# RISK FINANCING

Exploring different insurance options for your business

## The construction industry is fraught with risks. An obvious and significant way to combat these exposures is through insurance. Insurance simply means the transfer of risk. As a Contractor, you must be keenly aware that the construction industry's risks considerably impact your insurance options and premiums.

Luckily, there are a variety of risk financing options your company may use, depending on the amount of risk you want to incur. Risk financing refers to the different insurance methods for funding your risk or exposure to losses. Knowledgeable insurance brokers can help their clients to find the correct solutions that span the spectrum from paying every single dollar of every claim to a fully self-insured program.

Here are some risk financing options that depending on your risk appetite, might be a good fit for your construction firm when we talk about your options for your general liability, workers' compensation, and automobile liability programs.

**Guaranteed Cost**

**Deductible Plans**

Small Deductibles

Large Deductibles

Retrospective Rating Plans

**Self-insurance Plans**

Captives

Self-insurance

# GUARANTEED COST

A guaranteed cost plan, also known as first-dollar insurance, is when the insurance company pays for the entire claim, from the first dollar. There is no additional out-of-pocket costs for this type of plan, but premiums tend to be higher.

The insured pays a fixed premium (or a fixed rate that is applied to an exposure base) for the policy term. This option tends to be the most popular, as there is no fluctuation to the premium paid regardless of the number and dollar value that occur during the policy term.

# DEDUCTIBLE PLANS

Deductible plans, also known as loss sensitive plans, are useful when the client wants to take on a portion of the risk themselves in exchange for a lower premium. There is a cost benefit to a deductible plan since the insurance companies price these plans using a sliding scale which reduces the premiums as the deductible level increases. A deductible plan's final cost of risk is dependent on the premiums paid plus the actual losses during the period the plan is in effect. This is what we think of as your "traditional insurance" plan.

As a result, these programs create a strong incentive for insureds to develop and implement effective safety and loss controls. These plans are sometimes referred to as "performance-based programs" because the insured's own performance is in control of their losses, which ultimately determines their final premium. Their premium does not subsidize anyone.

## The most common deductible plans are:

### Small Deductibles

A small deductible program is a policy that uses a minimal deductible that can range from $100 to $50,000. As you would expect, there would not be much of a premium savings for small deductible programs. In many cases, the insurance company uses small deductibles to insulate themselves from risks that have a high frequency of small nuisance claims.

### Large Deductibles

When a client utilizes a large deductible, they are agreeing to take on a significant portion of their risk and potential claim costs. The large deductible program blends features of guaranteed cost and self-insurance plans. The deductible usually ranges from $50,000 to $500,000 or more and will often require cash or a letter of credit as collateral.

Under a large deductible program, the insured receives a significant premium credit but is also responsible for paying the losses that fall within their deductible layer. In some cases, an aggregate deductible may also apply to cap the insured's overall exposure.

If managed correctly, large deductible programs can offer the insured the opportunity to "bet on themselves" and reduce costs. In other words, the client agrees to take a risk as well as financial responsibility for the value of the deductible layer and receives a credit commensurate with their deductible instead of paying the full Guaranteed Cost premium which includes a charge for the "expected" losses (predicted loss levels). If the client is able to control their losses, then they may see considerable savings in their annual insurance premiums.

However, it is important to remember that under a large deductible plan, the final cost will vary widely, depending on an insured's loss history. As with all deductible plans, for the insured who has focused on reducing losses, there is a direct recognizable impact on their bottom line.

### Retrospective Rating Plans

A retrospective plan (retro) adjusts based on a look back at the losses over time. This plan can be executed based on either incurred losses, which is the total amount of paid claims and loss reserves associated with a particular time period, or paid losses. The primary difference is in the timing of payment—paid loss retrospective plans allow the insured to hold on to its money longer, which is why paid loss retros are considered cash flow plans.

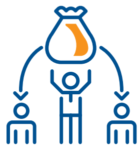
Paid loss retrospective rating plans are popular cash flow plans that offer benefits unavailable to insureds under incurred loss retro plans. The main difference being that earned premium, the portion of a policy's premium that applies to the expired portion of the policy, is calculated based on paid losses rather than incurred losses. That is to say, the carrier's reserves are not included in the retro's premium calculation. During the extended period between events and actual payments of claims, the insured retains the unpaid premium and unpaid loss reserves as income generating funds.

Retrospective programs are subject to minimum and maximum premiums. The minimum premium sets a lower limit on the ultimate retrospective premium. Regardless of how favorable their loss experience is, the insured must pay at least the minimum premium. The maximum premium provides the insured with a cap on losses, should the insured develop an unfavorable loss experience.

# SELF-INSURANCE PLANS

Large clients with the ability to fund losses from their balance sheet rather than utilize an insurance policy may self-insure their risks. Self-insurance plans are when the insured takes the risk on themselves but can decide the level of risk they want to take on.

## The most common self-insurance plans are:



### Captives

Though technically an insurance company, a single entity captive is fully funded by that entity and uses the funds placed in the program to pay losses.

A single entity or single cell captive is a legal entity, licensed as an insurance company, to insure a proportion of its shareholders' risks. Simply put, it is an insurance company owned by the captive members (shareholders). The captive members will accept a predetermined level of risk and pay the associated premiums for the administration of the captive (fixed costs) to the captive insurer. There are several types of captives that vary in funding requirements and additional conditions. However, generally, the risk in a captive falls onto the captive members.

When you become a shareholder of a captive, you will gain control over a range of unpredictability in the traditional insurance market. Traditional insurance markets focus on the carrier's overall profitability which results in inefficiencies where you pay more for a policy. With a captive, pricing is stabilized while outperforming the traditional markets.

Additionally, captives allow for the opportunity to capture underwriting and investment income. They can deliver investment income on your premiums, which compound the return of premiums through effective risk management and claims oversight. It can become another profit center and allows you to build additional equity. Captives can be a tool for increasing primary limits or enhancing coverage. Both can give your company a distinct advantage over the competition, when pursuing new business. Lastly, a group captive is a unique method to create a peer group of compatible owners. Whether you're an owner, CFO, safety director, or human resource specialist, you gain access to a knowledge base that will enhance your company as you grow and adapt based on future demands.

However, there can also be some challenges to be aware of if you decide to join a group captive. For example, if another member has a catastrophic loss, all remaining members are required to participate in that loss. This point illustrates the importance of selecting a captive with a strong safety culture.

## Self-insurance

Self-insurance is when the client does not purchase an insurance policy but relies solely on their own funds (i.e. balance sheet) to pay their claims. Companies can opt to self-insure their risks for many reasons. Whether it be for the lack of availability of insurance or simply a financial expectation that their annual claims costs will be less than their premiums, this solution is clearly not for everyone. Caveats to self-insurance include the cost of administration, contractual issues, cash flow being affected by cost fluctuations, and the fact that self-insured workers' compensation coverage may not be allowed by your state.

Companies can choose to either be completely self-insured and not buy any level of insurance or can limit their exposures and protect themselves for a truly catastrophic claim.

If they choose the latter, then the insured will need to set their "attachment point" for the excess policies to pick up the coverage. This is usually a discussion between the insurance companies and the client and is likely above $1 million and as high as $5 million.

Regarding a Self-Insured Program, when the "attachment point" is selected, it is the maximum amount you are required to pay before the insurance company begins payments. The maximum payment amount is called the Self-Insured Retention (SIR). Unlike a deductible, if you do not pay the SIR, the insurance company has no obligation to make any payments. SIR payments are required first, before the insurance company begins its payments.

# SUMMARY

Each of the risk financing options have their own benefits as well as drawbacks. None of this information is intended to be a complete benefit analysis of these risk financing options. To do so, one must perform a historical analysis to include claims, safety, and operations, combined with an operational projection for the firm's future, so that a risk management plan can be tailored to meet your needs. It's critical to partner with a good insurance broker like like Turner Surety and Insurance Brokerage, Inc. (TSIB), who understands the nuances in the process. Reach out to us to perform a historical analysis for your company. Let us effectively assist you with selecting the right risk financing program that meets your unique needs.

# ABOUT TSIB

We provide our clients with options and expertise that will help support and protect their businesses. It is more than insurance cost; it's Insurance Risk Financing and Risk Management Solutions tailored to each client's needs, with the goal of lowering their overall cost of risk. As a full-service brokerage, we at Turner Surety and Insurance Brokerage, Inc. (TSIB) support clients through a variety of programs and services. We train, educate, minimize risk, and help our clients grow their business.

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