ANALYZE RISKS
To Get Better Insurance at Less Cost

Insurance represents such a large expense to the average contractor that it warrants close attention.

By WILLIAM S. MCINTYRE
President
Rimco, Inc.

This is the second and final part of the article which appeared in the December, 1980 issue. William S. McIntyre, President of Rimco, Inc., is a major AWCI convention speaker. Part II continues with the major points that must be considered for a sound risk management program.

Joint ventures. Many contractors enter into joint ventures and usually each member will cover his own risks under his own policies. “Dummy” policies are written in the name of the joint venture. However, all coverage can be afforded under formal joint venture policies.

In some cases, the joint venture liability policy may provide Completed Operations for two to four years after termination of the policy. However, many do not and the contractors involved generally do not adjust their General Liability policy to provide coverage in future years.

If a loss happens, the joint venture policy, purchased at the time of construction, does not cover since Completed Operations coverage only applies during the policy period. The contractor’s policy, in force at the time, that does not provide coverage as coverage for joint ventures is specifically excluded.

Contractors who have been involved in joint ventures in the past should modify their General Liability policy to cover any residual liability.

Crushing work. Many contractors crush rock in connection with their construction operations. A common error has been that this work is classified into street or road construction or reconstruction rather than stone crushing, the proper code. The rate differential is substantial.

Ratable payrolls. The definition of “ratable payroll” for Worker’s Compensation and General Liability premiums vary from state to state. Some states require that total gross payroll be used in determining premiums while others limit payroll to an average of $100 per week.

Some of the $100 limit states are Florida, Louisiana, and Missouri. Texas is a $200 state, while most other states have a limitation of $300. There have been some changes in various states lately increasing the maximum chargeable payroll. This is an area for investigation.

Payroll classifications. Substantial errors are often made in the classification of payroll for Worker’s Compensation and General Liability. An office manager should make a careful review of the codes presently applied and review what other codes are available for the construction industry. How these codes can be, or might be, applied...
**The contractor’s equipment policies pay off on actual equipment values.**

*Therefore, a contractor should adjust the value of equipment owned periodically, yearly or oftener, to reflect any decline in cash values.*

to the current payroll, and might be applied to a future payroll should be examined.

In event of error, the insurance company may want to allow the change only on future payrolls. A contractor can and should demand that the change be made for the current year as well as any misapplications of the last four years. Overcharge recoveries amounting to hundreds of thousands of dollars have been made.

**Audits.** While premiums are normally paid monthly based on payroll, the insurance company audits payroll records at year’s end. But allowing an insurance company to prepare a premium audit is about the same as letting the Internal Revenue Service complete a tax return.

If possible, the contractor’s accounting department should have schedules prepared in the normal fashion for the auditor. Then he can be sure that the auditor is properly classifying payrolls and giving proper deductions for excess payrolls, overtime, truck driver payrolls, etc. If this is not possible, the accounting department should be aware of the methods in determining ratable payroll and see that these principles are properly applied.

**First aid folder.** While many contractors purchase Worker’s Compensation insurance, many pay all “small medical only” claims. This procedure reduces the doctor’s paperwork, which may avoid a $10 bill becoming one of $25. In addition, small losses are not included in the experience rating plan nor various rating plans which have a tendency to increase current and future costs.

**Broad Worker’s Compensation coverage.** Coverage for federal Acts, such as the United States Longshoremen’s and Harbor Workers’ Act, can be added for $25 or less a year. It has become very difficult to determine when these acts apply, but since the benefits under this Act far exceed many state acts, claimants have a tendency to seek relief under the Act whenever possible.

**Monopolistic States**

The Broad Form All States Endorsement is available to provide coverage for all states with the exception of “monopolistic” states such as Nevada, North Dakota, Ohio, Washington, West Virginia, and Wyoming.

Endorsements are available to extend coverage on a reimbursement basis to these states for Employer’s Liability as well as Statutory Liability. Voluntary Worker’s Compensation including Disease and Repatriation should be purchased if employees travel outside the United States. Care should be taken to see that all active executives, partners, and proprietors are covered.

**p) Broad Worker’s Compensation**

as the name implies, covers liability claims which might fall between coverage currently carried under present liability policies, those areas where current limits are insufficient, or where coverages are specifically excluded or not provided. Unfortunately, there is a great deal of difference in various Umbrella policies. The policy conditions and exclusions can vary substantially.

Be sure that the policy is not mere “excess” over primary liability policies. In other words, that it covers areas not covered by primary policies subject to deductible of $10,000 to $100,000.

Coverage should be afforded for Contractual Liability, Personal Injury, Completed Operations, Leased Equipment, and “xcu.” If coverage is not purchased in the primary policy, have an understanding with the Umbrella carrier that coverage will be afforded in excess of the normal required underlying limits.

Rates can differ substantially in a range of 400 percent. The present Umbrella market is rising substantially and an increase on renewal can be expected. Competitive quotations should be considered.
Underlying limits of the primary policies are also subject to negotiation. In the past it has been more economical to purchase increased limits under the Umbrella rather than the primary policies. Therefore, the primary policies should have the lowest limits possible.

r) Contractor’s equipment. Equipment policies normally pay on actual cash values rather than values indicated in the policy. Therefore, care should be taken that values are adjusted annually, if not sooner, to reflect any decline in actual cash value. These values should be agreed upon by the insurance company. Again, coverages and rates are negotiable. Check the following: “All Risk” coverage, rented and leased equipment, coverage for automobiles carrying specialized equipment, riot exclusion, unearned premium insurance, boom exclusion, repair and maintenance exclusion, and rental cost reimbursement.

s) Experience rating. Experience rating plans apply primarily to coverages such as Worker’s Compensation, General Liability, Auto Liability, Automobile Physical Damages, and other miscellaneous casualty coverages.

The theory of experience rating is that rates will be established for various industries for various exposures and those businesses which have lower losses than the average will acquire credits. Those having more than average losses will be subjected to penalties. These experience rating modifiers may be calculated by a particular state, a national rating bureau funded by insurance companies, or by a specific insurance company.

These plans compare premiums to losses, including reserves. Reserves can be defined as the money which insurance companies hold to cover both actual and potential losses or claims. Generally speaking, some insurance companies have a tendency to over-reserve. By overreserving, there is a tendency to increase specific experience rating modifiers, increase overall industry rates and obtain a tax float.

Thus, it is very important that the contractor review the reserves on open claims before they are used in computing experience modifiers and agree to the reserves that are being maintained. If additional coverage is purchased, it is possible for the contractor to request that self-insured data be used by the insurance company or bureau computing the experience modifier. If the losses have been low, or none, the modifier will be decreased by the additional premium and lower amount of losses.

t) Bidding insurance. While most
contractors are used to bidding on work based on specifications given to them by the owners, many do not apply the same principle in purchasing insurance. On the other hand, some have required bids on their insurance in the past. But due to the fact that bid specifications were not properly prepared, they probably obtained as many different proposals equal as the number of bidders.

Request Bids

It is impossible for an expert to compare a multitude of different proposals, much less the ordinary business man. Requesting insurance bids should be considered by the average contractor. Bids may be requested from various insurance agents or the insurance marketplace may be approached through one broker or agent.

In any case, it is quite important that the bid specifications be prepared so that bids may be easily compared. It is a good idea to have bid specifications prepared by someone who will not be bidding on the insurance package.

This will allow some professional input yet avoid a conflict of interest. Perhaps one of the most important things to remember in putting insurance out to bid is to limit each agent or broker to a specified number of insurance companies. If more than one agent approaches the same insurance company, the marketing of your insurance package may not be too successful.

u) Self-assumption programs. Some common risk assumption measures used to determine the loss assumption ability for corporations are: Balance sheet or financial strength indicators.

1) Working capital method—a percentage of working capital is used to establish an assumption amount. Guides of 1 to 5 percent have been employed.

2) Asset method—A percent of the total assets of the corporation are used in determining the amount of risk to be assumed. Two percent of total assets is a norm.

Income statement or effect on corporate earnings.

1) Earning/surplus method—Generally, the suggested computation is one percent of current retained earnings, plus 1 percent of the average per-tax earning over the preceding five years.

2) Earnings per share—This is subject to the judgment of the officer and directors of the corporation as to what level of a reduction of earnings per share would seriously affect the value of their stock. This is especially important for publicly traded corporations.

3) Sales/budget method—Generally, 0.1 percent of annual sales is used in establishing the assumption limit.

Other financial indicators.

1) Non-dedicated cash flow—A considered risk assumption level would be one to two months of the previous year’s non-committed cash flow from operations.

2) Premium savings method—This method doesn’t consider the financial capacity of the organization facing the risk. However, premium savings must be taken into consideration in weighing the potential loss to be self-assumed.

Loss Potential

None of the above are exact for any one organization, but they do establish a range. The potential and frequency of loss must be taken into consideration as well. In other words, on losses which might happen once every ten years, a much higher loss assumption level can be assumed than those where the loss could happen once a month.

After the loss assumption levels are established, risk above these levels should be transferred. This is done by buying insurance under a contract with another party or, perhaps, avoided in the first place.

v) Self-insurance. All contractors self-insure a great deal, both consciously and unconsciously. Appropriate areas of self-insurance are physical damage to automobiles and equipment, liability deductibles, Worker’s Compensation, and deductibles for various coverages.

In the areas of Worker’s Compensation and Liability, the practical aspect of handling claims and engineering services must be taken into account. During the last five years, many competent servicing firms have come in their own and offer a multitude of self-insured programs,
ranging from claims handling, engineering services, to data accumulation.

w) Life insurance. While there are some cases in which policies with cash values are desirable, term life insurance is more desirable than an insurance policy that builds cash values. This is especially true if the coverage is being purchased for the exposure rather than as an investment program. Even as an investment, there are many more efficient programs than using the cash values of life insurance policies.

Remain Impersonal

While insuring a life is often a personal matter, it should be looked at from an impersonal standpoint to see if it makes good business sense.

x) Cash flow programs. To obtain most of advantages of self-insurance, and possibly avoid some of the disadvantages, many firms find it advisable to enter into various arrangements with insurance companies rather than establishing large-self-insured plans.

In certain instances, it is not legal or practical to self-insure. In addition, certain lines such as Liability require substantial amounts of reinsurance. Insurance companies can often purchase reinsurance at much lower rates than individual firms.

Cash Flow

Some examples of cash flow arrangements are:

1) Negotiate an “all lines” retrospective plan with an insurance company, subject to substantial self-assumption levels. A cash flow statement will be prepared monthly, indicating the premiums paid by the insured, losses actually paid, and expenses earned. The net cash on hand will be multiplied by an agreed upon interest rate and credited to the insured’s account. This interest rate can be tied to some rate indicator such as US Treasury bills.

2) Many insurance carriers will agree to letting the insured pay on an “incurred claim” basis. This is calculated by determining the monthly premium, applying the appropriate factors, such as basic premium factors, adding the incurred losses, subject to loss adjustment expense, and other items such as reinsurance and taxes. This basis is not too desirable since it does not leave much of the claim float with the insured.

3) A much more preferable basis is to project a retro on a “paid claim” basis and pay it monthly. In other words, the premium will be calculated as in “b” above, but rather than using “incurred losses” “paid losses” are used.

4) If the corporation is required to maintain compensating balances at a bank, the insurance company can open an account in its own name and deposit premiums collected from the insured into the account. The bank will then consider these funds as compensating balances and would allow the corporation to reduce its normal corporate account. This, in effect, gives the contractor the use of the funds held by the insurance company.

Payment Lag

5) Payment lag should be utilized in all of these except the monthly retro on a paid claim basis. A payment lag of 60 to 90 days is desirable. For instance, the January payroll report is payable on May 25th.

6) High deductibles can be utilized along with the retrospective rating plan. An “all lines” Retrospective D Plan can be written subject to deductibles of $50,000 to $250,000 for Liability coverages. This will substantially reduce the premium deposits and resulting expenses, but yet allow the corporation to tap the reinsurance markets of the insurance company.

7) Larger contractors who pay $500,000 or more may consider the use of a “captive” insurance company. Smaller contractors can group together to form a multiple owned captive company. Captive companies are feasible if large amounts of premiums are generated in specific localities. These companies can also receive Bond commissions.

The above examples can be modified, and often combined,
depending on the coverages and circumstances involved. As a matter of information, assuming expected claims volume of $1,000,000, the cash flow can amount to $2,000,000 at the end of five years. On this volume of claims, each 1 percent of interest will probably generate approximately $20,000 in ultimate interest income.

y) Losses. The amount of losses ultimately determines the amount of insurance premium paid, one way or the other. Therefore, the key to ultimate lower cost is to reduce losses. It is not necessarily in the vested interest of the insurance companies to reduce losses. After all, what would happen if all businesses were able to reduce losses by 50 percent?

In effect, the premium volume of the insurance companies would be ultimately cut in half. Therefore, while the contractor should rely on the insurance company to make adjustment on losses, he should retain some measure of control over such adjustments.

It is also highly advisable for the contractor to negotiate an arrangement with the insurance carrier whereby all claims to be settled over a certain amount are reviewed and approved by the contractor. Periodic reports should be made to what losses have occurred and the manner in which all open claims are presently being handled.

A few insurance companies strongly resist this sort of review by an insured. However, the insured should insist on it.

z) Railroad protective or owner protective. In many instances, the owner, or a railroad, will require a protective policy written in their name. This policy provides them coverage in the event they become liable for some act arising out of the contractor's operations. These premiums can be substantial.

Under normal circumstances, a contract is entered into with the railroad or owner which contains a Broad Form Hold Harmless Agreement. There is overlapping coverage between the hold harmless agreement and the protective policy. There is a Contractual Liability code for “Residual Liability” which can be used to recognize the duplication of coverage. In addition, the protective rates can be negotiated downward as well as upward.

If possible, negotiations should be made with the insurance company so that any losses will fall under the protective policy rather than being charged under the contractor’s normal policies and ultimately increasing his cost.

The above are only some of the methods and ways improved coverages or reduced costs can be achieved. Keep in mind while insurance is complex, it is still manageable.