



Reserve Leverage ratio:

$$\frac{\text{Loss Reserves}}{\text{Net Position}}$$

Risk transfer represents a unique product and pricing structure as compared to most business transactions. Typically, businesses sell items that have precise costs. However, final costs in risk transfer relationships are not known for years or possibly decades - which makes understanding potential ramifications of long term costs all the more important for pools.

On a pool's annual balance sheet, the unknown part of risk transfer costs include case reserves and reserves for claims that are incurred but not reported (IBNR). Reserves exist as a liability to the pool at the evaluation date of its financial statement. The reserve leverage ratio measures the relative size of those liabilities by comparing a pool's reserves to its net position, to estimate the pool's ability to absorb larger than expected losses. Generally speaking, the lower the ratio, the more financially able the pool is to absorb costs in excess of booked reserves.

Pool reserve leverage ratios are typically within the same range as those in the insurance industry. Typical ranges might be between 0.5 to 2.0. Reserving practices vary from pool to pool, so reserve leverage ratios will also vary. Higher ratios, although more leveraged, could also signify conservative reserving practices to smooth volatility for members and accommodate unexpected reserve development in longer-tailed lines of coverage such as workers' compensation.

For a pool with loss reserves of \$8 million and net position of \$2.5 million, the reserve leverage ratio is 3.2. This pool might decide to increase its net position to accommodate its booked reserves.

Because the reserves used to calculate this ratio are net of reinsurance, pools should be cognizant of the amount of reinsurance recoveries they might receive. Uncollectible reinsurance could substantially increase this ratio and affect the pool's financial strength. As with any ratio, monitoring pool performance over time and by multiple metrics is a good idea.