Target Equity Policy Summary

Adopted July 19, 2014

Overview

The Pool engaged PricewaterhouseCoopers (PwC) to conduct a members' equity study to aid the Board in determining the appropriate funding levels and target equity for the Pool and to ensure the continued financial strength and stability of the Pool. PwC's comprehensive analysis identified and measured the specific financial risks facing the Pool, as well as the correlation of those risks, including; underwriting risk, reserving risk, asset and credit risk, and operational risk.

After conducting their review and discussing with the Board and Executive staff the Pool's financial risks and funding objectives, PwC has produced a *Target Fund Balance Review,* which incorporates the following decisions made by the Board:

• A minimum consolidated members' equity target was established at a 1-in-250 year occurrence.

• A maximum consolidated members' equity funding level was established at a 1-in-20 year occurrence above the 1-in-250 year occurrence minimum level.

• Set the minimum target equity goals for the operating funds at 1-in-100 year event levels.

PwC's report quantifies the amount and types of risks assumed by the Pool and equips the Board and staff to explain to members, financial institutions, and other stakeholders the rationale for holding members' equity (within ranges) on a combined basis and on an individual operating fund basis. Furthermore, PwC's report provides additional context for decision making related to rates, reinsurance structure and equity returns.

Background

When governmental insurance pools first formed several decades ago, insurance coverage for public entities was becoming either unaffordable or unavailable in the traditional insurance marketplace. Pooling risks with similar entities was an alternative to the insurance marketplace and provided greater cost stability than operating with no insurance protection.

Even with the aggregation of risks from many different entities, the annual costs of the pooling programs were still uncertain and thus some form of capital was required. Initially, the capital for many pools came in the form of a "cash call" provision whereby a pool could assess its membership in the event of a funding shortfall. In essence, the contribution paid was a deposit

and there could be a retroactive assessment if the initial deposit was insufficient to pay for the program costs. For pools like TMLIRP, which are prohibited from implementing retroactive assessments of its membership, there was initially a heavy reliance on outside reinsurance with low attachment points and rates that included a “risk load” to build capital above and beyond expected losses. In the absence of the ability to assess members if capital were to be depleted, the pools would be in the untenable position of returning unpaid losses to their members.

Over time, most pools have built up a capital position which serves as a buffer between the program risks and capital depletion. The amount of capital to maintain is largely a function of the members’ financial expectations of the program it owns and participates in. Operating with a remote chance of returning unpaid losses to members requires more capital than a program which can tolerate periodic cash calls to replenish funding shortfalls that emerge.

For most pools, the members' financial expectations of the programs they participate in have matured over the years. When pools were first formed, the financial benefit of having some form of available coverage was much greater than the potential risk of receiving unpaid losses back. However, pool members now often have alternatives. They expect their program to deliver true risk transfer, stable rates, financial soundness, innovative and customized coverages and maintain a focused commitment to their own unique risks. These needs all require capital. At the same time, pool members face their own financial pressures and may prefer lower rates or a return of pool funds if the program has excess capital available.

This study was the result of the Pool's desire to ensure that the financial metrics used to assess its financial strength and guide key business decisions were consistent with its changing risk profile and operating environment and reflect current member expectations.

Project Approach

PwC combined the Pool’s risk assessment profile with the Board’s risk appetite/tolerance to assist in determining the appropriate levels of members’ equity. Under the PwC capital adequacy assessment approach, there are two main parameters in determining adequate funding levels:

1. **Board’s risk appetite/tolerance -** The Board’s desired level of protection helps define its target funding strategy. Its risk appetite can be translated into specific confidence intervals in the modeling of various program risks.

2. **Risk profile of the program -** The PwC study used an economic capital modeling approach that reflects the Pool’s own risk profile and includes:

    a. Underwriting Risk (also known as pricing risk), which represents risk that the actual outcome for the next year will deviate from the budgeted amount. Typical sources of this are volatility in the frequency or severity of claims and unexpected levels of catastrophic claims. Since the overhead expense items are rather

predictable, the majority of risk lies within the claims cost. Therefore, PwC modeled future claims and claims adjustment expenses, and the volatility around them, to measure underwriting risk.

b. Reserving Risk, which measures the potential for actual claims settlement costs deviating unfavorably from the current booked reserves. Typical sources of potential unfavorable reserve development include excessive inflation, emergence of latent or new types of claims and a change in the judicial environment affecting claim settlements.

c. Asset and Credit Default Risk reflects the risk that the value of investment and credit assets may deteriorate due to changes in macroeconomic financial conditions or a decline in the financial strength of debtors.

d. Operational Risk captures potential for fund deterioration arising from off-balance sheet or unplanned items.

From this model, PwC was able to obtain a distribution of funds needed at all confidence intervals that encompassed all major risk categories. By understanding the risk profile and sources of risk in quantified terms, the Pool is now able to make better decisions, by weighing the cost of capital against the estimated benefits in terms of equity growth and the Pool's overall risk appetite.

The Board will annually review the Pool's combined equity status. The Board will use the Members' Equity Policy (Exhibit A) to determine amounts eligible for equity returns on an annual basis from the operating funds, but when the combined equity amount is over the maximum, equity will be returned to members.

Exhibit A

Members' Equity Policy

1. The components of the combined fund balance will include the total of operating fund balances (Workers' Compensation, Liability, Property and Coastal Storm Funds), plus the total of non-operating fund balances (Large Loss, Reinsurance and Stability Funds).

2. Equity management and distribution for **Combined Funds**.

    - Equity will be managed to fall within the range minimum (1-in-250 years) and maximum (1-in-250 years + 1-in-20 years) by using Board approved methods.

    - If the combined equity balance is below the minimum amount of the range, no equity will be distributed from any operating fund unless specifically authorized by the Board.

    - If the equity balance is between the minimum and maximum amount of the range, equity will continue to grow, and equity distribution eligibility from the individual operating funds will be determined as prescribed in 3. below.

    - If equity on a combined fund basis is over the maximum, all equity over the maximum will be returned from the operating funds in a manner determined by the Board.

3. Equity management and distribution for the individual **Operating Funds.**

Minimum target equity *goals* for each of the operating funds are based on a 1-in- 100 funding level. Over time, each of the operating fund equity balances will grow to at least the minimum target goal.

- If the equity balance in a fund is below the minimum target equity goal and the fund produces less than a $1 million equity increase during the most recently completed fund year, no equity will be returned.

- If the equity balance in a fund is below the minimum target equity goal and members' equity:

    - increased by $1 million during the most recently completed fund year, and
    - in addition to the $1 million gain, the increase at least offsets any loss of equity in the year immediately preceding the most recently completed fund year,
    - the fund will return 50% of the equity gained.

- If the equity balance is above the minimum target equity goal and members' equity:

    - increased by $1 million during the most recently completed fund year, and
    - in addition to the $1 million gain, the increase at least offsets any loss of equity in the year immediately preceding the most recently completed fund year,
    - the fund will return 75% of the equity gained.

Due to the relatively small members' equity balance, the type of losses covered (i.e. catastrophic wind), the limited geographic spread-of-risk (first tier only), and limited outside reinsurance, equity gains in the Coastal Storm fund will not be available for distribution until such time as it is determined that the Coastal Storm fund's equity balance is sufficient to allow equity returns.