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# Pooling 101

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Self-Insured Groups (SIGs) are a very good way to cover one's workers' compensation liabilities for someone who understands the principles of risk finance and pooling. Pooling has nothing to do with swimming (hopefully), but has to do with collectively sharing risk and funding it as a team, not individually, as many companies do under stand-alone self-insurance.

Is this a new concept? Certainly not. Pooling workers' compensation liabilities (in California) has been around since the 1970's, when governmental entities found it difficult, if not impossible, to obtain various forms of insurance; including workers' compensation from the standard markets. The solution was for the various cities, counties and special districts (fire, water, park & recreation, etc.) to join together and create Joint Powers Authorities ("JPAs"), which are, for all intents and purposes, public sector SIGs. (See: <http://www.cajpa.org/about>)

The essential problem of risk financing is claim volatility; if you are self-insured you may have no claims one year, a few the next, more the next, a large claim in the fourth year, none in the fifth, etc. Self-funding can make management of cash flow very difficult.

How does pooling work? Well, before a SIG/JPA is even started, the various members agree to pool their resources (money) into the entity to fund the losses and other costs (excess insurance, TPA costs, accounting fees, actuarial fees, legal fees, administration fees, broker fees, loss control and safety fees, etc.), so that all of the regulatory and other needs of the SIG/JPA are met. [Of note, the California SIG regulations have codified many of the best pooling practices into them, which requirements do not exist for JPAs. (See e.g. <http://www.dir.ca.gov/t8/ch8sb2a13.html>)]

In describing the pooling concept, it's somewhat like how the Bailey Bros. Building & Loan Association [Jimmy Stewart's financial institution] operated in the movie *It's a Wonderful Life*: <https://www.youtube.com/watch?v=iPkJH6BT7dM>. [Note that at the end of the clip, all turns out OK.]

Importantly, all members of a SIG/JPA have to be committed to the pooling process and entity like a "marriage" and not a "fling." SIGs are NOT a market that can be entered to get the best rate for one year and then left to chase the lowest rate the next year. Conversely, both SIGs and JPAs are long-term commitments, where all of the participants are in the relationship for the long haul, through sickness and injury, until death do they part...or something like that.

Why? Because actuarially speaking, everyone has a bad day. So, today it's Mr. Martini's company, then it's Joe's company [see film clip above], and on and on, so that eventually every SIG/JPA member will have claims – large and small. So, if everyone in the SIG/JPA uses proven and reliable risk control (as a means to lessen their claims), then the injuries incurred will likely be true accidents and not the result of unsafe workplace conditions. Thus, once all members of the SIG/JPA are as safe as all other members, then as accidents occur, the cost will be spread across all of the members, so that every member will have their turn at having the "bad" accident year, but the annual out-of-pocket cost of each member will be stable. And, as the losses occur, the SIG/JPA will have enough money to cover those losses.

How does this work? Well, it's the law of averages. If you ask an actuary "does having 80 (of 100) years without any significant losses mean that I won't have any significant losses in the



future (when calculated at the 80<sup>th</sup> percentile actuarial confidence level),” they will likely tell you that your next 20 years will all have significant losses above the number initially given. Why? Because that’s what the 80<sup>th</sup> percentile actuarial confidence level means... i.e., in 80 of 100 years, your losses will be less than or equal to the number that they’ve calculated the annual losses to be. [Of course, if you have 80 straight years without significant losses, then you’re more (statistically) likely to be dead of old age than you are to be worrying about your claims! Or perhaps, your actuary should reconsider the assumptions.] This is why I like to say 8 out of 10, or 4 out of 5 years, but that just leaves room for the argument that the claim years have not had time to fully develop.

Mostly, pooling is about finding good quality people to go into business with, as your pooling partners, along with the advisors that will assist you in setup and operation of your SIG/JPA. As stated in a prior blog, you need to be able to trust those with whom you are partners. Then, when hard times hit, everyone will stand up and pay their share of the necessary amount to make the SIG/JPA whole. This might be the way of the evil “A” word (assessment), which is no more of a truing up of what the initial contribution should have been when first paid; just as a dividend is a truing up of the overpayment that you made when you initially paid your premium in standard insurance.

Does an assessment mean that someone messed up? Not usually. As I will discuss in a later blog, it’s a truing up that can occur in a myriad of cases. So, stay tuned.

As for pooling, the old adage about not swimming with sharks or alligators holds true: Make sure that you know and can trust everyone, with whom you swim, and you should be OK.

