NOTES FROM KING STREET

Quarterly Newsletter from Energy Insurance Services, Inc., Volume 3, Issue 1

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View from the Corner

King St
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2018 was a banner year for EIS. Our most significant milestones include

- Record written premium of $290.9 million (cumulative of all MBPs)
- First issued policies backed by catastrophe bonds
- General Account (GA) Surplus reached $3.5 million – 18 months ahead of plan
- 2018 CAPTIVE OF THE YEAR as recognized by the Captive Insurance Company Association

The level of written premium was achieved, in large part, by participants building additional capacity using EIS as an efficient access to reinsurance markets. Other new written premium was realized from new net risk coverages issued to buy down deductibles or to quota-share with mutual and commercial insurance.

The GA surplus is a key strategic measure for EIS. Starting in 2017, we targeted $3.5 million as a ceiling capable of supporting our regulatory obligation and the magnitude of potential enterprise risk factors we track and measure. As we go forward, EIS will target more modest annual increases to keep pace with inflationary trends.

Throughout 2019 we will be working with EIM Members to explore new program ideas, promote the recently introduced EIS MARS program and other avenues to enhance risk financing efficiency. EIS will also be developing its next three-year strategic plan (2020 – 2022). We believe 2019 will present some interesting challenges including uncertainty in a variety of areas such as the appetite of reinsurance markets for catastrophic risk and interest rate growth, implications of recent tax court rulings that are favorable and unfavorable. These are only a few of the dynamics that will help us set the plan for the years to come.

Captive Optima – DIC Cover

Optimization

"Mind the gap" is a phrase made famous from the London Underground. It is an appropriate phrase for anyone who has experienced riding in the tubes under London. The irony of equating this phrase to insurance 'coverage gaps' has likely occurred more than a few times to many risk managers visiting London.

The phrase 'coverage gap' has long been used to express incongruency among insurance forms that are unique from carrier to carrier, syndicate to syndicate and so on. When confronted in building substantial coverage limits, it is not uncommon to find that no one underwriter can provide all the capacity that an energy or utility company needs or desires. Filling capacity by building or quota-sharing layers of coverage is quite common and accepted. One of the little annoyances to many risk managers is that not all underwriters willing to provide capacity are willing to write a following form over underlying layers. Some lines have fixed this problem with underwriters emerging to fill those gaps with difference-in-conditions (DIC) coverage that is intended to fill the gaps. Examples include the D&O market that have underwriters providing excess and DIC coverage over a variety of layers to drop down when a layer will not respond to a covered claim in the DIC language. Another example is the punitive damages wrap coverage that is offered in concert with liability insurance layers.

Using a captive facility to bridge coverage gaps is an opportunity to optimize a complex layered insurance program. The use of an actuary to help price a captive's DIC cover, opine on the need for capital to sustain the coverage, and possibly set IBNR reserves is something that should seriously be considered. EIS has issued DICs in the past and has at least one program using DIC language in an excess liability layer.

MIND THE "COVERAGE" GAP

Focus on Benefits – Medical Stop Loss

Most EIM Members self-fund their employee benefit plans. However, over the past few years several inquiries have been made to EIS about exploring a stop loss cover to protect against catastrophic or unpredictable medical losses. These inquiries were initiated because of substantial financial surprises that have impacted Members' earnings due to one or two catastrophe health claims within one year. The cost of certain medical treatments coupled with the pharmaceutical expense are sending the cost of an individual's care into the millions of dollars! Captives are increasingly being used to address catastrophic medical losses.

There are three basic approaches to structure a stop loss cover: specific, aggregate and a combined specific and aggregate basis.

- *Specific stop loss* – protects against a catastrophic claim on any one individual
- *Aggregate stop loss* – protects against unexpected frequency and severity of all claims in a defined time period
- *Both specific and aggregate* – protects for a combination of individual catastrophe and the unexpected aggregation of loss in a defined time period

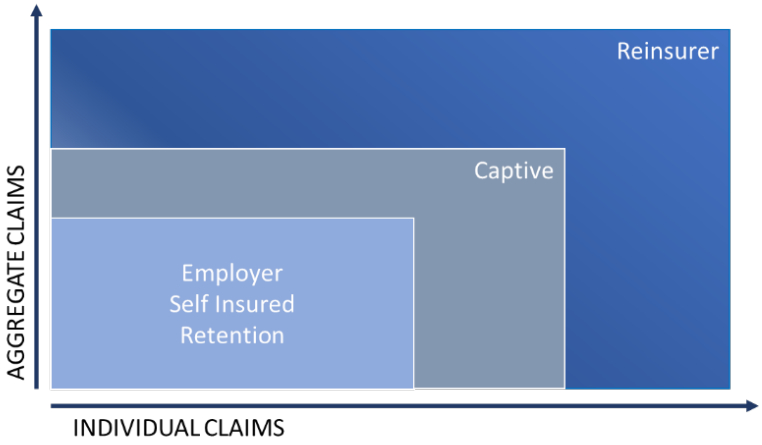
Combining those structures can lead to a number of variations to meet the unique needs of an employer and the characteristics of its employee census.

Key objectives in exploring medical stop-loss in a captive depends whether your company already insures this risk or not.

- If your company uses stop loss insurance now –
  - Assessing the efficiency of an existing stop loss program
  - Reducing cost of insurance programs over time
  - Lessening dependence on traditional insurance and market shifts
- Whether or not your company uses stop loss insurance now –
  - Improving cash flow and more efficient loss funding
  - Holding reserves and earning investment income
  - Seeking medical stop loss reinsurance or including this risk in a multi-line aggregate reinsurance protection with other lines insured within the captive

Below is a sample schematic of a captive used to help fund for medical benefit claims.

- The employer retains some risk, typically expected losses
- The captive provides additional retained risk for unexpected individual and aggregate loss
- The reinsurer protects the captive for worse-case scenario of individual and/or aggregate loss



Insuring medical stop loss cover into an existing captive with traditional property and casualty insurance is, in nearly all instances, adding significant stability to the captive's risk portfolio due to the uncorrelated risk of medical stop loss to other captive insured risks.

Operational Considerations

Energy Captive Management

Putting Your Money to Work

One great advantage of insuring your risk in a captive is making an investment return on its premium. This sounds great, but it is imperative to remember that this is an insurance company, and it is critically important that money be available to pay claims. We all know investment returns are not guaranteed and that the captive can lose money; therefore, you need to be smart and diligent in your decisions.

The best place to start is with an investment policy statement that outlines your objectives and criteria. The most typical objectives include

- *Maintenance of liquidity for claims and expense payments*
- *Preservation of capital*

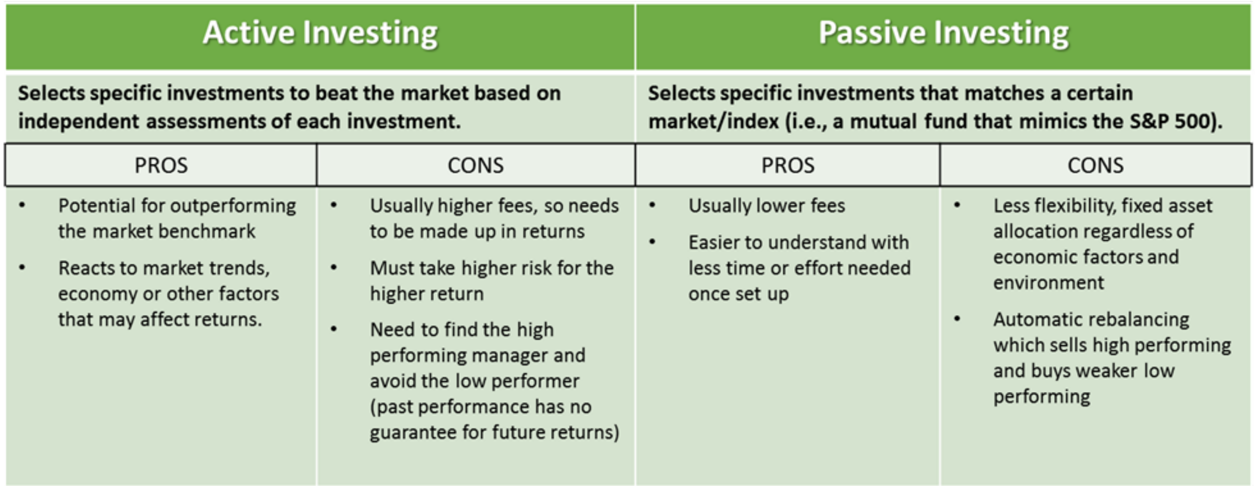
With these objectives in mind, what are your investment options?

Investments may be foreign to some while they may be second nature to others. There are advisors who specialize in insurance company investing who will be more than willing to work with you. You may have in-house investment specialists, who are a great resource to help shape your strategy. Either way, having a well thought out, clear and concise strategy is where you need to be.

Just holding cash in a checking account is a very safe strategy and may be the best choice for a minimally capitalized captive that has short-tailed coverages. Claims are hard to predict but knowing your historical data and claim payment pattern is necessary to best match your assets with your cash needs. If your claims have longer payout periods, keeping asset values up with inflation can be critical to meet those future payments that may be years down the road. The risk of holding cash vs. invested assets needs to be considered.   Knowing your risks and weighing them against the upside will help you make an educated decision on what is best for the captive.

A common investment strategy is a mix of equities, fixed income and cash equivalent investments. Coming up with the right mix of these investment classes and subclasses is where you want to lean on your investment expert. They will help explain the risk reward of different mixes.   A good blend should help diversify your risk.

Once you have picked your investment mix the next item to consider is having active or passive investments. Below is a table that helps summarize high level differences:



Active Investing		Passive Investing	
Selects specific investments to beat the market based on independent assessments of each investment.		**Selects specific investments that matches a certain market/index (i.e., a mutual fund that mimics the S&P 500).**	
PROS	CONS	PROS	CONS
• Potential for outperforming the market benchmark • Reacts to market trends, economy or other factors that may affect returns.	• Usually higher fees, so needs to be made up in returns • Must take higher risk for the higher return • Need to find the high performing manager and avoid the low performer (past performance has no guarantee for future returns)	• Usually lower fees • Easier to understand with less time or effort needed once set up	• Less flexibility, fixed asset allocation regardless of economic factors and environment • Automatic rebalancing which sells high performing and buys weaker low performing

The key question to remember is: what is your risk tolerance? Is it worth the risk to go after the higher return at the potential cost of lower returns? Each member's situation is different, and we will be glad to work with you to find the right strategy or advisor.

EIS Financials

As mentioned above, EIS had a solid year in 2018, as did our participants. Our general account represents the operational aspect of EIS. Our revenue comes primarily from our management fees. These annual fixed fees have largely remained unchanged since 2011. More importantly, our operational costs have been effectively flat over the past three years.

	2018 *(unaudited)*	2017
EIS GENERAL ACCOUNT		
Revenue	**$2.44 million**	**$2.39 million**
Expenses	**$1.76 million**	**$1.77 million**
Shareholder Equity (Surplus)	**$3.49 million**	**$2.93 million**
MUTUAL BUSINESS PROGRAMS		
Assets	**$1.59 billion**	**$1.45 billion**
Liabilities	**$1.44 billion**	**$1.31 billion**
Surplus	**$142.2 million**	**$141.7 million**
Gross Written Premium	**$290.9 million**	**$209.0 million**
Net Written Premium	**$76.8 million**	**$71.1 million**
KEY OPERATIONAL DATA		
Active MBP Count	**15**	**15**
EIM Member Participants	**19**	**19**

Our protected cell or Mutual Business Program (MBP) count has also remained steady. We are hopeful that a few EIM Members will establish programs in 2019.

A few participants have increased their writings significantly. Gross written MBP premium has been on a strong growth trend for the past three years. As we entered 2016 gross written stood at $148 million. Today it is above $290 million. Most of this premium growth is being ceded to reinsurers; however, our participants' net written has grown 166% since 2016. Not too shabby!

Save the Date!

EIS ANNUAL PAC CONFERENCE | NOVEMBER 4 – 7, 2019

THE SANCTUARY | KIAWAH ISLAND, SC

EIS Mission Statement

“To provide a facility to meet EIM Members’ dynamic and specific business requirements for the placement and management of alternative risk solutions.”

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