Member Equity Policy

I. Purpose:

The purpose of this policy document is to clarify members' rights and responsibilities in relation to their individual member equity account. While CIRSA's Bylaws provide the guiding principles, this policy details how these principles are applied in operation.

II. Member Equity Account Defined:

Each member has an individual member equity account. Their account balance quantifies their ownership share of the CIRSA pool(s) in which they participate. The sum total of all member equity accounts equates to the pools' total resources, or working capital.

Member equity account balances have been designated into loss, reserve and operating funds.

A separate loss fund is established for each claim year to fund claims to a certain dollar limit. A special loss fund, called the excess fund, has been established to fund claims over that dollar limit and up to the pool's self-insured retention. The reserve fund may be used to pay claims when contributions for a claim year are insufficient. The operating fund pays all other expenditures including administrative expenses and reinsurance premiums.

III. Calculation of Member Equity Account Balance:

Each member's entire contribution to the pool is deposited into their individual equity account. Those contributions are broken-out then deposited into their designated loss, reserve and operating funds.

Withdrawals from equity accounts include a proportionate share of all claims and expenses incurred by the pool, not just those directly attributable to their own entities. The proportionate share is determined by taking each member's individual contribution, by fund, relative to the pool's total contribution from all members.

A member's equity account is only charged for claims assigned to claim years in which they actively participated. A member's financial responsibility is determined separately for each claim year of participation. That percent share of responsibility is deducted from the member's account for all development on these claims until final settlement. Due to the nature of our coverage, it may take many years to reach settlement on all claims for any single claim year.

Operating expenditures are also deducted from a member's equity account proportionately to their contribution for the years in which they participate in the program. Former members may be charged an administrative fee which is deducted from their equity account.

Any residual balance of contributions remaining after deducting claims and expenses earns interest. Interest is allocated to individual member equity accounts proportionately to their relative balance.

IV. Evaluation of Member Equity Account Balance:

CIRSA engaged PricewaterhouseCoopers (PwC) to conduct a member equity study to aid the Board in determining the appropriate funding levels and target equity for CIRSA, and to ensure the continued financial strength and stability of CIRSA. PwC's comprehensive analysis identified and quantified the specific financial risks facing CIRSA, including underwriting risk, reserving risk, asset and credit risk, and operational risk. The analysis also provided a number of approaches for addressing those risks.

After review of PwC's July 2017 study, the Board has adopted the following as CIRSA's target equity policy for each of CIRSA's two pool funds (property/casualty and workers' compensation):

- A minimum member equity target is established at a 1-in-200 year occurrence.

- A maximum member equity funding level is established at two times a 1-in-200 year occurrence.

PwC's report identifies and quantifies the types of risks assumed by the property/casualty and workers' compensation pools and provides a methodology to re-compute the valuation of these risks going forward. Briefly, a 1-in-200 year occurrence is defined as a financial event occurring in the next one-year time horizon, for which there is a 0.5% chance that the current pool financial risks will fully deplete the pool's financial position. PwC will be engaged periodically to update their evaluation of the pool's risk profile. Between studies, staff will update annually the valuation of a 1-in-200 year occurrence, and update ranges to reflect evolving risks as our membership changes and grows.

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. Public entity self-insurance pools were established as 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 member entities, the annual costs of pooling were still uncertain; thus, some form of capital was required. Initially, the capital for some pools came in the form of the assessment power. The assessment power permits a pool to assess additional contributions against its members retrospectively in order to avoid financial impairment or insolvency. In Colorado, the assessment power is required by the state Insurance Commissioner to be included in a pool's formation documents. Such a power, while providing a safety net in the event of a financial shortfall, can be problematic to exercise; those pools that have had to use the assessment power have no doubt faced resistance from members and former members.

CIRSA's Board has always been of the view that the assessment power should not be relied on as a substitute for financial stability. For this reason, CIRSA has over time built up a capital position intended to protect against the risks inherent in pooling. In so doing, the question has had to be confronted: are the funds being held by CIRSA are adequate for that purpose, too little, or too much? The PwC study provides a tool to help answer that question.

PwC Approach

PwC combined CIRSA's risk assessment profile with CIRSA's risk appetite/tolerance to assist in determining the appropriate levels of member equity. PwC uses two main parameters in determining adequate funding levels:

1. **The organization's risk appetite/tolerance** - The organization'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 CIRSA's own risk profile and includes:

    a. Underwriting Risk (also known as pricing risk) represents the 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 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 the 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, CIRSA is able to make informed decisions, by weighing the cost of capital against the estimated benefits in terms of equity growth and CIRSA's overall risk appetite.

In keeping with the fund designations of equity account balances, the overall target balance is designated to the excess, reserve and all other funds. These target amounts, by fund, are then allocated to active and former members. The allocation is based on their percent share of responsibility for claim years in which there are unsettled claims.

V. Member Equity as a Factor in Determining Member's Contributions:

A member's equity account balance is a factor in determining their ongoing contributions to the pool.

Specifically, each member's contributions to the excess and reserve funds are contingent on their equity account balance in these funds. A member's contributions to the excess and reserve fund are discounted as their actual equity account balance reaches their allocated share of the target.

VI.. Distribution of Member Equity:

The Board will annually review CIRSA's equity status, and when the equity amount is over the maximum pursuant to the policy set forth below, equity will be returned to members.

The following policy applies separately to the net equity position of the CIRSA property/casualty and the workers' compensation pools:

- Equity will be managed to fall within the range minimum (1-in-200 years) and maximum (2 times 1-in-200 years) by using Board-approved methods.

- If the equity balance is below the minimum amount of the range, or is between the minimum and maximum amount of the range, no equity will be distributed unless specifically authorized by the Board.

- If equity is over the range maximum, all equity over the maximum will be returned to members and former members in the manner prescribed in the CIRSA Bylaws and Intergovernmental Agreement.

Distributions are deducted from the recipient members' equity accounts. Distribution to any individual member is limited to the balance in their equity account.

VII. Withdrawn Members:

Even after withdrawal from a pool, a member's equity account is maintained for their benefit. Their account balance will change over time due to their proportionate share of development on claims assigned to claim years in which they participated and interest earnings on their account balance. Also, an administrative fee may be deducted from their equity account or billed.

When the Board approves a distribution of member equity, this may include withdrawn members. Equity account balances are not fully distributed until all claims are settled for the claim years in which they participated.

If a former member reapplies to the pool, their equity account balance will factor in quoting their contribution for coverage.

After the reserve fund is used to pay claims for a claim year in which previous contributions were insufficient, the Board may determine that replenishment of the reserve fund is necessary. Replenishment may include an allocation to former members.

VIII. Expelled Members:

An expelled member loses all rights to their member equity balance. Their balance will be redistributed by proportionate share to all other members. For each applicable claim year, the proportionate share is determined by taking each member's individual contribution, by fund, relative to the pool's total contribution from all members.

IX. Reporting of Member Equity Account Balances:

Each April, members receive an equity report which provides their balance as of December 31 of the previous year. Enclosed with the member equity report is a copy of CIRSA's independent audit of the pool's overall financial position.

Revised: 8/1/17