Mr. Loy Dale
Executive Director, School and Agency Operations
Southwest Washington Risk Management Insurance Cooperative
Educational Service District 112
2500 NE 65th Avenue
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October 11, 2013

Dear Mr. Dale,

This letter is in response to your recent questions regarding pool solvency measures and other risk and capital matters related to property/casualty public entity pools.

Overall Context

Pools have uncertain costs. As with any business with uncertain costs, some sort of capital is necessary to absorb the uncertainty. The amount of capital required is a function of both the risk/uncertainty and the level of importance it is for the pool to maintain solvency. The greater the risk, the more capital is required. And similarly, if maintaining solvency is a low priority, then less capital is required.

Response to Questions

What do funding confidence levels indicate? Why are they important?

The financial statements and budgets of pools include estimates of the unpaid claims and future pool losses, but actual financial results will vary from these point estimates. Confidence levels provide a means to quantify the uncertainty in these estimates which allows for more informed decision making and financial monitoring.

What does a 70% confidence level mean?

Any single reserve (unpaid claim) estimate represents just one number within a range of possible outcomes, each with an associated probability. These probabilities form the basis of the confidence level analysis. The 70% confidence level would represent the point in the distribution that 70% of the outcomes are expected to be below.

For example, if the 70% reserve confidence level was $6 million, the actuary is indicating there is a 70% chance actual unpaid claims will be less than $6 million and likewise a 30% chance the actual unpaid claims may be greater than this level.

Is funding at a 70% confidence level sufficient for a public entity pool?

The risk (potential demands on capital) associated with a property/casualty insurance entity is generally categorized in four areas:

Reserving	• Actual unpaid claims may be higher than current estimates
Underwriting	• Next year's losses may be higher than projected
Asset/Credit	• Bond holdings may go down in value • Excess carrier or reinsurer may fail
Operational	• Next year's administrative budget may be exceeded due to an unforeseen event

In the context of current Washington pool regulation, it is important to note that only the confidence level around the reserving risk category is being considered. The uncertainty and potential demands on the capital from the other risk categories are not being considered.

So a pool funding at the 70% reserve confidence level has a 30% chance of having insufficient funding in place to satisfy its unpaid claim obligations. The actual likelihood of having insufficient funding is greater than 30% as the other risk categories also contribute to the uncertainty and thus capital requirements.

The only context where a 70% reserve confidence level would be considered sufficient funding would be when a pool that had other sources of capital. For example, this scenario could prove sufficient if an integral part of the pool's funding mechanism included a reassessment provision whereby the pool would collect funding shortfalls from its membership. However, due to financial pressures on the members, the actual execution of this funding model may not be realistic.

Is a pool's self-insured retention and stop loss coverage considered in determining its confidence level?

Confidence levels are based on pool-specific parameters, including self-insured retention and stop loss coverage levels, which are used in the probability distributions. All else being equal, the confidence level funding requirements will be lower for a pool with a $100,000 self-insured retention level versus a pool with a $1 million self-insured retention level.

How does stop loss coverage work? Does it extinguish all further claim payments for the pool once the attachment point is reached?

Stop loss coverage generally works whereby the aggregate claims experience below the specific self-insured retention level is capped at the stop loss attachment point subject to the stop loss coverage policy limit.

Stop loss coverage does not necessarily extinguish all future liabilities for the pool once the attachment point is reached. Specific situations where the pool would have continuing exposure include the aggregate claims experience exceeding the stop loss policy limit or a financial failure of the stop loss insurance provider.

What must be in place for a pool planning to reassess its members for funding shortfalls to be successful?

Key elements include:

1. **Method.** A specific method that details exactly how the funding shortfalls are assigned to the membership, including members who may have since left the pool.
2. **Recognition.** The membership should be fully aware of their potential additional financial responsibilities to the pool in the event of a funding shortfall.
3. **Financial Ability.** The membership needs to have the financial ability to fund their share of any shortfall in a timely manner. Appropriate accruals and funding needs to be in place at each member to handle these financial obligations.

In a public entity pool, what issues would there be if only enough money to pay claims and expenses for that year were funded?

In a "pay as you go" insurance program, either the pool is not fully funded or the member is purchasing extremely limited insurance coverage. Either scenario can create issues for the program members.

Pool is not fully funded

If the pool is providing occurrence or claims-made coverage, but is only funding its cash flow obligations, it has a funding shortfall that needs to be addressed in order for it to satisfy its obligations. Key elements to address the shortfall include: a specific reassessment method that details how the shortfall is allocated to the membership, recognition from the members that they have additional financial responsibilities beyond their initial contributions, and the financial ability of the members to fund their share of the shortfall.

Pool is only providing coverage for "claims paid" during a year

If the pool is only providing some sort of "claims paid" coverage, the actual financial protection being provided to the member is very limited. They would only have coverage for claims that are being paid that year, and not have any coverage for future claim payments on events that have pwc

occurred. To a large extent, the members would be considered self-insured but may be under the illusion they have purchased financial protection.

Qualifications of Actuaries

Kevin Wick is a Managing Director with PricewaterhouseCoopers LLP and is a member of the American Academy of Actuaries and a Fellow of the Casualty Actuarial Society. He has consulted with public entity pools for over 25 years, including many risk pools in Washington State.

He has recently authored a paper (*"Have Pool Expectations Surpassed their Solvency Measures?")* that examines and challenges the common financial metrics currently used by pools. This topic, along with a more detailed *Funding Framework for Maturing Public Entity Pools,* has been presented at several pool industry meetings.

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We are pleased to have the opportunity to provide services to Southwest Washington Risk Management Cooperative. Please call Kevin at (206) 398-3518 if you have any questions.

Very truly yours,

Kevin Wick

Kevin L. Wick, FCAS, MAAA
Managing Director