August 19, 2014

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Submitted to the ERISA Advisory Council, United States Department of Labor

Issue: Outsourcing Employee Benefit Plan Services
Specific Discussion Topic - Insurance

My name is Brian Smith and I am the Chief Operating Officer of Segal Select Insurance Services, Inc. Segal Select is a wholly owned subsidiary of The Segal Group and operates as a national insurance broker. Segal Select specializes in four core products in two industry groups. The core products are:

- Fiduciary liability insurance,
- ERISA fidelity bonds,
- Employment practice liability insurance, and
- Cyber liability insurance.

The two industry groups are:

- Taft-Hartley jointly-trusteed multiemployer benefit plans and
- Public Sector benefit plans.

I have been asked to speak to you today about "insurance." More specifically, insurance that plan sponsors should seek or require from their various service providers. Although seemingly straightforward, the subject, like most ERISA topics, can be extremely complex. My goal is to provide clarity by proposing general guidelines that plan sponsors can use and recommendations for the Department of Labor (DOL) to consider. I will begin by explaining some basics about the insurance industry and how it relates to ERISA plan sponsors and benefit plans. I will then address the types of insurance policies that a plan sponsor may want to require from their service providers, what is available in the market, and some other considerations.

The Insurance Industry and Its Point of View

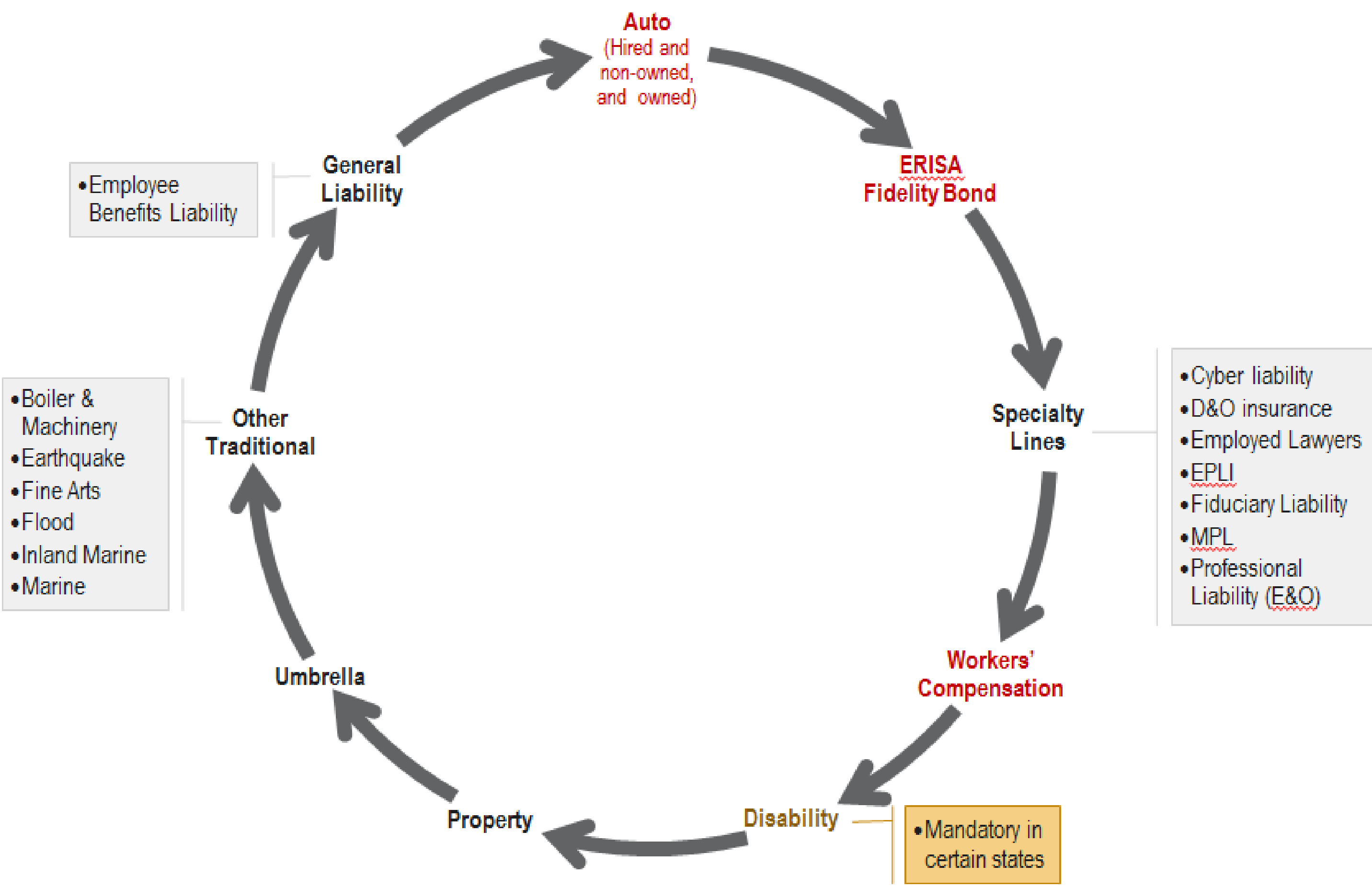
The insurance industry is primarily regulated by the states – each state establishes its own statutory law, regulated and enforced by a State Insurance Commission. For insurance carriers, this state statutory structure introduces layers of compliance and complexity. ERISA does not change this except for §412, which mandates the purchase of an ERISA fidelity bond, when applicable, and §410(b), which permits the purchase of fiduciary liability insurance.

The insurance industry is divided into two components: life, accident, and health (LAH), and Property and Casualty (P&C). Today's discussion will focus on the P&C component.

Within the P&C segment, insurance lines are further divided into traditional property and casualty, and specialty lines. P&C offers multiple policies and each is underwritten based upon an insurance carrier's own priorities and regulatory compliance requirements. Once underwritten, the policy may or may not be consistent in language (even within the boundaries of the same insurance carrier). Depending on the type of insurance, the policy and rating formulas may be highly regulated and each policy must be negotiated and approved by each State Insurance Commissioner before it can be sold. Depending on the state, this may be a file and use procedure or a negotiation. It may take more than a year for an insurance carrier to get a single policy approved in all 50 states. This complexity is one reason why many policies have "state amendatory" endorsements attached, and why endorsements are generally used to amend an otherwise-approved policy.

Traditional P&C includes policies for property, casualty (general liability), auto and workers compensation. Fiduciary liability, fidelity bonds and professional liability are examples of Specialty Lines. These and other types of insurance are represented in the following graphic:

Potential Types of P&C Insurance



Red = Mandated Statutory Insurance

Source: Segal Select Insurance Services, Inc.

Plan Sponsor Requirements for Provider Insurance Coverage

Next, let us take a brief look at the types of insurance a plan sponsor should consider or require from its service providers. In addition to selecting the type of policy, the most basic guidelines include selecting the insurance carrier, the limits of liability, cost, scope of coverage and broker selection.

Insurance Carrier – Trying to analyze the financial strength of an insurance carrier and keeping that information current is an almost impossible task. At Segal Select, we use the data provided by rating agencies such as A.M. Best, Standard & Poor's or Moody's. We do recognize the limitations of the existing rating agencies to capture key information about financially distressed insurers. Therefore, it is crucial for plan sponsors to consult with their insurance broker to determine the "rating level" (financial strength rating) that is appropriate.

Limits of Liability – Two issues should be addressed: Is sufficient capacity (limits of liability) available? And, what limit of liability should be required? In general, capacity is not an issue except in a situation where premium volumes and loss ratios do not support writing very high limits of liability, *e.g.,* certain lines of professional liability insurance. When considering the limit of liability that should be required, cost becomes the major consideration.

Cost – Insurance is a risk transfer in which the insured pays a premium now for the potential of a much larger future payout should a covered loss occur. In determining the premium, insurance carriers look at such factors as the type of risk, the potential severity and frequency of a loss, market share and revenue potential. In some product lines, including workers compensation, cost may be highly regulated by the states. In other lines, such as professional liability coverage, there may be less regulation and various underwriting factors may produce a significant premium cost. For service providers with thin profit margins, the cost of insurance can be significant.

An example may be illustrative: In the broad category of professional liability insurance, premiums may range from one percent or less of the limits of liability purchased (*e.g.,* $1,000 premium per $1 million in limits of liability) to premiums in excess of ten percent of the limits of liability purchased ($100,000 per $1 million in limits of liability). If a plan sponsor requests options for $1 million, $3 million and $5 million in limits of liability, the premiums may range from $1,000 to $500,000 or more.

Scope of Coverage – Scope of coverage is the breadth of coverage provided. In an *ideal* world, one insurance policy would cover everything. In the *real* world, no single insurance policy can cover every possibility. In general, insurance must contain a "fortuitous" element: there must be an element of chance. Insurance policies also contain exclusions, which represent exposures an underwriter does not want to or cannot cover.

Broker Selection – Most commercial insurance carriers sell their insurance policies through a network of independent agents and brokers. For the plan sponsor, the benefit plans and the service providers, the choice of the right broker (another service provider) is critical. Insurance is a universe of specialization and the right broker must be selected for the specific coverage being sought.

Assessing Risk

In addition to all the items just discussed, in determining what type of insurance is needed and available in the market, the plan sponsor, possibly with the assistance of a broker should perform a risk assessment to determine requirements for service provider insurance coverage. Here are some specific examples:

1. **ERISA Fidelity Bond** - If the service provider "handles" plan assets, then an ERISA fidelity bond is required. Fulfilling this requirement, however, can be a complex process and requires an understanding of §412 of ERISA, §2580 of the Department of Labor's "Temporary Bonding Rules," and the DOL's 2008-04 Field Assistance Bulletin (FAB). This also results in my first set of recommendations:

   Any service provider that "handles" plan assets should be required to purchase an ERISA-compliant fidelity bond. Based upon the DOL's 2008-04 FAB, compliance includes but is not limited to:

   - the plan must be a named insured on the bond,

   - the amount of the bond must be compliant, (under ERISA the maximum is $500,000 per plan), and

   - the bond must provide first dollar coverage (*i.e.,* no deductible).

   Subject to certain requirements, §412(2) and (3) exempt certain entities from ERISA fidelity bond requirements. Banks, which may serve as plan custodians, fall under this exception due to the fidelity bond they are already required to buy through their regulator. Depending upon the assets handled by the custodian, the plan sponsor should determine the custodian's fidelity bond limit of liability and decide whether an even higher limit of liability should be required.

2. **Professional Liability Insurance –** Service providers are by definition providers of professional services. Requiring them to purchase professional liability insurance gives plan sponsors additional recourse beyond their own financial strength and adds due diligence because the service provider has been underwritten by an insurance carrier[1].

   We recommend that professional liability insurance should be required.

   The real consideration is what limits of liability and what scope of insurance are needed. The scope of the work being performed by the provider and the financial consequences of mistakes must be considered. Knowing that mistakes will happen is a given, but what will be the cost of the mistake? Will it be measured in hundreds of dollars, millions, or even more? This must be balanced against the cost of the insurance. Because professional liability insurance can be extremely expensive, the service provider's goal will be to pass it along to the plan sponsor.

   Here are three specific coverage observations:

   The **scope of coverage** for a professional liability policy is heavily dependent upon the definition of professional services. The plan sponsor should require that each service provider contractually warrant that the definition of professional services within its

[1] The scope of due diligence or intensity of underwriting done by an insurance carrier cannot be determined, so for this plan sponsor, this "due diligence" standard is minimum. It will be significant if a service provider says it cannot purchase professional liability insurance.

professional liability policy is sufficiently broad to cover all of the work for which it is being engaged to perform.

ERISA exclusion – Most, if not all, professional liability policies contain a broad exclusion for anything "involving, arising out of, or in any way related to ERISA" (exact language will vary). The existence of this exclusion defeats the purchase of the insurance for any professional work done on behalf of an ERISA plan sponsor or benefit plan. At Segal Select we have reviewed many professional liability policies and see this exclusion frequently. However, the intent of this exclusion should be to exclude only ERISA liability for plans sponsored by the service provider; that is, for plans it sponsors for its own employees. If asked, the insurance carrier should be willing to clarify this with an endorsement that specifically says it applies only to plans sponsored by the service provider or that it does not apply to any service provider client to which it is providing professional services.

Multiemployer plan exclusion - For service providers to multiemployer benefit plans, plan sponsors must be careful to look for policy language that excludes coverage for any union, union sponsored, or multiemployer plans. (Again, the exact language of the exclusion will vary.)

3. **Traditional P&C and other Specialty Lines –** Most of these will not really relate to the service provider's services and, therefore, need not be discussed today. Nonetheless, plan sponsors should always be aware of these coverages as they are important part of any entity's financial viability. In addition, certain coverages may be relevant. For example, for multiemployer plans, if a service provider is being engaged to host a Board of Trustees meeting or other plan meeting that will be attended by various service providers and guest presenters, the plan may want to require general liability insurance with certain minimum limits of liability.

In all instances, the concept of risk assessment is the starting point. From there, the type of insurance coverage can be identified, and required limits of liability must be balanced against the premium costs.

I have one more observation and recommendation: §404(a)(1)(A)(ii) of ERISA requires a fiduciary to defray "reasonable expenses of administering the plan." Our experience at Segal Select has been that the plan sponsor, for example, a multiemployer plan Board of Trustees, interprets this requirement as a need to obtain multiple quotes and purchase coverage at the lowest premium cost. But, multiple quotes may not be available and the lowest premium cost may provide a policy that is grossly inadequate with respect to limits of liability, scope of coverage or both.

Conclusion

Using the principles of risk assessment and a knowledgeable broker(s), plan sponsors can identify appropriate insurances to be required by its service providers.

DOL Recommendations

We do have two specific recommendations for consideration by the DOL:

1. ERISA Fidelity Bond -- The DOL's "Temporary Bonding Regulations" date back at least four decades. Its 2008-04 FAB provides some clarity but further clarity would help. We recommend that both the DOL's Fidelity Bond regulations and its 2008-04 FAB should be reviewed and updated.
2. Defraying Administrative Expenses -- We recommend that the DOL consider providing guidance as to what §404(a)(1)(A)(ii) of ERISA means with respect to purchasing insurance.

Thank you for your time and attention. I am available to answer any questions.