Simple Risk Financing Options

Introduction

Insurance should be the last resort for the risk manager because identifying, controlling, and managing risks <u>internally</u> is much more cost effective in the short and long term. Nonetheless, insurance is an important part of most risk management programs, and it is heavily relied upon by organizations as a source for providing external funds for financing risks, particularly when losses for the organization are unpredictable, when losses are potentially catastrophic, when the competitiveness of the insurance market prices premiums below their underlying loss costs, and when additional services provided by the insurance carrier are valuable.

Guaranteed Cost/Fully Insured Plan

Program Mechanics

Simple risk financing insurance-based options, such as the guaranteed cost/fully insured plan is relatively simple and straightforward. Some of the issues are nothing more than the pure mechanics of the program: how and when the insurance policy is issued, and by whom; how the premium is paid (e.g., one annual payment or installments); and how losses are paid, and by whom. Since these simple risk financing options consist of ordinary insurance policies, the answers to those questions are simple: the carrier performs all services; pays any covered losses over deductibles or retentions, and within policy limits; and is willing to negotiate premium payments. Annual payment is always acceptable, and if the premium is sizable, installment payment plans of differing types can usually be obtained.

With this type of insurance, the degree of retention or internal financing generally appears to be non-existent, except for the trivial degree of retention found in a "maintenance" deductible feature, or the use of a very small deductible which would allow the insurer to eliminate small losses that would have exorbitant handling costs relative to the amount of the loss. While "small" is always a relative term, for any organization with a risk manager, anything up to $1,000 is probably considered "small," and that threshold could extend even further. The key difference between a simple financing option and a loss sensitive option is the intent of the organization and carrier. A "small" deductible is usually nothing more than a policy requirement with very limited alternatives, but can be increased somewhat..

However, the degree of retention that is critical, and often overlooked, is the retention of losses outside the four corners of the insurance policy—losses in excess of the purchased limits; losses subject to excluded perils and hazards; and losses limited by policy definitions, limitations, and conditions. For risk managers using the simple risk financing options and the "assurances" of insurance coverage, these extra-policy losses create the "worry factor," or the "what keeps you awake at night" scenarios.

Fixed versus Variable Costs

Simple financing options are rated prospectively, meaning the rates are determined prior to the policy date. These rates are generally based on rates taken from rating manuals for the applicable exposure classifications (e.g., types of building construction and location, ISO general liability codes, NCCI workers' compensation class codes, etc.), modified by the underwriter, and applied to the units of the selected exposure base to create a "fixed" premium. In reality, only the rate is fixed, as the premiums may be adjusted based upon actual exposures determined after the policy expiration by a premium audit. However, because the rates are determined prospectively, or in advance of the policy term, the premium is considered "fixed," as it is predetermined based on the estimated number of units of exposure the organization expects to have throughout its operations during the policy term. In other words, it is "fixed" because it is highly predictable when considering the exposure units and is not dependent on losses during the policy period.

Cash Flow

There are limited cash flow opportunities in simple risk financing programs. Cash flow arises only when premium deferral is possible through installments. Thus, the time frame for the organization to retain the use of cash is limited to a policy term of twelve months, and even then, installment plans rarely permit the premium to be spread over more than ten months. The only other cash flow possibility is limited and arises from the retention of small deductibles in which the limiting factor is the relatively low level of cash involved.

Loss Sensitivity

Because of the prospective nature of the premium computation, there is no real degree of loss sensitivity in the short run (e.g., during a policy year). However, that does not mean the program cannot be affected by losses, because experience modifiers and underwriter's judgments are affected at renewal time. These factors are sensitive to frequency (frequency leads to severity) as well as severity (payments made by the carrier on large losses, while usually limited in their effect on experience modifiers, contribute to the total cost of the insured's policy at renewal).

Service Options

Nearly all, if not all, required or necessary services (as well as a number of services that are not required) are provided by the insurer. The quality of the services depends upon the philosophy of the insurer and the professionalism of the employees assigned to the particular insured. This is negotiable to some degree, but only in terms of the personnel who will actually deliver the service. The insurer can provide all underwriting, loss control and engineering, claims adjusting and settlement services, auditing, and reports to regulatory agencies and the insured. The important point to remember (and this is only a statement of fact, not an indictment against an insurer) is that <u>the providers of these services provide the services primarily for the benefit of the insurer and not the insured.</u> Loss control and claims management services, for example, may provide benefits to the insured, but they are primarily conducted to protect the insurer's profitability.

Program Flexibility

Because simple risk financing options are based on common insurance policies, there is minimal flexibility in program design, except for limits of coverage, deductible options, and a rather small number of endorsements, to tailor coverage to meet specific needs. In general, these programs are considered to be simply adaptable to specific needs, but their customization possibilities are rather limited.

Accounting and Tax Impact

With these simple risk financing programs that use insurance policies, the accounting and tax issues are relatively straightforward. Premiums are deductible when the obligation is <u>incurred</u> for accrual basis accounting systems, and when <u>paid</u> for cash basis accounting systems. Losses are deductible only to the extent the insurance policy does not pay, and thus are tax-deductible only when an uninsured loss is paid by the insured (e.g., under the deductible, excluded, etc.).

Summary

To reiterate the general characteristics described above, guaranteed cost and/or fully insured programs have the following characteristics:

- There is a 100% transfer of the financial responsibility to the insurer, up to policy limits and subject to policy terms and conditions.
- There is no loss sensitivity for experience in the current policy year.
- The premium is fixed; however, it can be endorsed for changes in exposures, and is often audited when exposures are known to be variable.
- The insurer will provide <u>all</u> services; no opportunity is available for "unbundling" of services.
- Premiums are subject to discounts, credits and debits, and experience modification ratings (at the underwriter's discretion or according to manual rules), and the rating options can be customized to some extent (also at the underwriter's discretion and according to manual rules).

Advantages

There are several distinct advantages to a fully insured program. The first is budget certainty (even auditable premiums can be certain from a budgeting standpoint). Second, fully insured programs provide convenience, as the insurer provides all services in an "easy, one-stop shopping" experience. Third, the insurer or its agent/broker provides certificates of insurance required to support contractual compliance. In addition, poor experience may even go unpunished at renewal, tax deductibility is very clear and unlikely to trigger a tax audit, and coverage is normally standardized and predictable. However, sometimes there can be flexibility in coverage options, depending upon the request.

Disadvantages

Insurance policies are generally the most expensive option for financing risk, as insurer expenses are passed along, in addition to the costs of losses and loss adjustment expenses. These insurer costs, including their profit and contingency loadings, are rarely less than 30% of the premium. In addition, there is either very limited or no cash flow advantages accruing to the insured organization; all cash flow advantages belong to the insurance carrier that collects the premium immediately (or in a few months) and pays losses over the next several years. The only availability for any cash flow is if the premium is deferred over 10–12 months. Good experience is not rewarded in the short run (unless the rewards come in the form of underwriting concessions). Services provided by the insurance carrier may be inappropriate or inadequate, and any supplementary services required will be purchased at an additional expense to the insured. Since fully insured programs are based on standardized policies, there is little flexibility in general, with few or no options for customization. Last, and most importantly, the lack of short term incentives to reduce losses may affect the total cost of risk in the long term.

Guaranteed Cost Programs with Dividends

Some types of coverage may use the basic guaranteed cost or prospective rating approach and provide an additional feature that may result in lower rates, depending upon the insured's loss experience and the general loss experience of the insurer. Typically, these programs are used only with workers' compensation coverage, but other dividend programs are technically possible, usually on larger accounts.

The two variations to a guaranteed cost program with a superimposed dividend plan are a flat dividend program and a sliding scale or variable dividend program. Both of these programs require the insured to have a loss ratio under a specified threshold and the insurer to have a minimum underwriting profit on its portfolio of similar policies. In addition, the declaration and dividend amount is determined for that block of policies by the insurer's board of directors, so even if the insured has a good loss ratio, there may be no dividend declared.

Generally, these programs are not considered to be cash flow programs for an organization, or even considered particularly loss sensitive. Though they are loss sensitive in the sense that costs can decrease based on loss experience, costs can never increase. This stems from the fact that, historically, the dividend represented a planned overcharge of premium that was a buffer or cushion against adverse loss experience, and when good loss experience resulted, the insured received a return of the excess charges. This arrangement was a common feature among mutual insurance companies whose owners were its policyholders. In effect, the owners were charging themselves additional premium "just in case" and giving themselves a reduction if losses were under the target. To compete with mutual insurance companies (and reciprocal insurers), many stock insurance companies began to offer dividend plans that were very similar to those offered by mutual insurance companies. To maintain profitability, the stock insurance companies recouped the return premium by reducing the commission paid to the agent.

The flat dividend plan is the least loss sensitive of plans which are not really loss sensitive; however, the effective premium can change according to losses. If the insured has a loss ratio under the threshold, and the insurer also has an underwriting profit, the board can elect to pay a dividend of a flat or fixed amount, usually expressed as a percentage of premiums.

The sliding scale or variable dividend program is much more loss sensitive in that the percentage of the premium reduction increases according to a schedule as the insured's losses decrease (again, premiums can only be reduced by loss experience and never increased). An insured with losses in the lowest range or band will receive the maximum dividend or premium reduction scheduled, and, as the losses rise, the percentage of reduction decreases. The schedule below depicts a possible sliding scale dividend plan on a workers' compensation policy having an audited premium of $270,000.

Exhibit 10.4: Sliding Scale Dividend

Losses ($)	Credit (%)	Credit ($)
0 – 24,999	50%	135,000
25,000 – 49,999	40%	108,000
50,000 – 74,999	30%	81,000
75,000 – 99,999	20%	54,000
100,000 – 135,000	10%	27,000
Over 135,000	0%	0

The characteristics of dividend plans are essentially the same as those of a guaranteed cost insurance plan. Like a guaranteed cost program, there is no cash flow advantage except premiums that are paid in installments. In fact, the dividend feature may have a negative cash flow if the dividends represent a refund of excess premiums.

The tax-deductible feature of the dividend program remains the same as a guaranteed cost program. That is, the premiums are deductible when the obligation is incurred for accrual accounting, and deductible when paid for cash accounting. Dividends are taxed as ordinary income (e.g., not as stock dividends or investment income).

The insurer provides claims services, as with the guaranteed cost program. This leads to one common criticism or belief that the insurer increases reserves prior to the date the dividends are calculated to subsequently increase the insured's loss experience with the intention of eliminating any dividend, even though the claims will probably settle for less. From a practical standpoint, this is unlikely. Some insurers are willing to have an independent claims consultant review their reserves prior to dividend computation.

Another feature of dividend plans, unlike a guaranteed cost program, is a loss limitation—an agreement that severe losses will be limited to a lesser amount, thus dampening the impact on the loss experience for dividend purposes. This is generally funded by a slightly lower dividend percentage.

Like most guaranteed cost plans, there is little flexibility in dividend plan design. While there is a wide range of plans available, most of them are "shelf products" with little customization or flexibility.

Advantages

For qualifying insureds, dividend plans do have distinct advantages over non-dividend guaranteed cost plans. While the effective premium is subject to change because of the dividend, the maximum cost is known after audit. Another way of describing a dividend plan is to view it as a loss sensitive plan in which there is no downside, although the potential upside benefit is limited by the dividend schedule and the uncertainty of receiving a declaration of dividend by the insurer.

When the schedule provides generous reductions for favorable loss experience, the insured has a real incentive to reduce losses, albeit less dramatic than true loss sensitive plans. However, the premium savings benefit can be dampened by the schedule.

Disadvantages

Similarly, there are disadvantages—two of which are serious. Dividends are uncertain with respect to declaration, and nothing will disappoint managers more than working hard to reduce losses only to have the insurer decide against declaring a dividend. Second, the insured is at the mercy of the insurer with respect to the claims management, including the reserving process.

While most insurers operate honorably, it takes only one instance of dishonorable behavior to cast aspersions on all. In addition, dividend programs can have much of the otherwise positive results of loss control eliminated by one severe claim. While loss limitations may be available, these features come at a cost of a reduced schedule of premium credit.

Cash Flow under a Dividend Program

As mentioned previously, dividend programs are not really cash flow programs. In fact, it can be argued that the cash flow is negative, as the premium may be higher initially, only to be returned later, assuming a dividend is validated and declared.

Small Deductible Options

Much like a guaranteed cost program or a dividend program, a small deductible program is based on standard insurance policy options. Generally, these are rated on a manual basis, with deductible options provided in a table of deductibles with corresponding premium credits. These are usually called tabular plans, and the deductible options may range from $1,000 to as much as $50,000.

Mechanics

Small deductible options are offered with almost any line of coverage. While in many cases, the deductible is used by the insurer as an underwriting tool for acceptability, it can also be used by an insured to take a step toward more retention while obtaining a reasonable premium credit.

The amount of the total retention can range from very slight to very significant, particularly if the insured is subject to high-frequency losses and there is no aggregate deductible limitation.

The typical arrangement for applying a deductible option is for the insurer to handle the claim as if it were fully insured, with a reimbursement to be made by the insured at a later date, according to the deductible reimbursement agreement.

Characteristics

One characteristic is a fixed premium, as this is basically a guaranteed cost program that simply has a larger deductible than the standard policy deductible. However, the total cost of risk is variable because of the inclusion of losses in its calculation. Such plans can be quite sensitive to losses, depending upon claim frequency, the size of the deductible, and whether or not an aggregate deductible limit is used.

Small deductible plans present two new cash flow opportunities. Premium deferral options and deductible credits provide some cash flow benefits. The second, and more dramatic cash flow opportunity, is tied to the payout lags inherent in the deductible reimbursement. In a small deductible option plan, the insurer pays the losses in full and then is reimbursed by the insured at a later date, creating the payout lag—a time in which the insured has use of the funds that would otherwise have been paid out earlier as a deductible.

The insurer provides all services, including claims services, even though the insured may hire a claims consultant to review claim reserves for another opinion and to protect the insured's interests. The insurance carrier also provides loss control services as an effort to improve loss frequency or severity.

Even though the underlying forms and coverage tend to be standardized, small deductible programs can have some flexibility with respect to deductible level options, including the use of aggregate deductibles. Taxation issues are straightforward, with premiums being fully deductible as an ordinary business expense when paid or when the obligation is incurred (cash versus accrual accounting). Losses are only deductible when the deductible reimbursement is paid to the insurer.

Advantages

Small deductible plans have several important advantages. Because of the fixed nature of the premium and with predictable losses, programs can be structured with reasonable budget certainty, particularly when aggregate deductible limits are used. The insurance programs underlying the small deductible options commonly use policy forms that are easy to understand and easy to establish, and deductible reimbursements that are relatively easy to administer, depending upon the insurer.

Certificates of insurance are standardized and issued by the agent/broker or insurer. Because the insurer initially pays the losses in full, there is no need to show any deductible on the certificate of insurance, as that is considered a private contractual matter between the insurer and the insured (except in the case where the insured agrees to disclose any deductibles to a certificate holder).

The direct savings in premiums and cash flow savings can be substantial, particularly if loss frequency is low and the premium credits are reasonable. A small deductible program provides a real incentive for the insured to reduce frequency. Subsequently, any reduction in frequency lessens the likelihood of a severe loss occurring. Remember, if no losses of any size occur, there can, by definition, be no severe losses.

Disadvantages

Small deductible plans, because they are based on standardized insurance policies that are usually class rated or manually rated, often have little flexibility with respect to coverage and pricing. The rating schedules frequently do not offer credits that are adequate to justify the additional expenses of paying losses within the deductibles. This is particularly a problem for an organization with high-risk exposures.

Another possible disadvantage is that the services provided by the insurer may be inadequate or inappropriate for a particular insured but are included in the premium without the option of removal or unbundling. Additional services purchased to meet any inadequacies will obviously increase the total cost of risk.

The insured purchasing a small deductible plan may become more interested in claims handling. However, they have little or no control over the payments, since the insurer provides the claims services and will reserve and make payments according to their own philosophy and interests.

The total cost of risk may also be increased, as the insurer is likely to require a certain level or type of security or collateral. When the security is provided in the form of an escrow account for claims payments, the insured loses the cash flow advantages. When the security is provided in the form of collateral, there will be fees or expenses (such as the fee for a letter of credit or premium on a surety bond) that increase the total cost of risk. Further, a letter of credit or surety bond may reduce the ability of the insured to obtain other borrowing or may increase the cost of other borrowing. Opportunity costs are also affected by the requirement of security or collateral.

Lastly, another disadvantage arises for claims with a long development time (e.g., products liability or medical malpractice), as the policy accounts may be held open for a long period of time before the final cost is known. The length of development depends upon the type of program, the nature of the exposure and claim, and the claims settlement philosophy and practices of the insurer.