COMPLETE ACTUARIAL SOLUTIONS COMPANY

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All organizations, both health care and non-health care, that record liabilities net of insurance coverage purchased should be aware that auditors are increasingly requiring the recording of gross liabilities offset by insurance receivable

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Accounting Change for Health Care Organizations
(Accounting Standards Update No. 2010-24)

Historically, accounting rules relating to the handling of expected insurance recoveries for health care organizations have differed from those in other industries. The health care industry was explicitly allowed to report insurance liabilities on a net basis. This means they could report liabilities as one figure that takes into account anticipated insurance recoveries. For example, if a hospital faced gross medical professional liability losses of $1,000,000 but had purchased a commercial insurance policy covering $750,000 of those losses, the hospital could simply report a net liability of $250,000. This was in contrast to other industries, which in theory were required to report in more detail. In the above example, a non-health care organization should report a gross liability of $1,000,000 and an insurance receivable asset of $750,000. In practice, this more detailed reporting method is not always used, especially when the insurance receivable asset is not large enough to be of material financial concern.

The current trend is moving away from different accounting treatment by industry, including health care entities, and towards consistency with International Financial Reporting Standards (IFRS). In August of last year, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2010-24 for Health Care Entities (Topic 954) entitled "Presentation of Insurance Claims and Related Insurance Recoveries." Under this update, self-insured health care organizations will no longer be allowed to report liabilities on a net basis for fiscal years beginning after December 15, 2010. In order to accommodate the more detailed reporting of liabilities, all actuarial reports for health care organizations need to include projections that are both gross and net of anticipated insurance recoveries. This could represent a change since previous actuarial reports may have provided only projections on a net basis. This change does not impact the entities profit or loss (P&L) statement since this newly reported insured layer liability will be offset by a new insurance receivable asset on the balance sheet.

It appears that auditors may focus more on the implementation of this accounting update with regards to medical professional liability than for other liability lines such as workers' compensation and general liability. Regardless of the line of business, the materiality of the insurance receivable asset will likely determine whether auditors will require the more detailed accounting discussed above.

All organizations, both health care and non-health care, that record liabilities net of insurance coverage purchased should be aware that auditors are increasingly requiring the recording of gross liabilities offset by insurance receivable assets.

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Ask the Actuary: Capacity

Q: What is capacity and what is its role in insurance?

Capacity is the basic underlying financial driver of insurance markets. It is the level of protection an entity's financial strength provides against the risk of a large loss.

<u>Insured's Point of View</u>

A typical homeowner does not have the financial capacity to deal with the loss of his home to a fire. Meanwhile, a real estate holding company (REHC) has the capacity to withstand a small fire loss but not a large one. Therefore, a market for fire insurance is created due to the homeowner's inability to withstand the loss of a home valued at $200,000, or the inability of the REHC to withstand the loss of an apartment building valued at $5M.

<u>Insurer's Point of View</u>

Capacity also determines how much insurance an insurer is able to offer. For example, the Thinly Capitalized Insurance Company (TCIC), with $5M of surplus, cannot expose itself to a potential claim that may wipe out its surplus. It can offer a policy to the homeowner but not to the REHC. An old industry standard suggests limiting the potential loss caused by a single event to no more than 10% of the insurer's surplus. REHC looking for coverage for a building valued at $5M will need an insurer with at least $50M in surplus.

Just as significantly, capacity level and insurance prices are connected. In order to protect policy holders, regulations limit investment strategies for insurance companies. Therefore, the insurance operations need to be profitable to prevent capital from fleeing in search of a higher rate of return in a less regulated investment environment.

Let us assume TCIC offers our homeowner a policy for a premium of $400 which includes a $20 profit/risk margin. This transaction eliminates the homeowner's risk of loss but TCIC will be required to set aside an amount (for example $100) of surplus to make sure there are enough funds to pay outstanding claims if losses prove to be much worse than expected. At $100 of surplus set aside per policy, TCIC will be limited to writing no more than 50,000 policies before its $5M surplus is exhausted.

At $20 of profit per policy for 50,000 policies, TCIC expects to earn $1M of income from insurance operations, or a 20% return on it $5M surplus capacity. However, insurance pricing is affected by competition, so TCIC will have difficulty selling 50,000 policies at that price since competitors with excess capacity of their own seeking less than 20% return will undercut its pricing.

Ask the Actuary: Capacity (continued)

Self-Insurer's Point of View

Self-insurers, including captives, RRGs, pools, and other risk retention programs look at capacity from both an insured's and an insurer's point of view. A self-insurer isn't looking to justify its self-insurance program through profits but rather through the avoidance of paying for commercial insurer's profits and expenses as well as avoiding the instability of commercial insurer rates through hard and soft markets. In other words, a self-insurer wants to shield its organization against the impact of insurance industry capacity swings. Hard markets are caused by reductions in overall industry capacity, resulting in higher profit/risk margins especially for riskier lines of business. This exposes insureds to large increases in pricing not necessarily driven by loss experience. At the same time, a self-insurer must view capacity in terms of the risk of loss the organization is willing and able to withstand.

Interesting Articles

Insurance captives' profitability soars

Profitability increased by 49% and policyholder dividends were up 73% for captive insurance entities followed by rating analysts at A.M. Best in 2010.

Workers' compensation claim frequency increased in 2010

Claim frequency for workers' compensation injuries increased 3% in 2010, marking the first increase since 1997.

At-home workers create new risks for employers

As more companies allow their workforces to move from cubicles to home offices, risk management plans may not be keeping up with the exposures related to at-home worker

Medical malpractice insurers enjoying high profits

Thanks to tort reform & patient safety improvements, medical malpractice insurers are performing well despite losing premium volume.

Market Focus

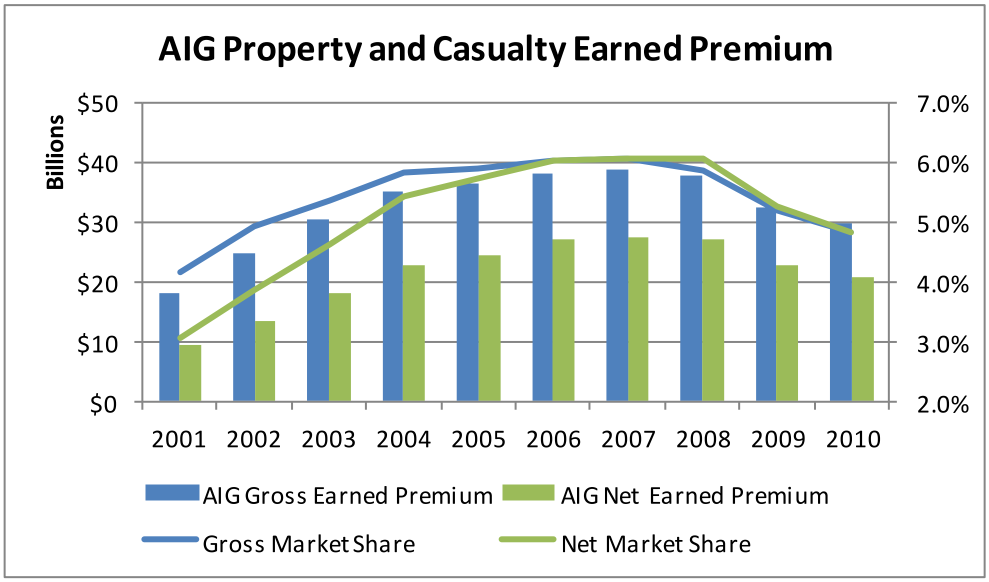
In this issue, we look at one of the largest commercial insurers in the United States, American International Group (AIG).

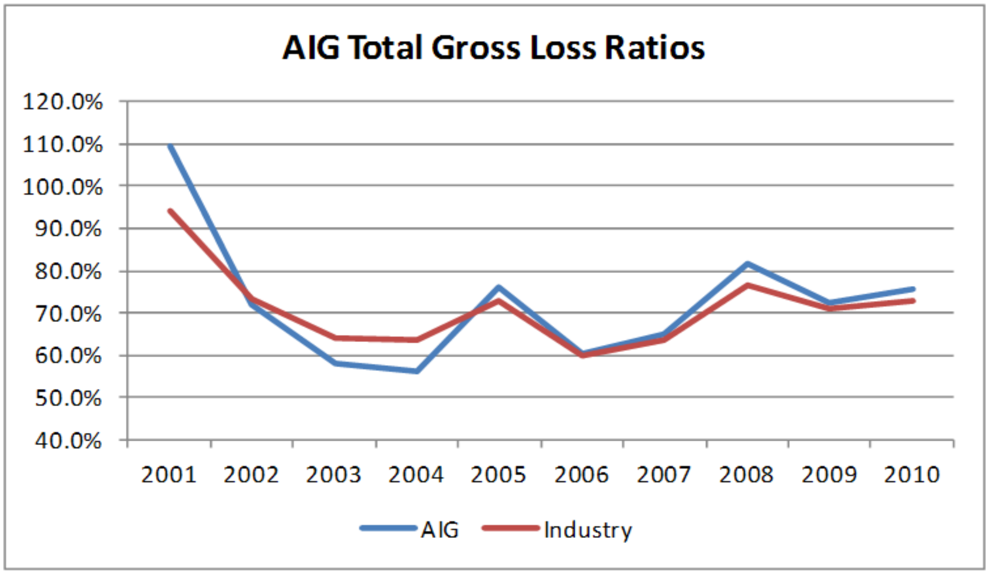
AIG's total property and casualty earned premium and market share have declined since 2008 .

Since 2005, total gross loss ratios have closely followed those of the overall industry.

Market Focus: American International Group (AIG)

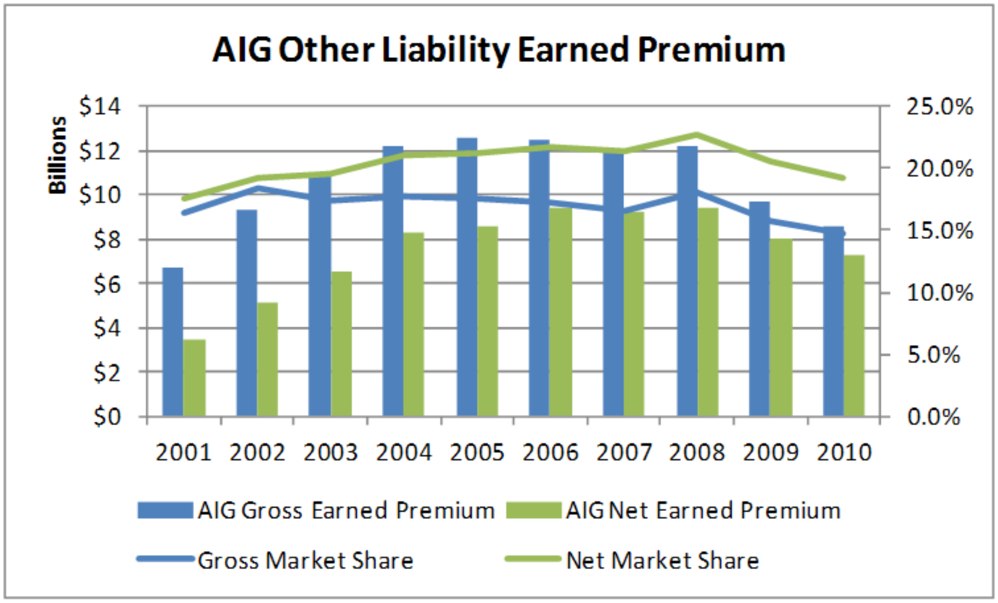
AIG is one of the largest commercial insurers in the United States based on gross written premium and is the second largest property and casualty insurance group (behind only State Farm Group). The financial crisis of September 2008 greatly impacted AIG (through its securities lending program, not its insurance operations). In reaction to this, the Federal Reserve Bank of New York extended emergency secured loans to AIG, and the U.S. Treasury Department purchased preferred stock in the company as part of a rescue package that totaled over $150 billion. We look at gross and net premiums and gross loss ratios over the past 10 years for AIG's property and casualty operations in total, as well as for four specific lines of coverage. This information is based on their most recent annual statement, a copy of which can be obtained from the National Association of Insurance Commissioners.



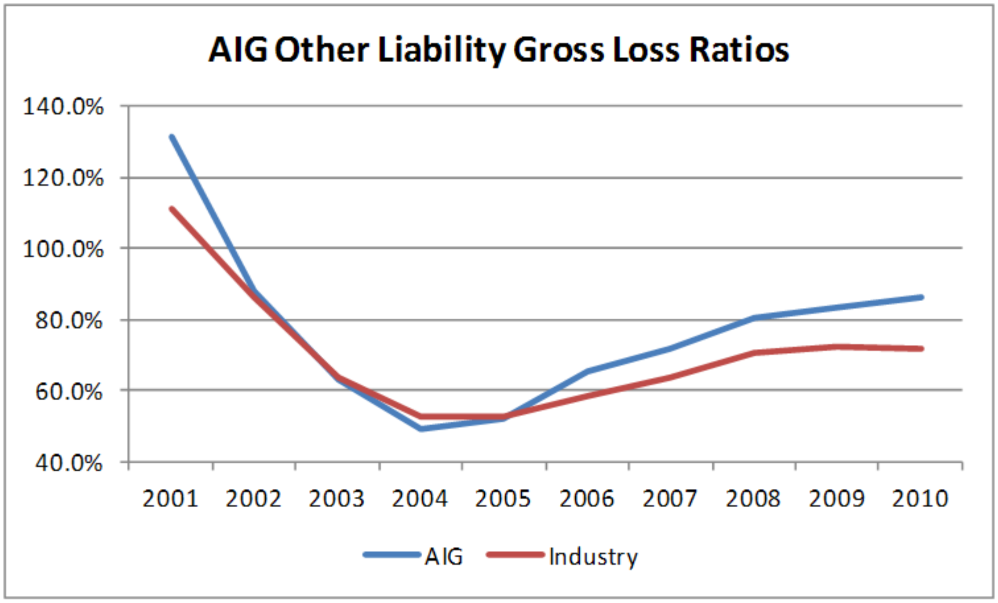


Market Focus: AIG (continued)

Other liability earned premium and market share have declined since the September 2008 financial crisis.

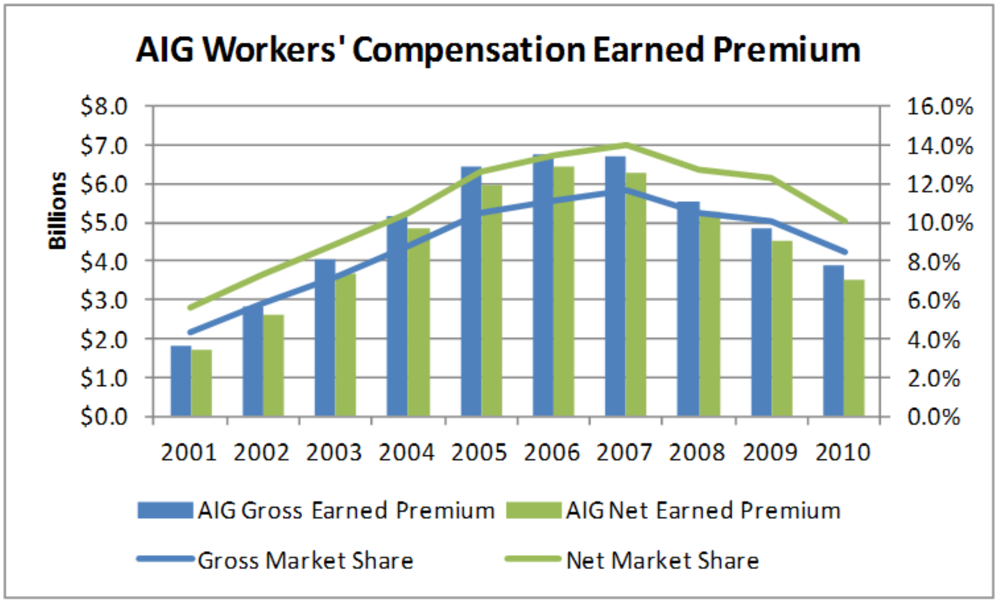


The gap between other liability loss ratios for AIG versus the industry has widened since 2008.

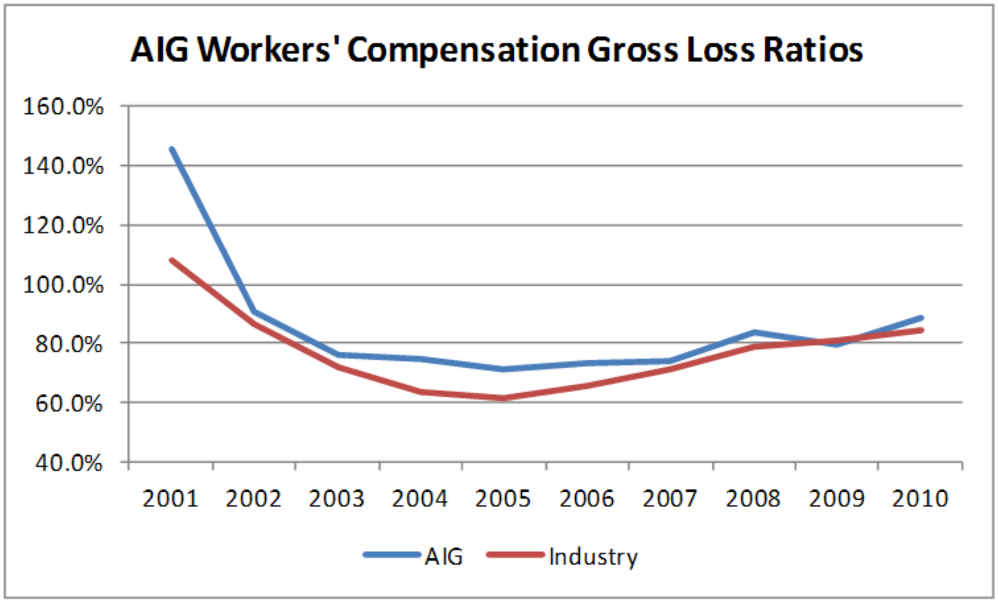


Market Focus: AIG (continued)

Workers' compensation earned premium and market share had already begun declining prior to the September 2008 financial crisis.

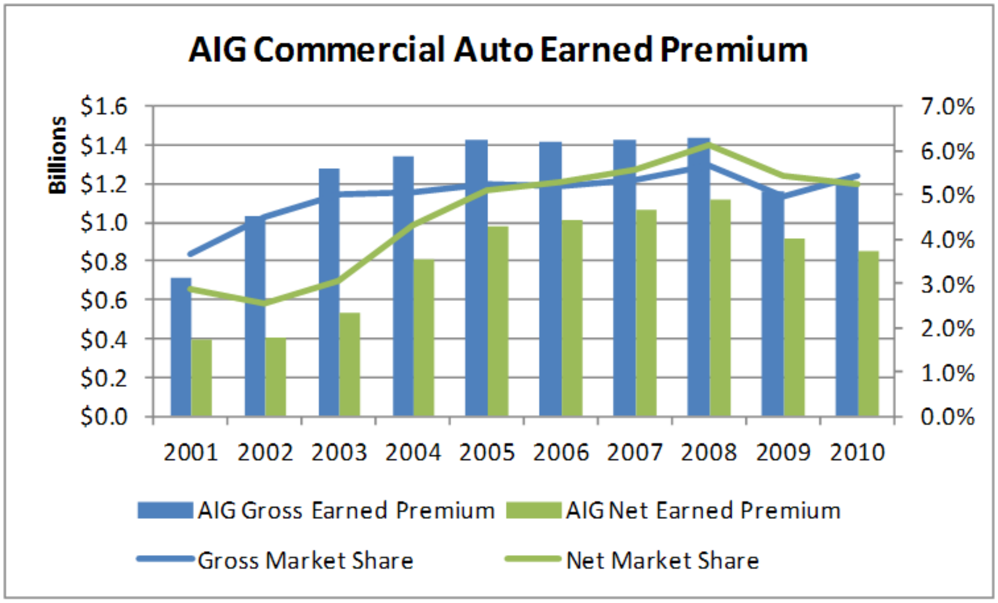


Loss ratios for workers' compensation are now close to the industry level after being higher than the industry level for much of the last decade.

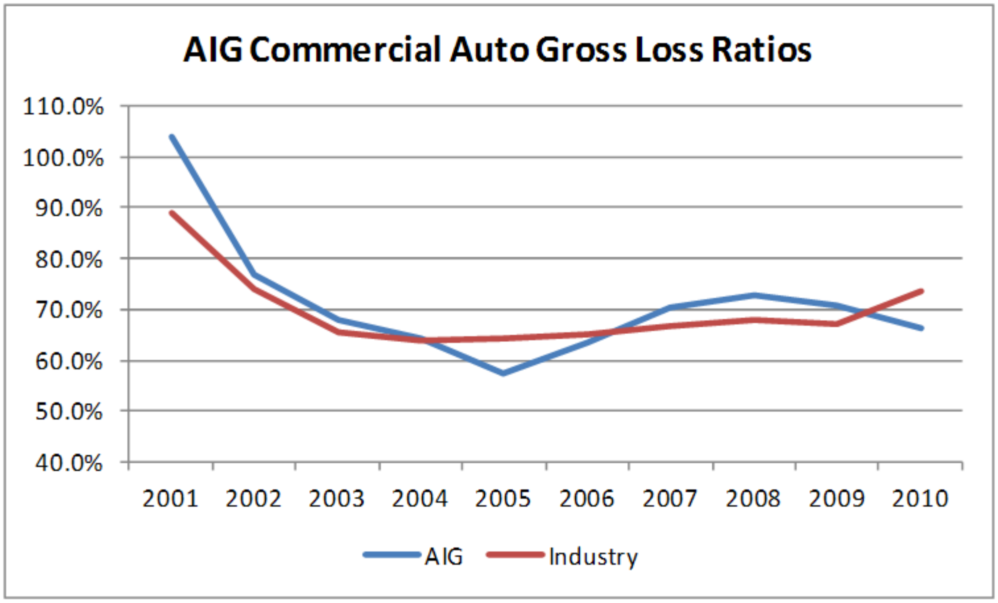


Market Focus: AIG (continued)

In contrast to the previously mentioned lines of coverage, commercial automobile liability premiums have remained relatively strong for AIG.

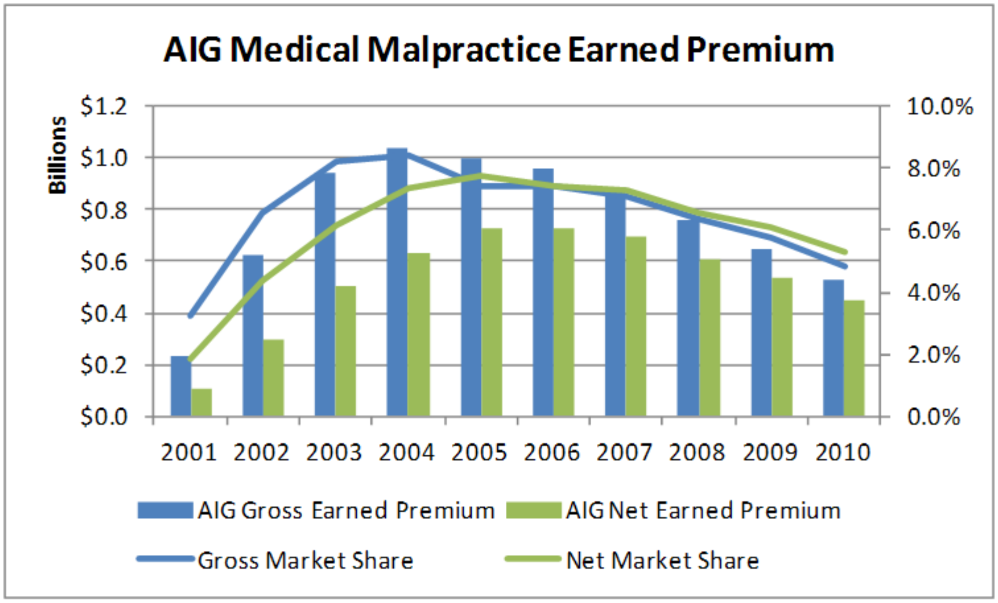


Commercial auto liability loss ratios have improved somewhat since 2008 while industry loss ratios deteriorated during the same period.

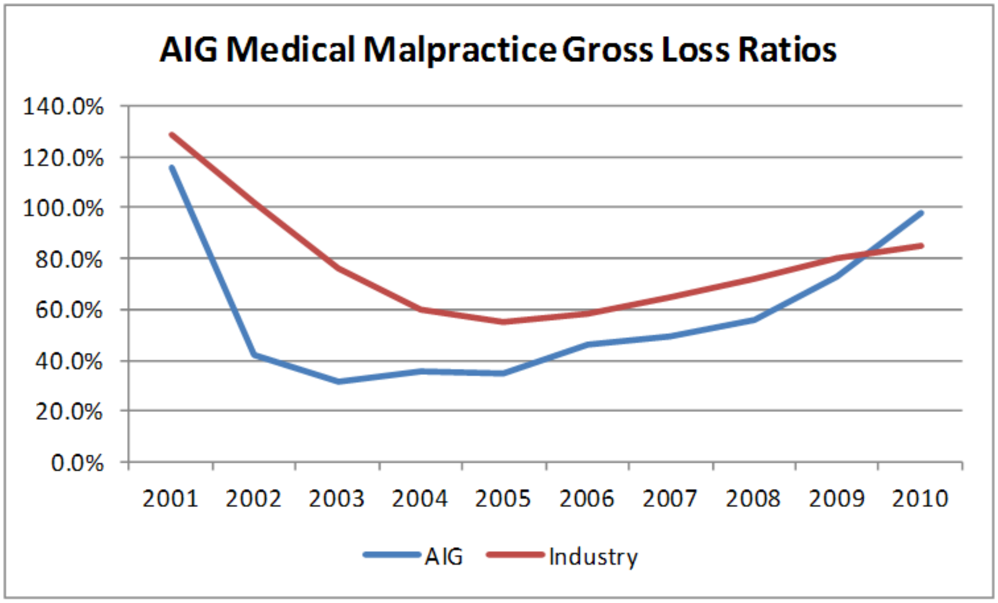


Market Focus: AIG (continued)

Gross medical malpractice premiums have been declining for AIG since 2004. Net premiums began declining several years later.



After being below the industry level for many years, medical malpractice gross loss ratios increased significantly after 2008 and climbed above the industry level in 2010.



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About CASCO

We provide ongoing actuarial services to over 100 clients in several areas:

- Professional and General Liability
- Directors' & Officers' Liability
- Workers' Compensation
- Automobile Liability
- Managed Care Errors & Omissions
- Medical Benefits Stop Loss Risk
- Disability Benefits

We help clients with:

- Annual funding/pricing analyses
- Liability and cost projections for accounting and budgeting
- Formal opinions and reports to meet regulatory and audit needs
- Communication with auditors, regulators, and excess insurers
- Other regulatory or administrative problems
- Impact analysis of judicial/law changes affecting program costs
- Strategic risk financing studies
- Retention limit analysis (single and multi-line)
- Internal cost allocation
- Pro-forma projections of program results under varying scenarios
- Cash-flow forecasts to help in setting investment strategy
- Evaluation of insurance products
- Projecting costs for acquisitions and new ventures
- Expert witness testimony
- Benchmarking data on loss costs, trends, retention limits, and more

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