# WC

WORKERS' COMPENSATION

OCTOBER 2016 | NOVEMBER 2016
ISSUE 5 VOL. 2




# Redefining Retaliation

HOW TO MODIFY POST-INJURY DRUG TESTING AND REPORTING POLICIES AS OSHA EXPANDS ITS REACH P18


A publication of CLM
TheCLM.org

# Trends in Alternative Risk Financing

## A Close Look at the Pros and Cons of Top Program Options

*By David R. Leng*

Alternative risk financing is when a business does not purchase traditional, guaranteed-cost insurance policies but instead purchases insurance where it takes on some risk for potential rewards. There are more insurance premiums invested by businesses in the alternative risk financing market than you might realize, with the use of captives being the most popular of the alternative risk financing programs used.

A September 2006 report by Conning Research & Consulting found that alternative market mechanisms covered about 30 percent of the U.S. commercial insurance market. Since that report, the alternative market percentage had continued to grow rapidly. According to various insurance industry reports, there were approximately 35 percent more captives in 2014 than in 2006. Why is it that alternative risk financing is so popular?

When you have your house in order and have control of your risk profile, whether buying insurance outright for your organization or buying excess coverage when you are self-insured, it typically comes down to financing your risk and purchasing some form of insurance. There are multiple types of programs available to transfer risk to an insurance company for a premium. Here, we will go through a number of the programs, summarizing and providing highlights along with the advantages and disadvantages of each. The programs range from the highest cost for you to insure your risk to the lowest cost. Each one has pluses and minuses and, ultimately, you must make a decision based on the cost-benefit analysis for your company.

### Guaranteed-Cost Program

With the guaranteed-cost program, you pay a certain premium based on the underwriter's perception of your risk, with the only variation being the year-end premium audit. There is no real risk to you as an organization outside of retentions or deductibles per claim, which are very small. The main advantage of this program is that you can budget exactly how much you will spend for the year.

The reason guaranteed cost has

the highest associated cost is because insurance companies are in business to make a profit for their shareholders. They are going to determine the amount that they want to charge for the potential losses for your organization based on what the underwriter perceives as your risks. The underwriter then is going to add its expense ratio (cost of marketing acquisition, policy underwriting and service, and agent commissions) and the insurance company profit, and it will even add in a margin of error. Typically, insurance company expense ratios are in the 25 percent to 35 percent range. After adding in profit and margin of error, you are looking at 35 percent to 50 percent of your premium being used for expenses not associated with paying any claims on your behalf. Therefore, your premium will be two to three times what underwriters expect to pay in claims.

### Dividend Program

The dividend program is nothing more than a guaranteed-cost insurance policy with a potential return of premium based on the overall loss ratio (losses divided by your final premium) months or years after policy expiration. However, insurance companies tend to charge a little extra premium for policies with a dividend associated with them because they know that they ultimately may have to pay out a portion of the premium and they must maintain profitability.

### Retrospectively Rated Program

The retrospectively rated program (retro) takes risk-versus-reward a step further. After your policy expires, the insurance company retroactively will determine your final premium, looking backwards at the total claims amounts and calculating your final premium based on the total amount of the losses plus a tax and administrative expense multiplier, subject to both minimum and maximum premium limits.

Retros have the advantages of both significantly lower premiums, as minimums may be 40 percent of your standard premium (when claims are controlled), and flexibility of design. Unfortunately, retros have earned a bad reputation because insurance companies typically present retros to businesses that are experiencing significant losses. Insurance companies are able to collect extra premiums to offset these losses by using high maximums. Instead of a normal 110 percent or 120 percent of standard premium maximum, they might use 200 percent or more.

**If your captive takes in more money than it spends after all expenses and claims are paid out, then it generates an underwriting profit that may be returned to you as the owner.**

### High-Deductible Program

A high-deductible program is the step just before using a captive or self-insured program, and you use a large deductible per claim, typically a minimum of $25,000 or $50,000 per claim or even larger deductibles of $100,000, $250,000, $500,000 or more per claim. To prevent too much financial uncertainty caused by a high frequency or severity of injuries, you may use an aggregate deductible amount to have some maximum cost certainty. The aggregate might be two to five times the amount of the per-claim deductible or more, depending on the premium size of your company.

Through these high deductibles, you will find yourself paying most, if not all, of your claims costs. You are purchasing excess coverage from an insurance company for very large claims or very bad years. You receive a substantial premium reduction through a large credit that is applied to your policy to reduce the insurance premium portion you pay. In essence, a high deductible is not much different from self-insurance, except that you do not have to deal with all of the state regulatory issues of self-insuring.

Much like retros, the insurance company will mark up claims to include handling expenses, development factors, taxes, and possibly fees. Read your contract to understand exactly what it is adding to each claim dollar spent on your behalf, including reserves. The downside to this program is that, from a tax standpoint, you can only deduct as an insurance expense the amount of premium that you pay and the amount you pay for actual claims paid. You will not be able to deduct the reserves you must set aside and pay to the insurance company.

### Captive Programs

Captives, with over 6,700 worldwide and a 35 percent growth since 2006, are the most popular of the alternative risk financing options because you receive the potential benefits of owning your own insurance company. A captive is its own legal entity and is recognized as an insurance company. It enables you to take a portion of your risk individually or as part of a group and earn the potential underwriting and investment income profits that normally would go to the insurance company.

For statutory insurance needs, you use a "fronting" insurance company to issue you an insurance policy. The fronting company keeps a small percentage fee for the issuance of your insurance policies and for dealing with any necessary regulations. Your captive will then act as a reinsurer, receiving a net remaining premium and reimbursement for claims.

For nonstatutory required coverages, you can use your captive for reimbursement of unexpected losses from pretty much anything you can calculate actuarially, making a captive an incredibly flexible insurance tool.

If your captive takes in more money than it spends after all expenses and claims are paid out, then it generates an underwriting profit that may be returned to you as the owner. While the monies are held by the captive, the funds can be

invested, and any proceeds are available to pay claims or are returned as profits to the captive owners.

However, much like a regular insurance company, you may not want to have your captive pay for all of your potential claims by itself. If that is the case, you can purchase reinsurance for the captive in order to limit what you potentially may have to pay out, allowing your captive to function much like a high-deductible program. The captive will pay for claims up to an amount where any single claim or all claims in aggregate exceed a threshold at which the captive's reinsurance starts to provide excess coverage. The excess reinsurance thereby limits how much you may have to pay out for claims in a particular year.

When it comes to calculating your premiums for your captive program, the total amount you pay will include the fronting company fee, the reinsurance for your captive, and an amount for operating costs. In addition, you pay a premium for your estimated (or potential) claims. This is called your initial loss fund. As your actual losses may exceed the amount estimated, you also must set aside additional funds or a letter of credit to guarantee payment for the potential loss fund gap. The potential loss fund gap is the total amount you might have to pay if all of your losses exceed the initial loss fund and before remaining claims costs are picked up by the reinsurance company. If all goes well and you have fewer, if any, claims, you will reap the rewards of both an underwriting and investment profit. In the group captive world, if the entire group has a bad year, you might need to pay into the potential loss fund gap, as well.

Much like retros or high-deductible programs, the period in which your captive adjusts the losses could take three to five years to play out and for a captive year to close. It takes a long-term investment for the dividend to be paid. The big advantages are that the premiums, including the amount paid in for your loss funds, may be tax deductible. Your potential "profits" will be earned as dividends and may be taxed as capital gains, depending on your captive ownership structure and nature, should your captive declare a dividend several years down the road.

There are two types of captives: single parent and group captives.

- **Single Parent Captive.** If you are paying a significant amount in premiums, typically a million dollars or more in casualty premiums, you may want to form your own captive and may not need to have others participate in it.
- **Group Captive.** A group captive entails joining in with a group of other companies that also have a significant focus on preventing and mitigating claims. In a group captive, you may be able to enter for as little as $100,000 of casualty lines premiums, such as workers' compensation, general liability, and auto coverage.

Due to the lower premium requirement as an entry point compared to self-insurance and the state insurance department regulatory compliance of self-insurance (see below), you can see why group captives are the most popular form of alternative risk financing.

An additional advantage of a group captive is that you can receive a higher risk versus reward similar to self-insurance when your premiums are not large enough to meet the regulatory requirements of self-insurance. Plus, you remove all of the regulatory headaches associated with being self-insured.

### Self-Insurance Program

Even with a self-insurance program, you typically purchase excess or reinsurance coverage to protect your organization when you have a significantly large claim or a series of larger claims so you will know what your maximum annual liability will be for any one claim.

For workers' compensation and auto liability, when you self-insure, you must file with the state insurance department to receive approval. Most states will tell you what reinsurance to purchase, stating the per-claim and aggregate retention amounts. You also will need an administrator to legally adjudicate your claims. You will need to set aside monies, known as reserves, to pay your claims and future claims. You also may have your program audited by an independent auditor to evaluate and make sure you have properly funded your program.

As I mentioned with high deductibles, your excess coverage premium, the fees that you pay for claims administration and actuary services, as well as the actual amount you pay for claims are tax deductible. However, you will not be able to deduct the amounts that you set aside for reserves. Because you self-administer much more of the process, the cost structure of managing a self-insured program is lower than in a captive and much lower than high-deductible programs.

### Words of Caution

As you can see, the more risk you take on yourself, the lower your cost of risk, i.e., your insurance cost. However, never take that huge step into alternative risk funding or any change beyond guaranteed cost unless you conduct an analysis and fully understand the risk/reward tradeoff. You also need to understand the cash flow implications and collateral requirements of each model so that, ultimately, you achieve the goal of dramatically reducing your costs.

One of the things I have seen in alternative risk funding programs is that many employers go into them assuming they are going to reduce their overall cost of insurance. But their downfall may be that their house is not order. When you actually calculate and analyze their annual costs, they may still be paying too much. Therefore, even though you may be in alternative risk funding, you need to continually analyze and benchmark your results. ■

*David R. Leng, CPCU, CIC, CBWA, CRM, CWCA, is vice president of the Duncan Financial Group and an instructor for the Institute of WorkComp Professionals. He has been a CLM Fellow since 2015 and can be reached at dleng@duncangrp.com.*