Loss Sensitive Financing Options

The risk manager has several options for selecting risk financing that offers a wider array of loss sensitivity. These options range from a program very similar to simple financing options, to a fully retained or "self-insured" option. It is nothing more than a matter of determining the mix of internal financing and external financing provided by insurance carriers.

Large Deductible Plans

Mechanically, large deductible plans are like small deductible plans in a few areas. Generally, an insurance carrier issues the policy, the insurance carrier retains the claims settlement function, and the insurance carrier or agent/broker issues certificates of insurance. Because the insurance carrier has a financial rating and may be an admitted carrier, this satisfies most requirements of certificate holders and regulators. However, the underlying difference is more pronounced. The insured has the opportunity to negotiate a much higher deductible (or retention) amount, and more than a minor premium reduction, while still maintaining the framework of a conventional insurance policy.

Specific Differences

"Large" deductible is a relative term, but in this context, it generally refers to a retention of $100,000 or more. The actual deductible amount is obviously negotiable, and can reach as high as $1,000,000, or in some special cases, it may even equal the policy limit.

Since the large deductible is negotiable, the risk manager must be careful in selecting the appropriate attachment point. The size of the deductible means there is a great deal of loss sensitivity, causing the insured to have an incentive for effective loss control programs. The process of stratifying losses and calculating the estimated losses (the loss "projection") is critical for both the insured and the insurance carrier. Part of the attachment point/deductible amount selection process involves a determination of whether or not aggregate protection (the maximum amount the insured will have to pay in a given time period) is needed. However, aggregate protection, when available in the marketplace, can be expensive.

Another characteristic that requires serious consideration is the tax impact. Premiums are deductible as paid (under cash systems) or incurred (under accrual systems), but losses are only deductible when paid, even by an accrual system taxpayer. This adds another layer of complexity to the analysis of the cash flow advantages of a large deductible plan.

Advantages

A large deductible plan has many advantages over a small deductible plan. First, the potential for positive cash flow is much greater, and related to that is the opportunity for a big payback for loss control efforts. Since the carrier is further removed from the financial responsibility of claims, the insured may be able to customize coverages to specifically meet the organization's needs, as well as services, purchasing only the services desired (known as "unbundling"). The insured also may have some influence on setting claims reserves and on settlements, although the ultimate responsibility remains with the carrier. Finally, because of these abilities to negotiate and customize services, the insured should be able to receive lower expense components and loadings, further reducing the premium and the total cost of risk.

Lastly, a large deductible may be a first step toward being fully self-insured or retaining 100% of the risk internally. It allows the organization to gain experience as a self-insured entity without assuming 100% of the risk.

Disadvantages

The advantage of positive cash flow has its mirror image: a larger deductible has the disadvantage of a grander scale of negative cash flow if the plan's loss experience deteriorates. Consequently, an accurate determination of the attachment points (the level of the individual claim limit and the aggregate claims limit) is critical. A related disadvantage is that aggregate protection may be cost prohibitive or not available in the marketplace.

The third serious disadvantage is that the insurance carrier generally requires financial guarantees or collateral to protect their financial position. These guarantees can be expensive in terms of the actual cost and can affect the insured's capability to borrow funds for operations or other uses. As long as claims remain open—a possibility that may run into years—the insured must maintain the collateral or security. As large deductible plans are used year after year, the collateral "stacks" with each year, requiring its own collateral to be maintained over the life of the claims. Thus, the financial impact of tying up credit can increase dramatically over long periods of time.

The Collateral Conundrum

A simple definition of collateral is "property, usually in the form of funds or personal property, pledged to secure a debt or a loan." In the case of a high deductible plan, the insurance carrier is obligated to pay all losses and then seek reimbursement from the insured. The contractual arrangement that establishes this reimbursement creates a conditional debt (no debt is incurred unless a claim is paid). To secure this conditional debt, the insurance carrier nearly always requires some type of collateral. The organization wishing to be protected decides what type of collateral is acceptable for various obligations. Each type of collateral has its own characteristics, including a degree of risk and flexibility.

The security agreement is not part of the insurance policy, but is a corollary agreement between the insurance carrier and the insured. We will define these terms within the confines of collateral agreements between insurance company and insured.

Cash and cash equivalents are the simplest form of collateral. The insured posts cash or cash equivalents (e.g., marketable securities of a high quality) into an escrow account controlled by the insurance company. Cash—the "poor man's credit"—is the most certain type of collateral. Once deposited into the controlled account, cash has zero risk. The insured, however, may be reluctant to use cash, because the insurance company may spend the cash readily, and the insured loses the use of cash that might be needed for ordinary operations, growth, or investments. Additionally, the insured may or may not earn interest on those funds, depending upon the outcome of negotiations.

Certificates of deposit (CDs) are contractual deposits with a financial institution. When CDs are used as collateral, the financial institution receives instructions to not release the funds to the insured without the permission of the insurer. Generally, the insured continues to earn interest on those funds (but may not *receive* the interest). The funds are more secure from the standpoint of the insured, as well, because the financial institution also receives instructions not to release the funds without the permission of (or at least notice to) the insured. CDs are not often used.

A letter of credit (LOC) and an "evergreen" letter of credit are examples of pre-qualified loans an organization may obtain from a financial institution. In effect, the LOC states that the insured has access to a guaranteed line of credit from the financial institution, and the insurer can access those funds according to the collateral documents. The "evergreen" LOC is simply an LOC that renews automatically and does not have to be replaced or renewed periodically. However, this line of credit carries a small fee (usually less than 1%), and the commitment to supply these funds on demand reduces the amount the insured can borrow for security purposes or other operational and investing activities. Additionally, if the LOC is drawn down (the loan is made), the contractually stated interest rate on the loan applies. All this notwithstanding, letters of credit are the most used form of collateral in high deductible plans.

Surety bonds are three-party contracts, generally issued by the surety departments of disinterested insurance carriers (although private surety companies are also used). The surety agrees to pay the stated amount to the obligee (the one to whom the obligation is owed—in this case, the insurance carrier desiring security or collateral) if the principal, or obligor (the insured owing the obligation), fails to perform the act stated in the surety agreement. For example, if the insured does not reimburse the insurance carrier for the amounts paid for claims under the deductible, the surety must pay the insurance carrier the amount the insured failed to reimburse. The surety then has a contractual right to seek reimbursement from the insured (the obligee, or principal), and will have secured some type of collateral or security on its behalf. The premium on the surety bond is a cost of risk to the insured. Surety bonds are not often used as collateral on high deductible plans, as the surety premium is a cost in addition to the usual cost of collateral, e.g., LOC fees, etc.

Accounts receivable—the trade credit collectible to the insured—can be factored or sold to another party to generate immediate cash flow rather than waiting for the slower receipt of funds from those vendors or other debtors. Because of this feature, accounts receivable can be pledged to the insurance carrier as collateral to secure reimbursement. If the insured fails to pay the reimbursement, the insurance carrier can factor the receivables. Since there is a credit risk and expense (and loss of cash flow) assumed by the purchaser of the receivables, the amount paid for the receivables is discounted from the full amount of the receivables. There is no cost associated with pledging the receivables unless the insured defaults. However, if there is a default, the insured loses the entire amount of receivables pledged and the cash flow that would have been generated, possibly leading to a liquidity crisis for the organization. This method is not often used.

Self-Funding Approaches (SIR Plans)

Self-funding approaches, or self-insured retention (SIR) plans, as they are commonly known, move the level of loss sensitivity to the highest level possible for an organization. There are several variations of the SIR approach, including the ultimate in complexity, a wholly-owned captive insurance company. The two common types of SIR plans are qualified and non-qualified. These plans can either be fully self-funded or have excess insurance coverage in place, both per occurrence and aggregate, for catastrophic losses. Further, these plans can address a single exposure, such as workers' compensation, or multiple lines covered within a single self-insured plan (e.g., workers' compensation, general liability, employers' liability, automobile liability, automobile physical damage, etc.). These plans represent the ultimate in flexibility.

The General Mechanics of Self-Insurance

For practical matters, self-insurance means an organization's management has decided to retain some layer of primary coverage or risk financing, and to maintain some degree of control over the claims process. Also, the organization usually purchases a level of excess coverage (although not necessarily). Services such as loss control or claims management may be provided by outside vendors or by the organization's staff members.

When frequency and severity of losses are predictable, self-insurance is always the most cost-effective manner of handling exposures, and reductions in the total cost of risk will be significant. Remember, if losses are predictable to the insured, they are predictable to the insurance carrier. The premium charged by an underwriter will cover those losses, plus insurance carrier expenses, including premium taxes and assessments (on average, 5%) and profit loadings (another 5%) as well as the charge for services the organization may not need or desire.

Qualified Self-Insurance Mechanics

Qualified self-insurance is a mechanism for self-funding an exposure that is subject to state regulation, such as workers' compensation or automobile liability. The state has an interest in regulating these lines of insurance as a means of protecting the general public, just as the state has taken on the responsibility to the general public for assuring that injured workers are provided for and minimum financial responsibility is maintained by motor vehicle operators. With state oversight of a self-insured organization, the victims of industrial accidents and illnesses and of motor vehicle accidents will receive the same benefits as they would get from a traditional insurance carrier regulated by the state with respect to solvency and conduct.

For qualified self-insurance plans, regulators generally require three important filings. First, the plan must have a written actuarial opinion as to the expected losses and current valuation of open reserves. The self-insured organization must retain the services of a qualified actuary to perform this analysis. Second, the self-insured organization must complete and file audited financial reports on an annual basis establishing its financial viability and solvency, along with other informational applications and reports. Last, most regulatory bodies require each self-insured organization to file a surety bond as collateral, and do not permit other, less expensive forms of collateral or security that might be acceptable to an insurance carrier for a large deductible or retrospective plan.

Advantages

When losses are predictable with respect to frequency and severity, self-insurance is the lowest cost alternative compared to other risk financing methods. At a minimum, the organization will save an amount equal to the profit and contingency loadings of an insurance carrier and premium taxes—generally at least a 10% savings—especially when taking into account the unbundling of other insurer services.

The self-insured organization maintains a high degree of control over claims management, subject to the constraints of the regulatory bodies and applicable statutes. Further, loss control efforts that result in a reduction in frequency and mitigation of severity can be pinpointed to address specific needs, and are immediately recognized and rewarded.

Last, the self-insured organization is insulated from the adverse loss experience of other organizations that might be sharing their risk in any other traditional insurance programs or pooling arrangements.

Disadvantages

If program losses are not controlled to reduce frequency or severity, the financial punishment is quick and direct. Effective loss control efforts are critical to the successful management of a self-insurance plan.

While regulators may be satisfied with a qualified self-insured organization, third parties wishing to have certificates of insurance or other proof of financial capabilities are generally apprehensive of any self-insured program, even if it is a qualified plan. Contracts between two entities, such as a construction contract, frequently address, restrict, or even prohibit the use of self-insurance programs to satisfy indemnification requirements.

As mentioned before, as in any situation requiring collateral or security, the self-insured organization will incur the additional costs of a surety bond and will encounter restrictions of its cash flow and borrowing abilities. The principal sum of the surety bond is determined by the regulatory body.

An important drawback for privately held organizations is the disclosure of financial information required by regulatory bodies. Most jurisdictions have freedom of information acts; thus, the private financial information and ownership may become public knowledge.

Non-Qualified Self-Insurance

Non-qualified self-insurance plans, often generically referred to as SIR plans, are used when qualification by a regulatory body is not required. Common applications include general liability and products liability exposures, as well as professional liability lines, such as medical malpractice. These plans are often used in lieu of deductible programs to retain higher levels of risk than the excess-of-deductible insurance market is willing to provide at an appropriate premium.

The mechanics of the non-qualified SIR plan are the same as those under a qualified self-insurance program, except there is no reporting requirement, actuarial opinion, or surety bond in favor of a regulatory body.

SIR plans can be structured to assume virtually all losses in the working layer (e.g., the losses which are expected), particularly when the frequency and severity of losses are very predictable.

Advantages

Naturally, a non-qualified self-insurance plan preserves the same advantages as a qualified self-insurance plan, with a few additional advantages unique to SIR plans.

Since collateral is a matter between an excess insurance carrier and the self-insured organization, it is not subject to statutory control. Therefore, collateral or security options are flexible and subject to negotiation.

Claims handling responsibilities in an SIR plan are vested solely with the self-insured organization or its designated third-party administrator. The self-insured organization can elect to use its own in-house staff to administer claims, and in doing so, maintains the ultimate level of control over claims.

Disadvantages

Unlike a deductible plan, the excess insurance carrier is not obligated to pay (in effect, pre-fund) any claims beneath the SIR, with reimbursement to follow, which generally generates a cash flow opportunity for the self-insured organization. The self-insured organization does not generate any cash flow with an SIR plan unless another party pays the initial expenses of a claim.

Excess insurance carriers provide few, if any, services, so loss control and claims management becomes the sole responsibility of the self-insured organization.

Probably the most serious disadvantage arises out of the potential for claims reporting and claim coordination issues. Most excess insurance policies have terms and conditions that require prompt or immediate reporting of claims that fit within a described schedule of injuries (e.g., dismemberment, disfigurement, death), but at the initial report, and even into the claim investigation, these facts may not be known. Also, a common condition under an excess policy requires prompt reporting of any claim likely to exceed a given threshold. At the initial report and investigation, however, a claim may appear to be routine; but later, a suit is filed with a multi-million-dollar legal demand. This may result in a declination of coverage or reservation of rights (written notice that the insurance company reserves its right to deny coverage at a later date based on the terms of the policy) for late reporting of claims. The comprehensive understanding of policy terms and conditions and the coordination between excess carriers and third-party administrators is critical. If the self-insured organization has elected to handle claims internally, the organization must possess a high degree of sophisticated claims handling capabilities or outsource the claims management, which subsequently increases the total cost of risk.

Risk Transfer Options and Criteria for Comparison

	Type of Program	Degree of Retention	Cash Flow Advantages	Loss Sensitive
1.	Guaranteed Cost, Full Insurance	None	Generally No	No
2.	Dividend Plan	None	No	Yes
3.	Small Deductibles	Low	Some	Some
4.	Large Deductibles	Moderate to High	Yes	Yes
7.	Self-funding (SIR)	High	Yes	Yes