INFORMATION MEMO

LMCIT’s Financial Stability

Solvency and financial stability are critically important considerations, whether dealing with the League of Minnesota Cities Insurance Trust (LMCIT) or an insurance company. Learn about LMCIT’s financial strength, financial management practices and reinsurance protection and how these factors make it extremely unlikely that LMCIT would ever need to make an assessment of its members.

RELEVANT LINKS:

I. Financial stability

Agents representing private insurance companies have occasionally suggested that cities should be concerned because LMCIT's coverage is assessable. That is, the LMCIT coverage document gives LMCIT the authority to make an additional charge against the member city in the future, if LMCIT should need those additional funds in order to cover losses and expenses. Therefore, the argument goes, even though LMCIT has returned substantial dividends to its members in each year since 1987, cities should be wary of LMCIT because they might have to pay an additional assessment in the future. It's also been suggested that the city would therefore be better off dealing with a licensed insurance company that's protected by the state guaranty fund.

LMCIT Board of Trustees.

LMCIT has operated since 1980, and has never come close to needing to call on its members for additional contributions. An assessment would only become necessary if LMCIT were virtually bankrupt. LMCIT's financial strength and stability are an extremely high priority for the LMCIT Board of Trustees. The Trustees' policies and decisions on rates, reserves, fund balances, dividends, etc. are very conservative, designed to minimize the risk of financial problems. Here are some of those key financial policies:

- LMCIT fully funds all projected liabilities, undiscounted, at their full actuarially projected ultimate cost. Actuarial reviews are conducted annually.
- LMCIT maintains a very strong fund balance in addition to fully funding losses.
- LMCIT's rates are designed so that when combined with investment income they fully cover projected losses and expenses plus a substantial margin of safety.

145 University Ave. West
Saint Paul, MN 55103-2044
www.lmc.org
(651) 281-1200 or (800) 925-1122

RELEVANT LINKS:

LMCIT cannot unequivocally guarantee that it will never make an assessment, nor can any insurance company unequivocally guarantee they won't go broke and be unable to pay your claims. No one can predict the future, and it's always possible to imagine a conceivable scenario in which LMCIT would run out of funds and have to come back to the cities for an additional assessment.

But we can say that it would take a very unlikely combination of a number of different kinds of problems before LMCIT would need to make an assessment. Essentially, we're talking about a combination of an unprecedentedly large number of large claims, combined with the simultaneous bankruptcy of some of the largest reinsurers in the world. That's not to say it can't happen, but that combination of circumstances would also mean the entire insurance industry would be in a great deal of trouble – probably essentially broke.

For a city that is seriously concerned about that very small risk of having to pay a future assessment, here's a simple solution: Take part of the dividends you've received from LMCIT and set those funds aside as a reserve to pay that assessment if you ever had to do so.

II. Financial strength

LMCIT is extremely strong - stronger in fact than most insurance companies. The LMCIT Board of Trustees has always taken a very conservative approach in setting premiums, establishing loss reserves, and maintaining fund balances. These conservative financial practices translate into an extraordinarily solid financial condition. It may be helpful to look at some figures to see just how strong LMCIT really is.

A. IRIS ratios

Insurance regulators use a series of financial ratios called the IRIS (Insurance Regulatory Information System) ratios as a tool to evaluate the solvency of insurance companies - that is, to identify insurance companies that may be at risk of becoming insolvent. By looking at these same financial ratios for LMCIT, we can get an indication of how likely it is that LMCIT might develop the kind of financial problems that might make an assessment necessary.

RELEVANT LINKS:

Appendix A, IRIS financial ratios for LMCIT insurance programs.

The table in Appendix A shows the IRIS financial ratios for the LMCIT property/casualty and workers' compensation programs. The table also shows what the insurance regulators would consider an "unusual" figure for each ratio; i.e., a figure that might indicate possible future financial problems. For comparison, we've shown the same ratios for a couple of commercial insurers that are in the municipal insurance business, along with the average and median figures for commercial insurance companies generally for 2013, the most recent available.

With two exceptions, LMCIT's IRIS ratios are well within the range that insurance regulators would consider "usual." Overall, LMCIT's IRIS ratios compare very well with the average or the median for the insurance industry, and with those of companies that most people would think of as being strong and solid.

The two exceptions are LMCIT's workers' compensation program's two-year operating ratio and change in surplus. For 2013, these ratios are outside the "usual" range because of a significant increase in the actuarial estimates of the program's liability for future medical costs on incurred claims. In the subsequent 2014 actuarial review, the estimate of future medical costs was reduced substantially compared to the 2013 projection.

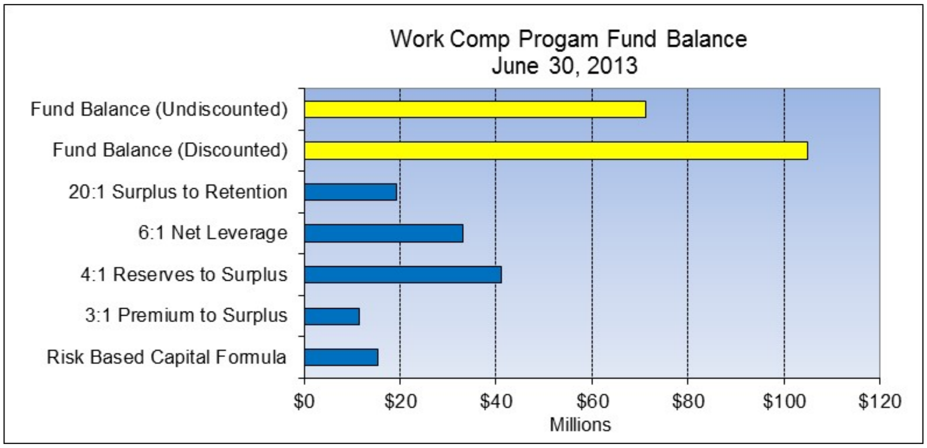
B. Risk-based capital formula

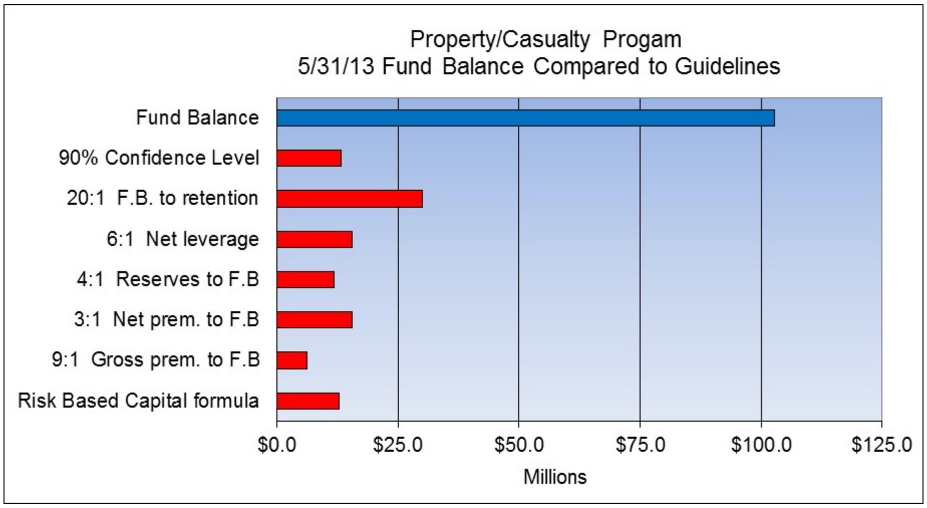
Another tool that insurance regulators use to evaluate an insurance company's financial condition is to calculate the company's "risk based capital" (RBC) requirement. The formula for the RBC calculation is designed to quantify various kinds of risk that an insurer is exposed to. These include not just the risk of losses on the insurance the company writes, but also other risks like investment risk, credit risk, and so on.

The RBC formula calculates a minimum fund balance (or "surplus" or "capital"; for this purpose the terms are interchangeable) the insurer should have in order to be reasonably assured that they're adequately funded. If an insurance company's surplus falls below half of that amount, the insurance regulators are authorized to take control of the company.

The charts below show the recommended minimum surplus under the RBC calculation for the property/casualty and workers' compensation programs, compared to LMCIT's actual fund balances. Also shown is the minimum fund balance indicated by several other common rules of thumb used in the insurance industry.

RELEVANT LINKS:





C. Stress testing

The LMCIT Board of Trustees uses a “stress-testing” approach as another way to evaluate fund balance adequacy. The stress test looks at several different “stressors” – extreme events that could result in a very large financial loss to LMCIT. It then calculates the amount of fund balance needed to be able to still meet minimum financial ratios even after incurring that very large financial loss. LMCIT's fund balances exceed the amounts suggested by any of these guidelines.

These fund balances are in addition to the reserves set aside for actual and projected losses. In short, LMCIT's funding is more than adequate by a wide margin to handle nearly any conceivable risk, without needing to go back to member cities for an additional assessment.

RELEVANT LINKS:

D. Reinsurance

There wouldn’t be much effect to LMCIT's finances if there was a single or series of catastrophic losses, as the catastrophic tornado losses in 1998 demonstrated. LMCIT anticipates that such losses will occasionally occur, and purchases reinsurance to deal with those risks. LMCIT retains the first $1 million per occurrence of property risk and $2 million per occurrence of liability risk.

Several different reinsurance agreements or "treaties" protect LMCIT and member cities against various kinds of risks:

- The casualty excess or "clash" treaty protects against the risk that our liability and related loss costs could exceed $5 million on a single occurrence.
- The excess liability treaty reinsures losses in the optional excess liability coverage. LMCIT retains responsibility for 40% of losses in the first $1 million layer of excess coverage.
- The excess property treaties cover up to $250 million per occurrence of property losses in excess of $1 million per occurrence.
- The equipment breakdown coverage provides $100 million of protection, plus $5 million for loss of income/extra expense, over a minor $100,000 retention.
- The Minnesota Workers Compensation Reinsurance Association (WCRA) reinsures LMCIT’s workers’ compensation risks above a $490,000 retention.

Appendix B, LMCIT reinsurer financial ratings.

LMCIT's reinsurers are among the largest and strongest in the world. Together, these reinsurance treaties help assure that regardless of how large a loss occurrence LMCIT might experience, no single occurrence or series of occurrences would pose a serious financial threat to LMCIT.

III. State guaranty fund

Minnesota Insurance Guaranty Association.

One question that is sometimes asked is, “Doesn't the state guaranty fund mean that in the case of a bankruptcy we'd be better off with an insurance company than with LMCIT?” The answer is no, not really. If a licensed insurance company becomes insolvent and doesn't have enough money to pay your claims, the Minnesota Insurance Guaranty Association (MIGA) may step in and pay some claims for some claimants, but the protection MIGA provides is actually quite limited and uncertain.

RELEVANT LINKS:

Minn. Stat. ch. 60C.

- MIGA protection is limited to $300,000 per claim. That would leave a big hole if a $3 million building burned down, or you got stuck with a $1 million liability judgment.
- A city receives no protection at all from the guaranty fund if the city's "net worth" is more than $25 million.
- The legislature can take away the MIGA protection at any time. That's what happened to about 30 Minnesota cities that bought workers' compensation insurance from the Home Insurance Company in the '70's and '80's. When they bought the policies, the law said that MIGA guaranteed the workers' compensation claims would be paid. Then the legislature changed the law to add the "$25 million net worth" exception. When Home later went broke, the cities with open old workers' compensation claims got stuck paying those claims themselves.

In short, MIGA provides only limited protection and only to some claimants; and whatever protection it does provide may or may not still be there in the future when you need it.

On the other hand, in the very unlikely event that LMCIT would ever find itself without enough money to pay the city's claims, LMCIT would make an assessment. That assessment would produce the funds to assure the city's claims are paid in full. With over 800 member cities and combined property/casualty and workers' compensation annual premiums of over $90 million, even a small percentage assessment raises a very substantial amount of money.

In short, LMCIT's assessability feature really means that in return for an extremely small risk of having to pay a small assessment in the future, the city gets an extremely high degree of assurance the city's claims will be paid.

IV. Further assistance

Pete Tritz
LMCIT Administrator
651.281.1265
800.950.1122
ptritz@lmc.org

For additional information please contact LMCIT's Administrator.

Appendix A

IRIS financial ratios

This table shows the IRIS financial ratios for the LMCIT property/casualty (P/C) and workers' compensation (WC) programs.

IRIS Ratio	An "unusual" value is	LMCIT P/C	LMCIT WC	Travelers P/C	SFM P/C	P/C average for insurance companies	P/C median for insurance companies
1. Gross premium to surplus	Over 900	53.5	55	68	144	651.3	119
1A. Net premium to surplus	Over 300	44.3	52.4	63	140	439.5	44
2. Change in net writings	Over +33 or under –33	2.1	4.6	3	4	0	2
3. Surplus aid to surplus	Over 15	0	0	0	0	5.8	0
4. Two-year overall operating ratio	Over 100	72.5	128.8	75	91	0	88
5. Investment yield	Over 6.5 or under 3.0	3.12	3	7	2.9	2.2	2.1
6. Change in surplus	Over 50 or under –10	-9.9	-31.6	27	10	53.6	5
7. Liabilities to liquid assets	Over 105	44.2	77	89	90	80.9	57
8. Agents' balances to surplus	Over 40	14.8	5.8	7	6	18.5	3
9. One-year reserve development to surplus	Over 20	-2.2	0.7	-2	-2	10.9	0
10. Two-year reserve development to surplus	Over 20	-10.4	-1.8	-5	0	15.9	0
11. Est. current reserve deficiency to surplus	Over 25	-7.1	-24.2	2	5	138.6	0

Appendix B
LMCIT reinsurer financial ratings

This table shows the financial ratings for LMCIT's reinsurers.

Reinsurer financial ratings	**Standard and Poors**	**Best's**
Gen Re	AA+	A++
Munich Re	AA-	A+
Lloyd's	A+	A
Great American	A+	A+
Mutual Boiler Re	AA	A+
NLC Mutual	Unrated	Unrated
WCRA	Unrated	Unrated