Thoughts on Self-Insurance

Managing Risk Isn't a Matter of Avoiding It But How Best to Handle It In the Most Economical, Sensible Way

As part of its overall risk management program, a contractor must determine how to most economically finance the risk of losses to which he is exposed. One method employed by many firms is to pay all or part of such losses itself, rather than purchase coverage from a commercial insurer.

The technique, called self-insurance or risk retention, is applicable to large and small companies alike. A firm's decision to self-insure, and to what extent, depends largely upon its management philosophy, its financial objectives, and the nature and frequency of risks to which it is exposed.

This article will acquaint contractors with conditions which could warrant self-insurance, the kinds of risks which are commonly self-insured, and some of the most frequently used risk retention methods.

Why Self-Insure

The principal goal of self-insurance is to reduce costs and enhance cash flow, but it can serve other purposes as well. One of the most important of these is to preserve the availability of catastrophe protection from a commercial insurer.

For example, an insured's adverse loss experience may result in its carrier's inability to continue on the risk. By retaining a level of risk appropriate to its financial capacity, however, the business is in effect sharing with its insurance company a specific portion of its losses. Thus the insurer, because it is participating only in unpredictable or catastrophic losses, is better able to provide protection at reasonable costs.

A company may also self-insure if it finds there is no insurance readily available for certain risks at a price it is willing to pay. An additional benefit of self-insurance is that it tends to focus management attention on the cause of losses, and on improved programs for controlling them.

In setting a maximum limit to its self-insurance, and choosing the method of financing its retained risks, a company will want to determine its capacity to absorb losses without significantly disrupting its financial results in the year the losses occur.

Factors to consider include earnings, tax profile, cost and availability of credit, liquidity, cash flow projection, dividend policy and return-on-investment goals.

It is important to remember, however, that in adopting risk retention limits a company is creating guidelines only, since the level of retentions actually employed will finally depend upon a trade-off between benefits and costs.

A professional insurance agent or broker, because of his knowledge of both the insurance marketplace and his client's needs, can be an important source of counsel in helping a company determine its optimum risk retention level.

Setting Risk Retention Limits

A common guideline by many companies to determine their total self-insurance limit for all risks is a percentage of net working capital, usually from 1% of current retained earnings plus 1% to 5%. A second approach is to limit risk retention to 1% of current retained earnings plus 1% of average pre-tax earnings over the preceding five years.

Publicly held companies often base their limits on earnings-per-share, while firms with high cash turnover may base self-insurance limits on a percentage of sales, generally from 1/10 of 1% to 1%. Non-profit institutions frequently use their annual budgets as a base, often taking 1% of that figure as their limit.

The objective is to relate the limits of self-insurance to the overall financial status of the company, rather than to simple premium savings.

In general contractors most often choose to retain risks where levels of loss are fairly predictable, or in the case of certain liability exposures,

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where insurance is prohibitively expensive or unavailable.

Examples of predictability are automobile damage and damage to other physical assets, particularly when loss frequency tends to be fairly consistent.

For instance, a company with a large stock of pumps, mixers, etc., might want to limit its commercial insurance coverage to a potentially catastrophic loss, such as the destruction of a major portion of its fleet in a garage fire or explosion. A company with a smaller equipment stock may want to buy only fire and theft coverage, and fund other perils from its working budget.

Another frequently retained risk, particularly by large corporations, is workers' compensation liability, because the size of their employee populations provides a spread of risk that usually makes retention economically sound. As with equipment coverage, a potentially catastrophic exposure is covered by limiting loss on a single occurrence, and purchasing excess insurance for losses over that figure.

Liability exposures, which subject a firm to claims from third parties, are being self-insured by an increasing number of companies. In the area of professional or products liability, for example, where insurance is becoming more expensive and more difficult to obtain, companies are retaining increasingly higher levels of risk regardless of predictability.

Financing Retained Risk

Methods of financing a retained risk range from the simplest—doing nothing about it—to the very complex-creating a subsidiary insurer.

For example, with losses which are likely to have low severity, such as auto damages, a frequent method of financing is deliberately to do nothing at all. When and if losses do occur they are simply recorded and charged to operating budgets.

But before a company can responsibly choose to non-insure potential losses, it needs to determine how much working capital it has available to pay for an unexpectedly large loss. A company which plans to cover specific risks out of current expenses must estimate such potential losses and prepare for them in its budget.

Companies retaining larger risks often establish a reserve to pay for losses as they occur. This may be a bookkeeping reserve or a funded reserve, depending upon the company's financial condition and on prevailing accounting practices.

Determining the size of the company's yearly contribution or the ultimate size of the fund itself is an arbitrary matter. Often a company will simply deposit in its own fund the premium it would have paid to a commercial insurer: the whole premium if the entire risk is self-insured, or, if the retention is a deductible, then the difference between the cost of first-dollar coverage and the premium.

In terms of the total size of the fund, a typical objective is to accumulate from two to five times as much as the company might lose in a single occurrence.

A more significant problem is how to finance a loss before the fund has accumulated enough money to pay for it. Some companies, recognizing the fund's vulnerability in its early years, make an arbitrarily large initial contribution. Others start with a limited retention program which is gradually increased as the fund increases its capacity to pay for retained losses.

Reserve funds such as this can be costly, since the IRS, in some cases, may permit no tax credit for self-insurance reserves, but only for losses when they are actually paid. Every company considering such a risk financing plan should consult legal counsel and tax advisors on specific tax liabilities.

What a reserve fund does provide is the use of a sizable sum of money that a company would otherwise have paid to an insurance carrier. As the fund grows the income the company derives from it can be significant.

Because a firm may need to draw on its self-insurance fund at a moment's notice, investments are generally made in short-term instruments. Some self-insureds, however, arrange stand-by loans to provide quickly the maximum amount of money the fund is likely to need to finance a loss, and thus free their capital for longer-term, higher yielding investments. The stand-by cost is generally nominal and the loan, if drawn down, is at prevailing rates.

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In this approach to retention the greatest savings will come through the use of straight dollar deductibles, where the amount the company has specified is deducted from each loss, regardless of size. This is an appropriate method for the company that knows exactly how much loss it can fund internally.

Companies that employ deductibles in their retention program often make use of an aggregate deductible, which puts a limit on the amount of retained loss. This prevents deductibles from accumulating beyond a company's ability to absorb them.

For larger corporations with extensive risk management programs and major retentions, a subsidiary or "captive" insurance company may be another approach. Often domiciled outside the U.S. in order to take advantage of an improved rate of return, such subsidiaries are of value primarily to corporations which operate in a number of countries. They may also be useful to organizations which have difficulty in obtaining coverage from regular commercial sources, except at uneconomical rates.

The Most Familiar Form of Self-Insurance

Almost all individuals and companies are familiar with and already practicing one form of self-insurance in the deductible provisions of their insurance contracts. These are usually accepted as an inherent part of an insurance policy, covering losses an insured can handle more economically than his carrier. A company may also be practicing risk retention involuntarily when it is exposed to potential losses not included in a "named peril" policy. For example, there may be no coverage for flood, earthquake, war, collapse or similar incidents which could create a loss for the firm.

The tax and legal consequences entailed are complex, and vary from company to company and state to state. Again, as with any method of risk retention, the corporation should consult with competent counsel and tax advisors to determine feasibility.

Because a risk retention program works in lock-step with a company's financial position and objectives it will change as they change, and thus should be subject to frequent review, certainly not less than once a year.

Growth of the company, for example, might make increased retentions desirable, or change the method by which risk financing is accomplished. An altered cash position could have the opposite effect and call for a greater use of risk transfer to a commercial carrier.

Past performance will need to be evaluated, and realized savings must be related to present insurance market conditions.

Operating costs should be carefully broken down and allocated, including the cost, if incurred, of obtaining services formerly provided by the insurer.

The savings realized in the program can be computed by comparing present premiums and retained losses paid to premiums that would have been paid for first dollar coverage. From these savings the company would have

An Incentive to Loss Control

One benefit of retaining a certain amount of risk is the stronger motivation of contractors to improve their loss control efforts. When a firm's individual profit centers are financially responsible for their own losses up to a given point, contractors generally have a better incentive to take strong and effective safety and security measures.

to deduct additional costs, such as loss prevention and administrative expenses, to arrive at the net savings realized.

While commercial insurers generally provide insureds with auxiliary services such as safety engineering, companies employing self-insurance extensively may want to consider additional services specifically tailored to their own risk retention needs. A firm can determine the need for such programs and the means of implementing them in conjunction with their insurance agent or broker.

A number of companies offer claims management and adjusting services, loss information systems, and loss control services. The cost of these auxiliary programs, if purchased independently, must be weighed against the savings achieved by risk retention.

Only through such reviews and analyses can the self-insured company be certain that its retention program is responsive to its financial needs and its ability to continue retaining risks.