Final Report & Recommendation

since 1909
ma & lee
insurance

Observations

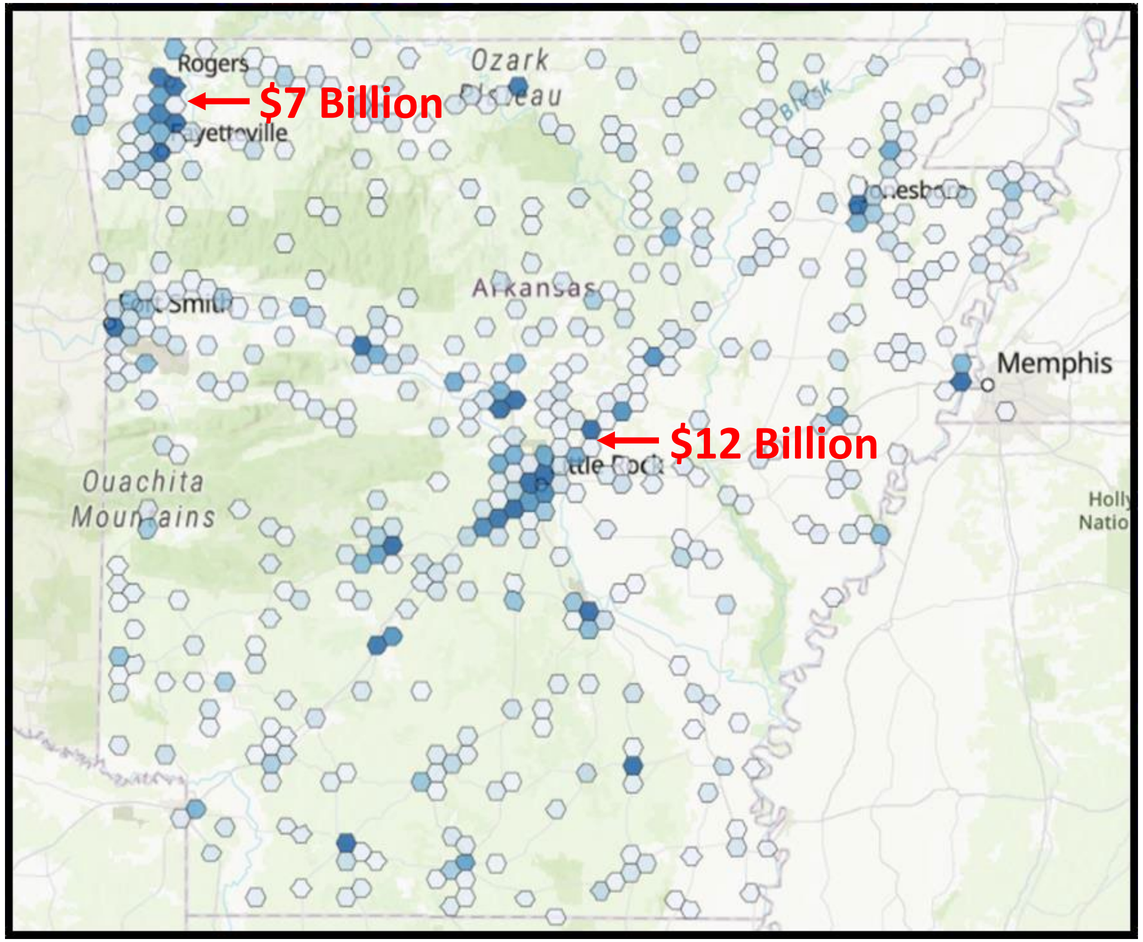
- Large property schedules used to be favorable in the market, now first-dollar capacity has out-priced this model

- The three school insurance programs are no different and being affected the same way as all other larger property programs

- Existing programs compete against one another over capacity from the same pool of insurance companies
  - Inadequate limits of insurance for all programs
  - Recent claims activity and study of statements of values raise concerns for certain properties
  - Rates charged to schools vary

Currently purchasing insurance like a consumer
Not like an insurance company

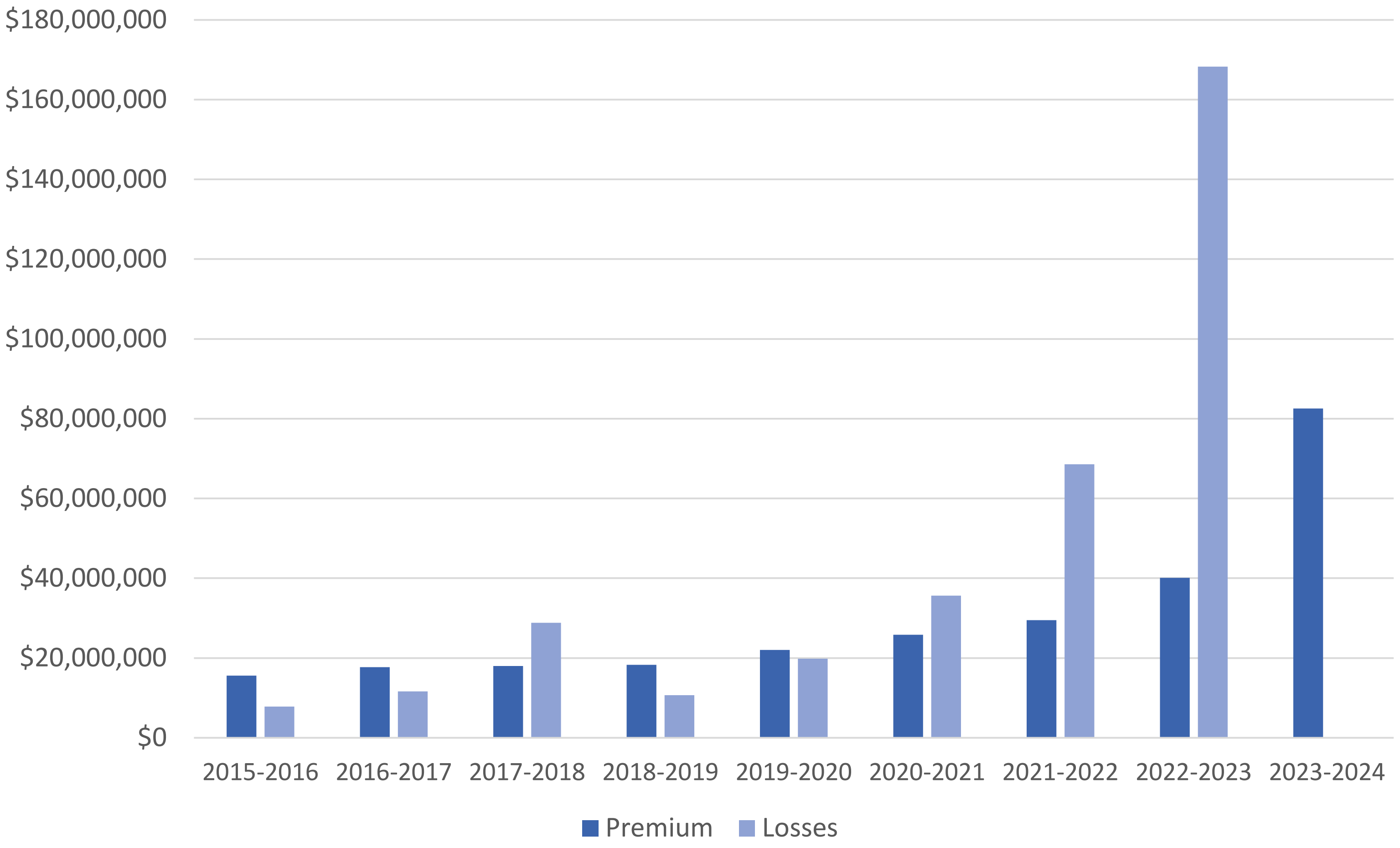
Risk Concentrations vs. Limits



- Inadequate limits for all programs
  - ASBA: $700 Million
  - APSIT: $500 Million
  - Higher-Ed: $500 Million

Limits are ~20% of maximum probable loss in both regions

Loss History & Premium Growth



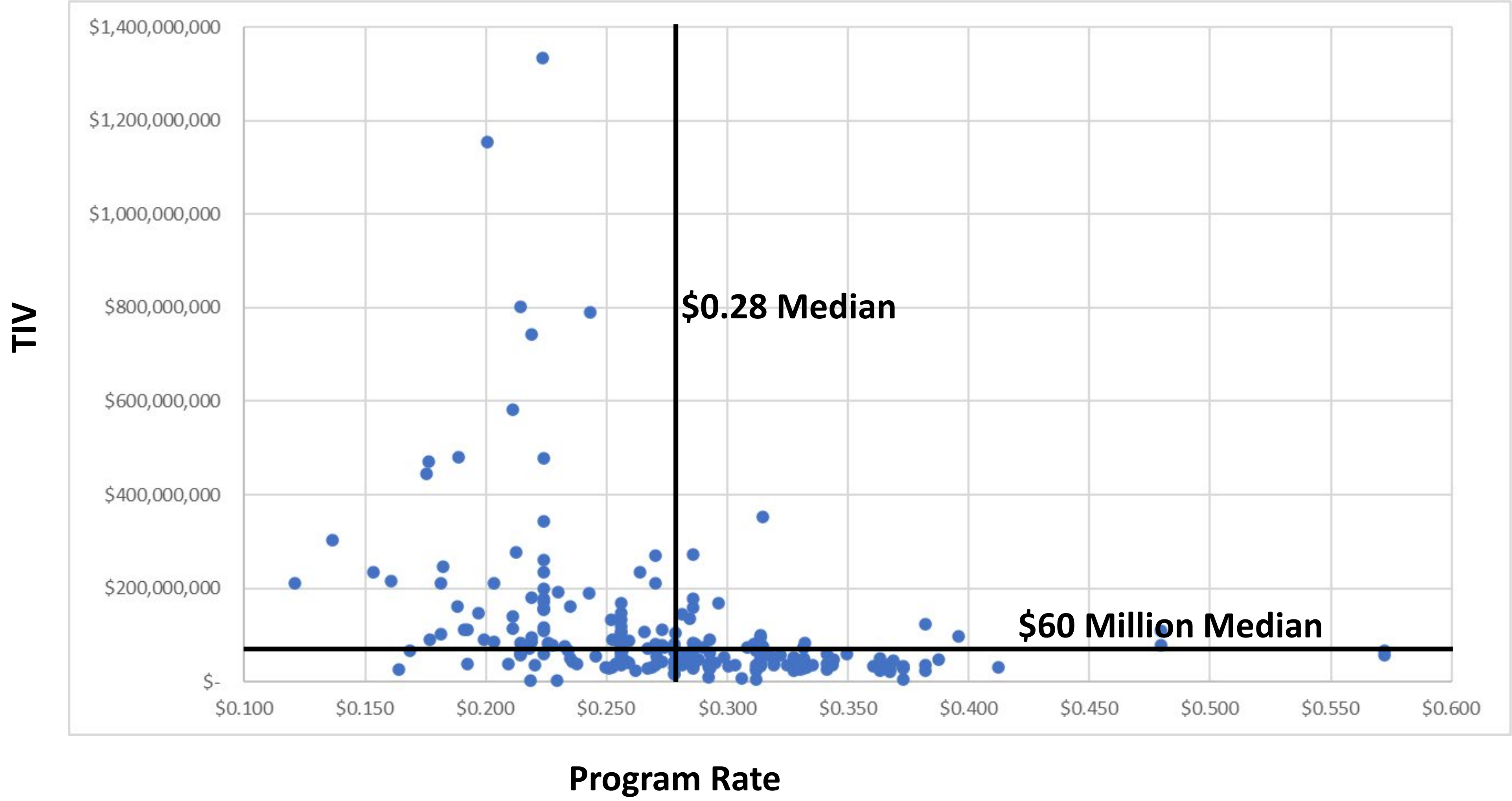
Loss Ratio	
2015-2016	50%
2016-2017	66%
2017-2018	160%
2018-2019	58%
2019-2020	90%
2020-2021	138%
2021-2022	233%
2022-2023	419%

Program Rate Variability

Conference	% Premium	% Value	Avg Rate	Avg Premium	Avg Value
2A	6.3%	4.8%	0.3101	$ 129,167	$ 40,545,714
3A	13.0%	10.6%	0.2998	$ 172,067	$ 57,725,094
4A	20.0%	18.5%	0.2630	$ 226,333	$ 86,687,990
5A	18.6%	18.6%	0.2460	$ 381,803	$ 157,753,799
6A	16.7%	17.9%	0.2268	$ 616,490	$ 274,064,650
7A	25.4%	29.6%	0.1997	$ 1,407,211	$ 678,272,162

Class	Total Premium	Total Value	Avg Premium	Avg Value	Avg Rate
2A & 3A	$ 10,714,313	$ 3,519,188,218	$ 155,280	$ 51,002,728	0.3045
6A & 7A	$ 23,319,466	$ 10,893,691,364	$ 932,779	$ 435,747,655	0.2141

Program Rate Variability



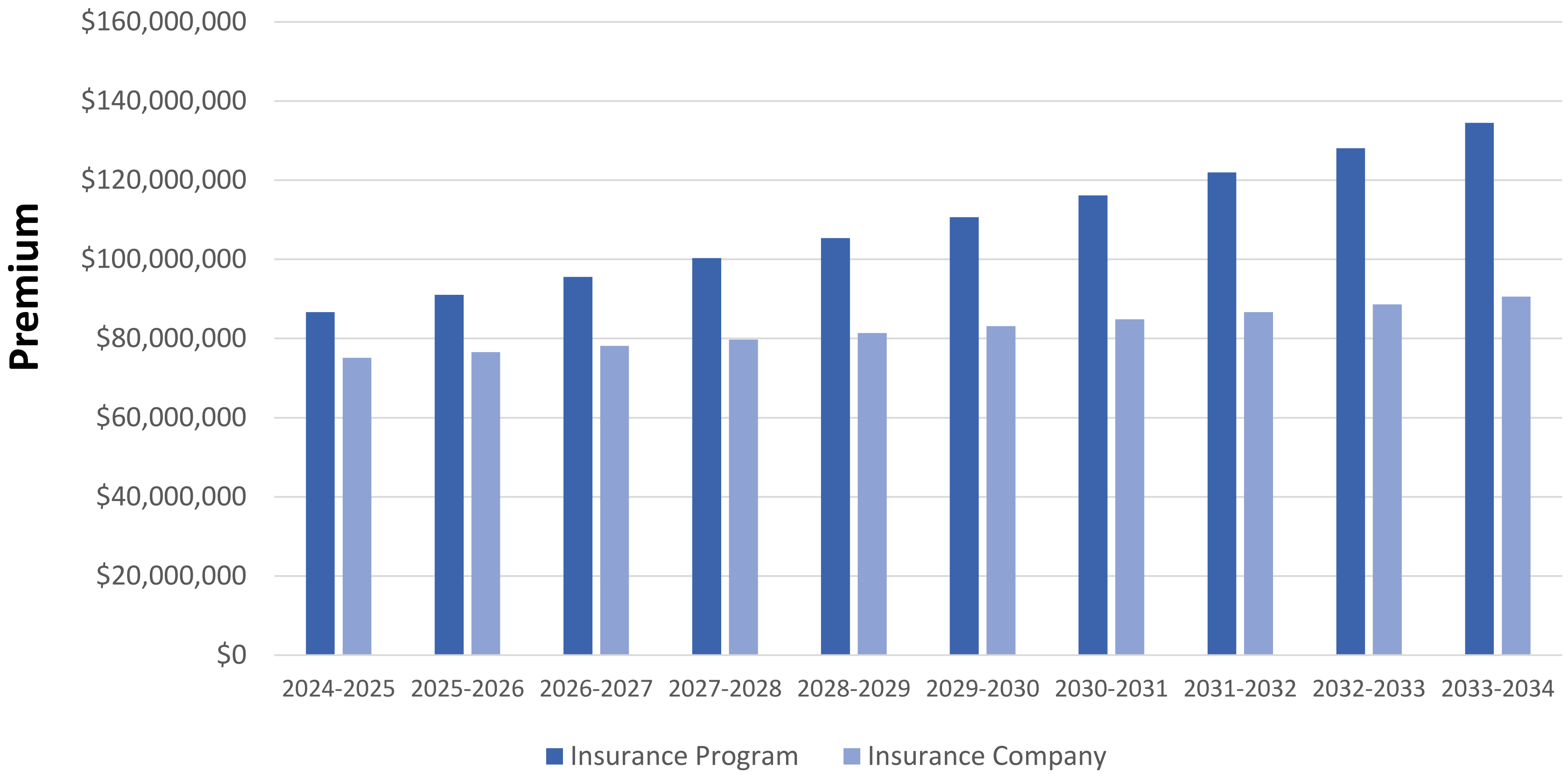
Cost of Maintaining the Status Quo

Increased cost of construction, frequency, and severity of storms have led to a paradigm shift in the insurance market

- $10+ million per year minimum to subsidize, but not fix, current programs
  - That amount invested conservatively over a decade would equate to the minimum capitalization needed to launch a state-owned insurance company
  - Cost of remaining underinsured could be in the billions in the event of a catastrophic storm outbreak

Knowing that there is a paradigm shift, we can't do a different version of the same thing and expect positive results. Tear it down and build it back from the ground up.

Insurance Program & Insurance Company Estimated Premiums



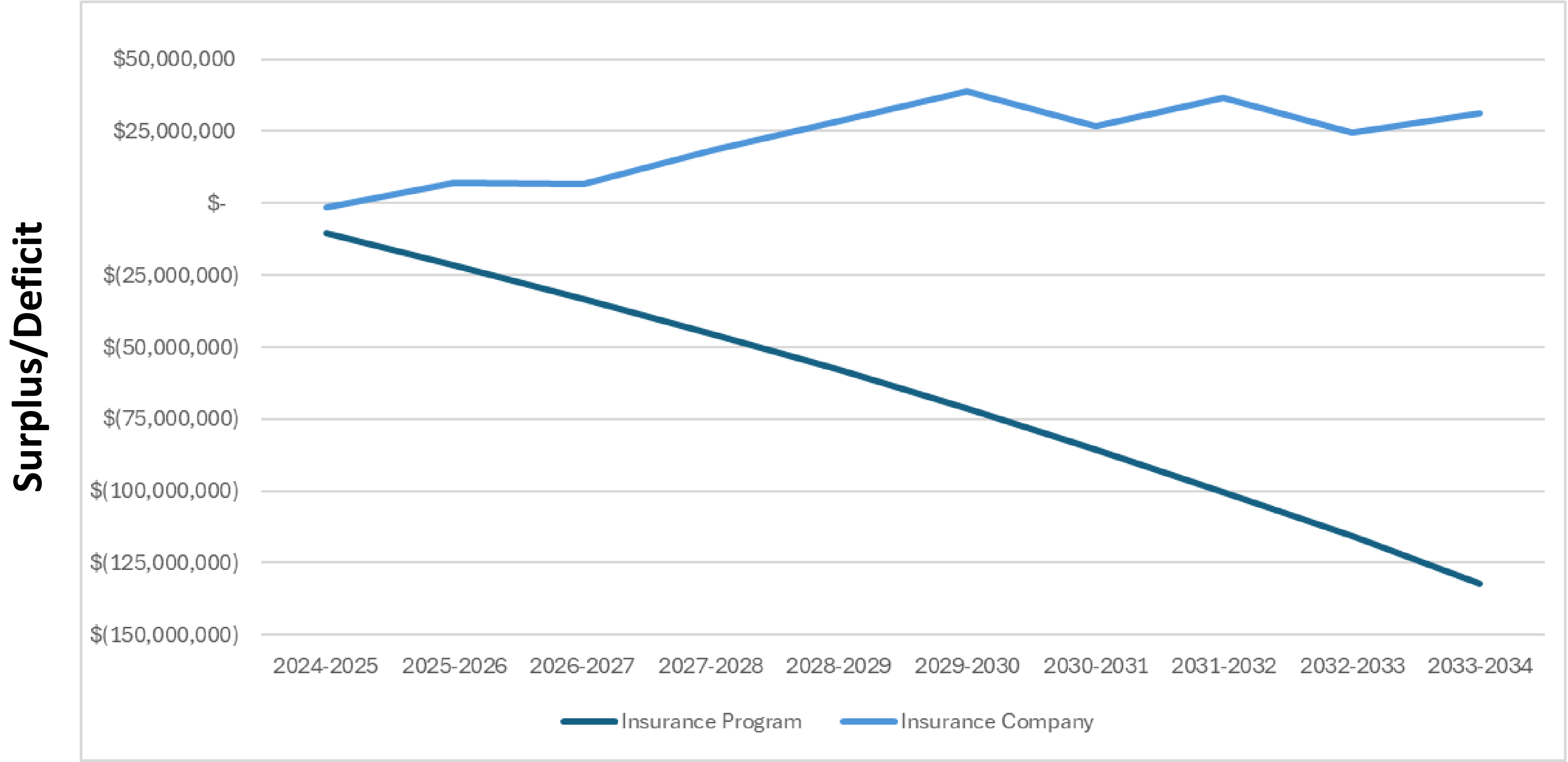
Insurance Program

Swiss Re estimates 5% to 7% annual premium growth for CAT exposed property

Insurance Company

Premium growth held at 2% by levers

Directing State Resources: Insurance Program vs. Insurance Company



Insurance Program

An expense that conservatively costs the state $130 million over 10 years

Insurance Company

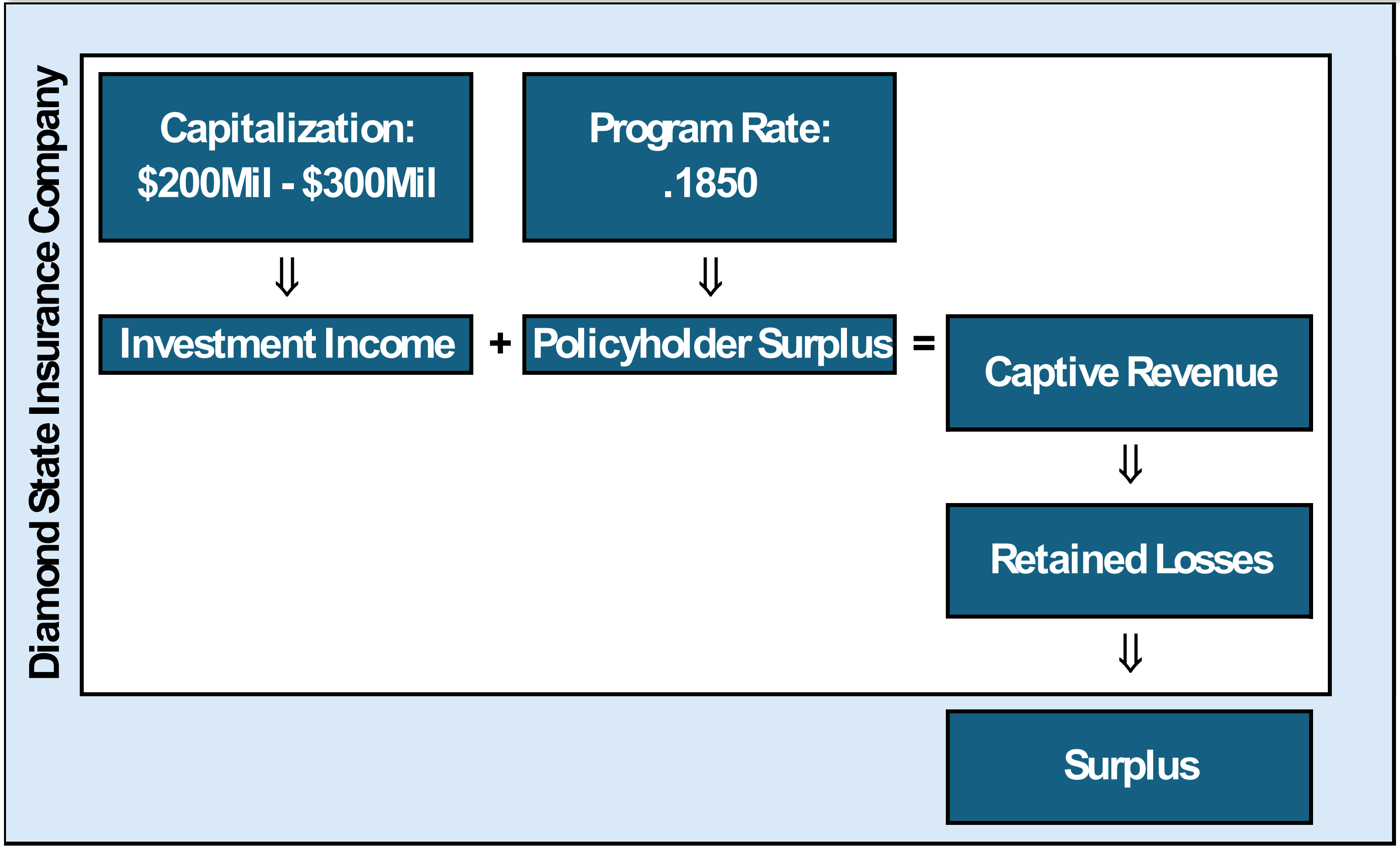
An asset that should generate $30 million in surplus over 10 years, while collecting lower premiums

Regaining Control

The only way to control the cost is to step into where the insurance companies are paying claims. Self-insuring the expected losses will lead to control over rates and cost

	Insurance Program	Insurance Company
Control	Market sets price, limited control.	Loss history sets price, greater control.
Costs	Premium costs expected to increase over time with natural disaster frequency and loss-cost inflation. Commissions and profit-requirements increase program costs.	Estimated cost savings of $10 to $12 million annually. Scale benefits entering reinsurance market; investment revenue should offset loss-cost inflation.
Values	Limits are inadequate: $500 to $700 million insured value, three separate programs.	Limits are adequate: $2.5 billion insured value.
Resources	Current staff tasked with risk management and purchasing insurance, resulting in sub-optimal outcomes.	Separate functions of risk management and purchasing insurance. Focus on the core competencies of loss prevention and managing claims.
Implementation	Zero implementation risk, “do nothing”.	High implementation risk mitigated by use of expert advisors and proper governance.

Special-Purpose Captive



Foundation for Captive

- Arkansas is a Captive Domicile
  - Captive legislation passed in 2001 and revised in 2017
  - 15 captive insurance companies in Arkansas by the end of 2022, $365 million in premium volume
  - Industry views Arkansas as “having highly available and experienced state captive regulators”
  - Very favorable tax environment

Demonstrates to Arkansas businesses, that they do not need to leave Arkansas to form a Captive Insurance company. This will bring back revenue to our state.

Elements for a Successful Captive

Funding and strategy are key:

Premiums collected from the schools and investment income must always exceed the loss forecast

- Capitalization must be sufficient to generate investment income that will help cover claims and protect the Captive
- Corporate governance must provide checks and balances to protect the Captive
- Proper valuation is critical to collect proper premiums for the Captive’s insured properties
- Focus on eliminating controllable losses and outperforming the loss forecast

Corporate Governance

<table>
<tr><th colspan="5">Arkansas Insurance Commissioner</th></tr>
<tr><th colspan="5">Board of Directors</th></tr>
<tr><th colspan="3"><u>Risk Finance</u></th><th colspan="2"><u>Risk Control</u></th></tr>
<tr><td>Reinsurance Broker</td><td>Captive Manager</td><td>Investment Advisor</td><td>Risk Manager</td><td>Claims</td></tr>
<tr><td>Placement
Risk Analysis</td><td>Accounting
Auditing
Actuarials
Tax</td><td>Strategy</td><td>Valuation
Risk Engineering
Loss Prevention
Claims Oversight</td><td>Adjudication
Settlement</td></tr>
<tr><td colspan="5">Annual Assessment of Insurance Company Retention</td></tr>
<tr><td colspan="5">Review of Deductibles, Policy Terms, and Conditions</td></tr>
<tr><td colspan="5">Evaluation of Sublimits, including Earthquake and Flood</td></tr>
<tr><td colspan="5">Determine Level of Coverage</td></tr>
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Levers

- <u>One-Time Levers</u>
  - Capitalization
    $200-$300 million
  - Captive Effective Date
    10/1/2024

- <u>Annual Levers</u>
  - Captive Retention *(Potential Rate Break)*
    $50 million
  - Deductibles Charge to Schools
    K-12: $25,000
    Higher-Ed: $250,000
  - Amount of Reinsurance Targeted
    $2.5 billion
  - Target Program Rate Charged to Schools
    .1850
  - Policy Level Terms and Conditions
    Margin Clause, Percentage Deductibles
  - Percentage of Schedule to Self-Insure
    Ex: $1 billion in value → $1.85 million in premium

Levers → Impact → Sustainability

Policy Term	Total Insured Value	Reinsurance Rate	Reinsurance Premium
2023-2024	$ 40,593,458,670	0.1050	$ 42,623,132
		Policyholder Surplus Rate	Policyholder Surplus Premium
		0.0800	$ 32,474,767
		Controlled Program Rate	Controlled Program Premium
		0.1850	$ 75,097,899

Impact - Looking Back

Policy Year	Incurred	Deductible $25k-$250k	Retention $50M	Reinsurance	Loss Fund	
2013-2014	$ 9,373,701	$ 3,101,843	$ 6,271,858		$234,202,909	
2014-2015	$ 9,941,911	$ 2,720,138	$ 7,221,773		$260,504,019	
2015-2016	$ 7,854,518	$ 2,544,422	$ 5,310,096		$288,678,810	
2016-2017	$ 11,636,598	$ 3,108,385	$ 8,528,213		$313,711,951	
2017-2018	$ 28,856,615	$ 4,006,931	$ 24,849,684		$322,294,896	
2018-2019	$ 10,670,073	$ 2,508,283	$ 8,161,789		$346,912,877	$232,312,978
2019-2020	$ 19,844,340	$ 3,151,628	$ 16,692,712		$363,667,452	$249,067,552
2020-2021	$ 35,658,201	$ 4,766,395	$ 30,891,805		$365,881,696	$251,281,796
2021-2022	$ 68,593,768	$ 3,193,744	$ 50,000,000	$15,400,024	$348,419,781	$233,819,882
2022-2023	$116,267,114	$ 8,033,510	$ 50,000,000	$58,233,604	$330,193,539	$215,593,639
2023 6 Months	$ 6,547,742	$ 862,067	$ 5,685,675		$356,281,622	$241,681,722
TOTAL	$325,244,581	$37,997,346	$213,613,605	$73,633,628		
10.5 YR AVG	$ 30,975,674	$ 3,618,795	$ 20,344,153	$ 7,012,726		
5.5 YR AVG	$ 46,832,952	$ 4,093,750	$ 29,351,269	$13,387,932		

Assumptions:

$200 million invested

Historical losses

.1850 program rate

.1050 reinsurance rate

$32.5 million policyholder surplus

4% return on investments

Impact - Looking Forward

Policy Year	Incurred	Deductible $25k-$250k	Retention $50M	Reinsurance	Loss Fund
2024-2025	$ 43,000,000	$ 4,618,566	$ 38,381,434		$ 198,621,583
2025-2026	$ 32,000,000	$ 3,463,925	$ 28,536,075		$ 206,949,816
2026-2027	$ 41,500,000	$ 4,041,245	$ 37,458,755		$ 206,602,470
2027-2028	$ 28,500,000	$ 3,175,264	$ 25,324,736		$ 218,286,693
2028-2029	$ 30,000,000	$ 2,886,604	$ 27,113,396		$ 228,558,465
2029-2030	$ 31,000,000	$ 3,463,925	$ 27,536,075		$ 238,724,591
2030-2031	$ 70,000,000	$ 5,773,208	$ 50,000,000	$ 14,226,792	$ 226,736,837
2031-2032	$ 31,000,000	$ 3,463,925	$ 27,536,075		$ 236,634,059
2032-2033	$ 59,000,000	$ 5,773,208	$ 50,000,000	$ 3,226,792	$ 224,360,880
2033-2034	$ 34,000,000	$ 3,752,585	$ 30,247,415		$ 231,243,982
TOTAL	$ 400,000,000	$ 40,412,455	$ 342,133,961	$ 17,453,584	
10 YR AVG	$ 40,000,000	$ 4,041,246	$ 34,213,396	$ 1,745,358	

Assumptions:

$200 million invested

$40 million loss forecast

.1850 program rate

.1050 reinsurance rate

$32.5 million policyholder surplus

4% return on investments

Protected by sideways insurance

Role of Risk Management

Opportunities to keep money in the program:

Preventing and controlling losses

- Fire, lightning, frozen pipes & flood, theft, vehicle impacts, sprinkler leakage as examples
- $50 million in these types of claims present an opportunity to keep money in the system

Precise valuations

- $12.5 million building → insured as $10 million → $18,500 in premium → **can still generate a $12.5 million loss**
- $12.5 million building → insured as $12.5 million → $23,125 in premium
- A healthy and sustainable insurance company collects proper premiums for exposure

Captive Recommendations

- Combine all programs into a special-purpose captive to provide catastrophic limits and lever economies of scale
- Capitalize with a minimum investment of $200 million
- Structure the insurance company to retain the first $50 million of loss
- Protect the capitalization with sideways insurance on retention
- Place reinsurance above retention up to $2.5 billion
- Charge sufficient premium to the schools to cover annual expected losses and reinsurance cost, creating policyholder surplus to be invested and to pay claims
- Establish corporate governance to eliminate conflicts of interest, provides checks and balances
- **Act Now**, begin operations by 10/1/2024

Captive Benefits

- Protects schools by providing controllable, affordable, adequate, and sustainable coverage today and for the future
- Access to reinsurance markets creates competition and improves access to capacity
- Controls cost, applying the same rate to all schools
- Eliminates frictional cost of multiple vendors while maximizing taxpayer value in financing
- Provides transparent, responsible corporate governance
- Immediately saves $10-$12 million day one
- Capitalized like an asset, not funded like an expense
- Sets precedent that other states will follow
- Proper valuations increase premium collected, adding more cash to the system for claims and investments
- Loss prevention decreases loss forecast, adding more cash to the system for claims and investments

Launching the Captive

The following actions need to happen in sequential order to deliver a positive outcome:

- Select implementation team
- Formation of the special-purpose captive
- Risk Finance begins operations
- Inclusion of remaining state property is evaluated
- Risk Management implements strategy for expanding valuation, loss prevention, and claims mitigation for properties that have not been under management
- Risk Finance recommends funding options
- Captive launched and programs rolled in