognizing the impact of collateral in times of economic concern, Integro has institutionalized processes and customized decision support tools to help our clients prepare, analyze and negotiate collateral requirements to achieve optimal results. Getting these results depends upon:

- Working with a technically proficient broker who understands the options available.
- Addressing the concerns of the insurer when collateral requirements are set.
- Targeting negotiation of collateral requirements when you have the greatest leverage.

Developing a collateral strategy that is aligned with the operational objectives of your organization should be done in advance of renewal. The best alternative will contemplate future plans, existing collateral requirements, borrowing costs, available cash and other financial considerations. Assigning a dollar value to these considerations and using a cash flow model to compare the alternatives can effectively direct you to the optimal solution and provide justification for your decision-making process.

Use of upfront analytical tools tailored to client-specific characteristics, while employing the leverage available during the renewal process can mitigate the insurer's ability to hold on to excess amounts of collateral. Pre-defined loss development factors and schedules for collateral return can often be negotiated.

Claims closure projects and other loss control initiatives with demonstrable impact can also contribute greatly to the negotiation process.

Conclusion

The “collateral damage” from a loss-sensitive insurance program will impact every organization differently. Any solution should be customized to address each individual fact pattern. In this period of elevated credit concerns and limited borrowing capacity, the importance of collateral for many companies cannot be understated. While collateral will continue to be required, there are tools and strategies available to insureds to lessen the impact of the collateral requirement.

Finally, it is important to understand that you are not alone in assessing the best ways to address your collateral concerns. The analytical tools and structural strategies mentioned above are already in existence and regularly employed by members of the Integro brokerage team as an important piece of the renewal puzzle.

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About Integro

Founded in 2005 as an alternative to the “Big Three,” Integro is rewriting the standards for quality service, execution, knowledge and client satisfaction in the risk management industry. Integro continues to grow organically from its headquarters in New York City and its offices in the U.S., Canada, Bermuda and London. 1-877-688-8701 www.integrogroup.com

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