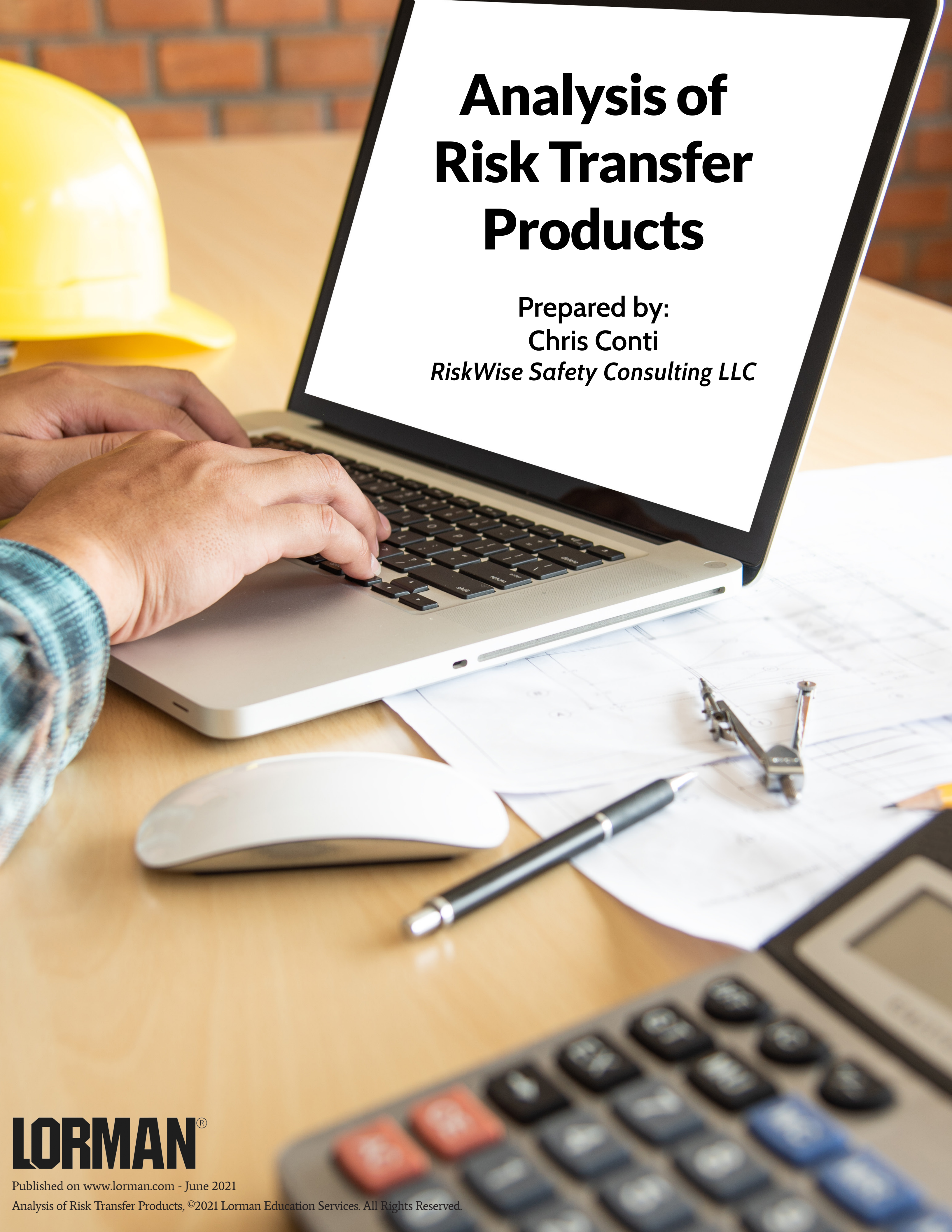

Analysis of Risk Transfer Products

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Analysis of Risk Transfer Products

In a shifting marketplace, it is important to know the different types of risk financing products and how they may or may not fit your particular situation. The selection of the appropriate risk financing product will be a decision based on the level risk tolerance of the insured, Balance Sheet of the insured, Loss Experience of the Insured, the marketplaces willingness to offer such products and risk management knowledge. Also, a detailed analysis of the cost/benefit of each approach is warranted. In this article we will explore guaranteed cost, retrospective rated plans, deductible plans, captive programs and self-insurance programs.

Guaranteed Cost

This plan is most often used by businesses for their workers' compensation. The insurer sets the rates at the beginning of the policy term, based on worker classification and prior loss experience. The rates remain the same throughout the policy period regardless of the losses experienced during that term of coverage. The insurer pays all losses and associated expenses. In a Guaranteed Cost policy, the only variable affecting premium that should change between policy inception and audit is payroll.

Generally accounts with annual premiums under $100,000 fit best in this program. The loss experience during the policy term will impact their premium in future years, but not in the current year. Accounts that have inconsistent loss experience from year to year will also benefit from the Guaranteed Cost plan.

Advantages of this program include fixed cost, all-inclusive coverage and no risk involved to the policy holder. Because the insurer assumes all of the risk a disadvantage may include higher policy year costs, no savings during low loss years and premiums are subject to market fluctuations. For most accounts, though, avoiding the risk of paying additional premium in a bad year out-weighs the disadvantages.

Retrospective Rated Plans (Retros) Retrospective means “looking back on” and that is exactly how this plan works. The ultimate premium is calculated after the policy expires, based on the loss experience of the policy year. This plan is one in a group of plans also referred to as “loss sensitive plans”. When considering a retro option, it is vital to be able to reasonably predict losses.

In a retro plan, the insurer issues the policy using an estimated rate per classification. Approximately six months after the policy expires the first calculation is made to determine if the account will owe additional premium or receive a return premium based on the loss experience of that policy term. Additional calculations will be made at 12-month intervals, usually for a period of three to five years. The final premium is subject to a predetermined minimum and maximum total premium.

A retro provides a simple manner of making premium cost loss sensitive. Expenses remain the responsibility of the insurance company. For those employers that effectively control their losses, the premium is lower than on a guaranteed cost plan. Conversely there are also disadvantages to this type of plan. If the loss experience exceeds expectations the ultimate cost is greater than the guaranteed cost plan. In addition, rather than closing out the premium cost after one year the final premium is not determined for several years. This can be quite costly as serious losses develop over a period of years.

Deductible Plans

Deductible plans, a true form of self-insurance, allows an employer to reimburse an insurer for workers’ compensation liability losses, up to a stated deductible amount, in return for a lower premium. These plans are used for accounts that would generate premium well into six figures under a guaranteed cost plan. As with the retro plan, it is crucial to be able to realistically predict losses. However, an account that has had problems in the past that have been corrected may benefit greatly from this plan.

The insurer issues a policy of workers' compensation similar to that of a guarantee cost plan. The insured is responsible for first portion of any loss up to the agreed deductible figure, including claim handling expenses. The policy will also contain an aggregate deductible, which limits the insured's maximum exposure during the policy term. These plans require collateral, usually in the form of a letter of credit. The upfront costs in this plan may be greatly reduced, 25-40% of the normal premium, and the possibility for a lower overall cost is substantially greater than a retro plan.

Of course, there are also disadvantages with this type of plan. Poor loss experience can generate costs that far exceed a guarantee cost plan. Some claims can take a long time to close and the client may find they are making payments over a multiple of years. Further, the required collateral can reduce the firm's credit lines and will multiply with each policy year the insured remains on the deductible plan.

Captive Programs

A captive program involves much more than purchasing insurance — the insured also becomes an insurer. A captive is an insurance company that is formed to provide insurance to its group or association of owners. A captive solution may be effective for a single parent company, members of a common industry, or a group of unrelated parties who want to share risk.

In this type of program, the insured becomes a member or owner of a reinsurance company. Along with other insured's, premiums are paid forming a pool to pay losses. An insurance carrier, otherwise called the fronting carrier, issues the policy, although the insurance company assumes very little of the risk. The premiums paid by the members are forwarded to the insurance company who, in turn, sends the funds, after expenses, to the captive group. The captive is then responsible for paying losses. The upfront cost for this program is typically somewhere between the deductible plan and retro plan pricing. The premiums are used to pay expenses to the fronting carrier, taxes, loss control, claim expenses and reinsurance costs. The captive normally purchases aggregate reinsurance to protect its members. Collateral is required for the difference between the premium collected and the maximum liability of the insured. The maximum liability to the insured is usually equal to one year of estimated losses. The insured will also be required to share in some part of the severe losses of other members.

Advantages of entering a captive plan can be substantially lower up front premium, especially in a difficult or hard market, stability of coverage and pricing and more control over claims. The account can also realize a profit down the road in underwriting profits and investment income. Participation in a captive program should be a long-term financial decision as its biggest advantage is to even out the cyclical nature of the insurance marketplace.

Disadvantages include possible significant penalties, long-term capital investment, responsibility for other member losses and loss of access to credit lines or collateral.

Self-Insurance

The lowest fixed cost program is self-insurance. With that benefit also comes the greatest level of risk. In addition, regulatory and administrative responsibilities can be burdensome.

State approval is required for each state where an account wishes to self-insure. In California, the approval process takes on average six to twelve months. Among other requirements, the account must have at least $5 million shareholder equity, average net profits of at least $500,000 and certified, audited financial statements. Collateral equal to 135% of estimated losses must be posted, subject to a minimum of $220,000. Although excess insurance may be purchased, self-insurers are required to retain a minimum of $120,000 per occurrence and $1,000,000 aggregate annually.

There are significant advantages to self-insurance programs over the above discussed options including the lowest fixed costs, maximum use of cash, control over claim, and no need to remarket insurance coverage year to year.

Comparing this to the other plan options disadvantages are; governmental regulations, controls and monitoring are time consuming, it carries the highest degree of risk, requires a substantial long term commitment, is difficult to accomplish in multi-state employment situations and ties up collateral to the greatest extent. There are also limitations to tax deductions versus the other programs discussed as well as short-term adverse accounting implications.