



# ***RISK FINANCING OPTIONS FOR CONTRACTORS***

**Presented by**

**Michael J. O'Neill, CPCU, ARM  
President  
ACIG Insurance Agency, Inc.**

In the extended soft market of the 1990s, many businesses, including contractors, abandoned loss sensitive insurance programs in favor of the unprecedented low prices that were being offered on guaranteed cost programs. Now, as premiums have turned the corner and started back up, contractors should reexamine other risk financing options, as they may offer contractors who can evidence a commitment to safety and loss control the opportunity to control rising prices. In this session, one of our most popular speakers will describe the various alternatives available to contractors and provide guidelines as to when each strategy is likely to be most effective and cost-efficient. Topics to be discussed include retrospectively rated plans (e.g., incurred loss, paid loss, depressed pay-in, investment credit, and deferred premium retros), as well as large deductible or matching deductible plans, self-insurance, and captives.

***Tuesday, October 30, 1:30-3:00 and 3:30-5:00 p.m.***



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**Michael J. O’Neill, CPCU, ARM**  
**President**  
**ACIG Insurance Agency, Inc.**

Mr. O’Neill is presenting Workshop G, “Risk Financing Options for Contractors,” on Tuesday. He has been involved in the construction insurance industry for more than 25 years. He is president of ACIG Insurance Agency, Inc., a construction-industry-owned insurance organization in Dallas. Mr. O’Neill is a frequent speaker for construction industry trade associations; he has spoken 10 times at the Construction Risk Conference and was a previous Words of Wisdom Award winner. His expertise lies in the areas of captive management, risk management, retention analysis, contractual risk transfer, development of specialized coverage, and risk funding programs. Mr. O’Neill has written many articles for construction industry publications, including AGC, CFMA, and *Engineering News Record*.

## ***Notes***

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# **RISK FINANCING OPTIONS FOR CONTRACTORS**

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**Michael J. O'Neill**  
**ACIG Insurance Agency, Inc.**

**I. Risk Management Defined**

**II. Review of Risk Techniques**

- A. Risk control
- B. Risk retention
- C. Risk transfer
- D. Risk financing

**III. The Risk Financing Process**

- A. Five key steps

**IV. Loss Payout Patterns**

- A. Workers compensation
- B. General liability
- C. Auto liability

**V. Risk Retention Basics**

- A. Rules of thumb
- B. Examples
- C. Analysis guidelines

**VI. Risk Financing Options**

- A. Guaranteed cost
- B. Incurred loss retro
- C. Depressed pay-in retro
- D. Deferred premium retro
- E. Investment credit retro
- F. Paid loss retro
- G. Large deductible plans
- H. Single-parent captive
- I. Qualified self-insurance
- J. Self-insurance wrap-around

# **Notes**

## **Risk Management Defined**

**Risk Management is a process of identifying risks and applying certain techniques to effectively handle those risks.**

## **Alternative Risk Techniques**

- **Risk Control**
- **Risk Retention**
- **Risk Transfer**
- **Risk Financing**

## **Risk Control Techniques**

- **Avoidance, elimination and reduction of risk through pre-loss activities**
- **Loss control reduces the probability that loss will occur**

## **Risk Retention Techniques**

- **The retention of risk**
- **Internal cost of risk retained**

## **Risk Transfer Techniques**

- **Non-insurance risk transfer through a contract or agreement**
- **Insurance risk transfer via premium payment**

## **Risk Financing**

- **Manages the sources and uses of funds to finance the recovery from accidental losses**
- **Decision methodology for making, implementing and monitoring choices for a cost-efficient funding of losses**

## **The Risk Financing Process Five Key Steps**

1. Identifying and analyzing exposures to loss
2. Examining alternative risk financing technique(s)
3. Selecting the best technique(s)
4. Implementing the selected technique(s)
5. Monitoring the results

### **Step 1: Identifying and Analyzing Exposures**

**Risk Quantification - statistical concepts and techniques used in developing a loss forecast.**

**Data sources needed, loss history, loss development, payout profiles, exposures and trending.**

### **Step 1**

**Loss forecasting is useful in a number of applications**

- **Determining appropriate retention levels**
- **Identifying, evaluating and selecting risk financing options**
- **Allocating risk financing costs and risk bearing capital**
- **Determine premium adequacy and fairness**
- **Budgeting organizational expenses**

## Loss Forecasting – Data Requirements

- Loss Data - all lines for past 5 years
- Historical Payrolls for past 5 years
- Ground Up Losses
- Loss Stratification

## Loss Data – General Liability

<u>Policy Year</u>	<u>Loss &amp; ALAE</u>	x	<u>Trend Factor</u>	=	<u>Trended Loss &amp; ALAE</u>	x	<u>LDFs</u>	=	<u>Ultimate Loss &amp; ALAE</u>
1996	\$ 450,392		1.34		\$ 603,525		1.308		\$ 786,141
1997	685,932		1.276		875,249		1.380		1,207,843
1998	214,322		1.216		260,683		1.58		413,704
1999	282,444		1.158		327,070		2.46		804,593
2000	<u>155,482</u>		1.103		<u>171,496</u>		4.61		<u>790,940</u>
	<b>\$1,788,627</b>				<b>\$2,238,023</b>				<b>\$4,003,221</b>

### Historical Payrolls

<u>Policy Year</u>	<u>Payroll</u>	<u>Loss Rate Per \$100 Payroll</u>
1996	\$ 21,372,460	3.678
1997	25,349,065	4.765
1998	23,890,319	3.053
1999	26,352,772	3.053
2000	<u>23,736,420</u>	3.332
	<b>\$120,701,036</b>	<b>3.317</b>

### Loss Pick Choices

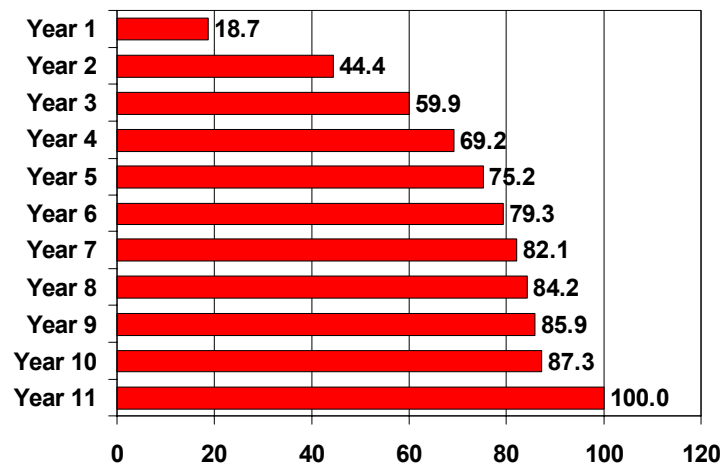
<u>Loss Rate Averages</u>		<u>Estimated Payroll</u>	<u>Projected Losses</u>
Weighted Avg. Last 3 Years	2.716	\$23,000,000	\$624,665
Worst Rate	4.765	23,000,000	1,095,914
Best Rate	1.732	23,000,000	398,286
Weighted Avg. All Years	3.317	23,000,000	762,828
Avg. Excl. Best & Worst	3.355	23,000,000	771,545

## Loss Payout Patterns

- Insurance company charges premium for exposures in the 2001-02 policy term
- Losses will be paid out over time and will vary by line of business
- ISO study of payout patterns

## Loss Payout Profile

### Workers Compensation

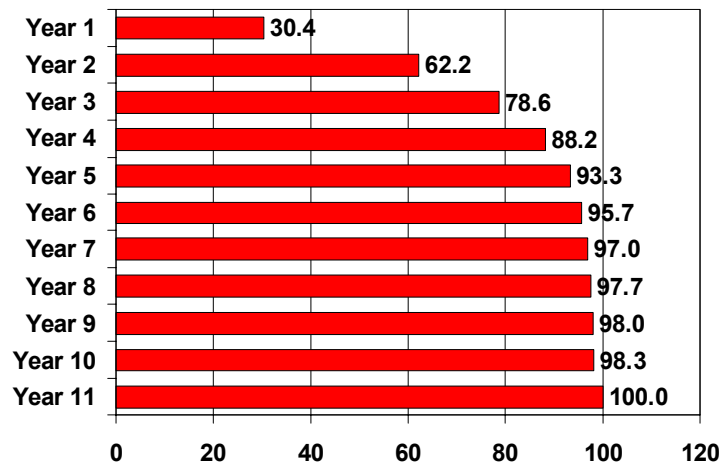


## Workers Compensation

- Payout pattern shows a steady increase over time
- Due to statutorily determined benefits
- Real unknown is the duration of the injury and treatment

## Loss Payout Profile

Automobile Liability

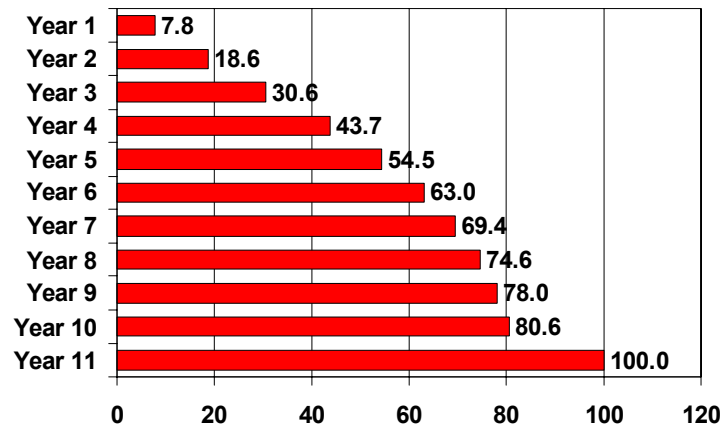


## Auto Liability

- Losses are paid out quickly
- Few late reporting/IBNR issues
- 30% paid out after Year 1
- 93% paid out after Year 5

## Loss Payout Profile

### General Liability (Including Products Liability)



## General Liability

- Slowest to pay out
- Longest tail/Most IBNR
- Late reporting, litigation, multiple parties and protracted discovery
- < 10% after 1 year
- < 60% after 5 years

## Payout Pattern Caveat

- Payout patterns vary by industry, by state and by company
- Large contractor will want to calculate its own payout pattern

## Risk Retention

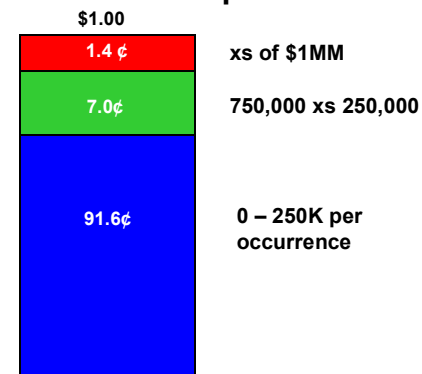
- An integral part of a risk financing program
- Retain losses for several reasons
  - Reduce cost of risk
  - Retention encourages loss control
  - Risk retention is looked upon favorably by the insurance markets

## Risk Retention Basics

- Retain predictable losses
- Avoid catastrophic risks

## Risk Retention Example

### Workers Compensation



## Risk Retention Analysis Guidelines

1. Working capital method
  - 2-15% of working capital
2. Total asset method
  - 1-5% of total assets
3. Earnings/surplus method
  - 1-8% of average pre-tax earnings over a 5-year period
4. Sales budget method
  - 1/2-2% of annual sales
5. Annual premium method
  - 10% of annual premium

## Factors Influencing Optimal Retention Level

- Retention capacity of a particular organization, loan covenants, other external forces
- Cost and availability of excess insurance
- Frequency and severity of expected losses
- Degree of risk aversion of company management

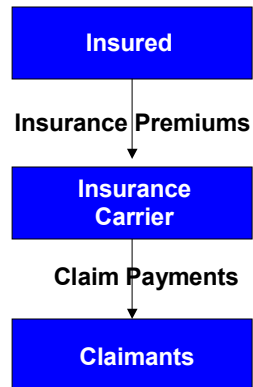
## Examining Alternative Risk Financing Options

- Guaranteed Cost Plans
- Incurred Loss Retro Plan
- Depressed Pay-In Retro Plan
- Deferred Premium Retro Plan
- Investment Credit Retro Plan

## Examining Alternative Risk Financing Options

- Paid Loss Retro Plan
- Large Deductible Plan
- Single Parent Captive
- Qualified Self-Insurance
- Self-Insurance Wrap-Around

## Guaranteed Cost Plan

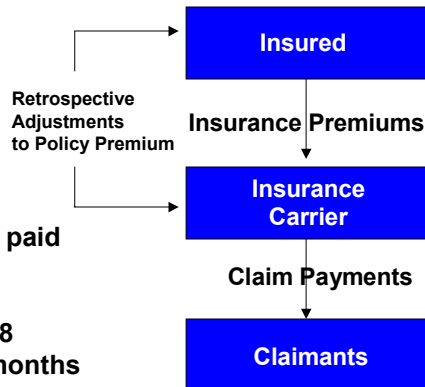


## Guaranteed Cost Program

- Most common program used
- Prospective plan where the premiums for the year are determined based upon insurance industry data.
- These policies are subject to premium audit based on payrolls, revenues, etc.
- In most cases, an insured's experience modifier is applied to modify the manual premium.

## Incurred Loss Retrospectively Rated Plan

- No collateral required
- Full standard premium paid during policy year
- Retro adjustments at 18 months and every 12 months thereafter



## Retrospective Rating Program Elements

### Basic Premium Components

- Insurer's expenses
- Profits
- Contingencies
- Commissions
- Charge to limit the maximum premium

## **Retrospective Rating Program Elements**

### **Excess Loss Premium (ELP)**

- Charge made to limit the losses to a fixed amount, i.e., \$250,000

### **Limited Losses**

- These are the total incurred losses, i.e., paid and reserve with individual losses limited to the loss limit.

## **Retrospective Rating Program Elements**

### **Loss Conversion Factor (LCF)**

- This charge is applied against the losses to cover unallocated loss adjustment expenses.

### **Limited Losses x LCF = Converted Losses**

### **Tax Multiplier**

- This component is the charge for premium taxes. These vary from state to state and line of coverage.

## Retrospective Rating Program Elements

### Subject Premium

- That portion of the premium affected by the loss experience.

### Non-Subject Premium

- This is the premium to limit the dollar amount of a liability loss.
- Risk Transfer Premium – not affected by losses.

## Retrospective Rating Program Elements

### Minimum Premium

- This is the least amount that will be charged; it is expressed as a percent of standard premium, i.e., 50 percent minimum.

### Maximum Premium

- This is the most that will be charged; it is also expressed as a percent of standard premium, i.e., 150 percent maximum.

## Retrospective Rating Program Elements

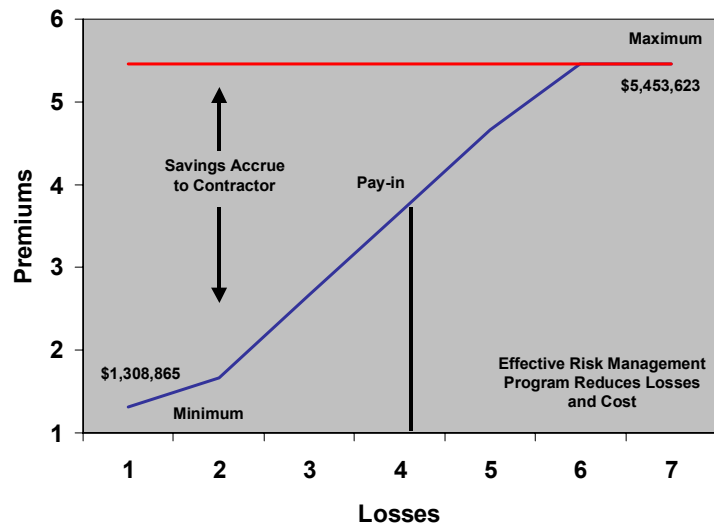
### Retro Adjustments

- These are calculated six months after the policy expiration and annually thereafter. These may be commuted at a specified time, e.g. 66 months; with any further risk accepted by the insurer.

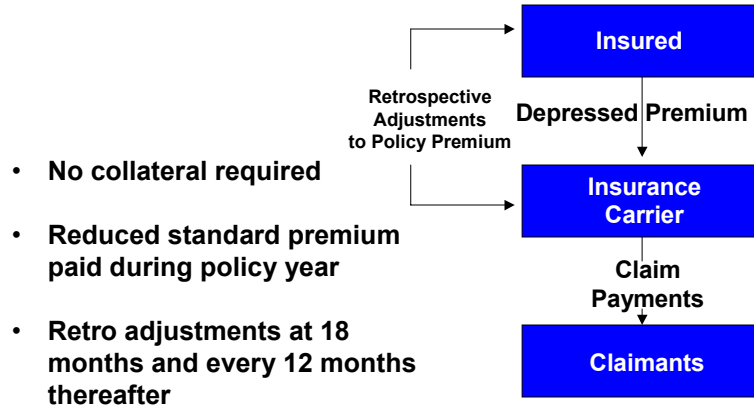
## Retrospective Rating Formula

$$\text{Retro Premium} = \left[ \left( \text{Basic Premium} + \text{ELP} + \left( \frac{\text{Converted Losses}}{\text{Losses}} \right) \right) \times \text{Tax Multiplier} \right]$$

## Risk/Reward Analysis



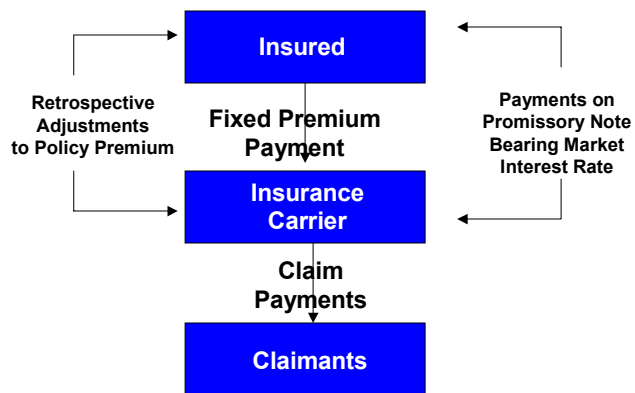
## Depressed Pay-In Retro



## Depressed Pay-In Retro

- Derivative of the Incurred Loss Retro Program
- Rather than fully funding the premium, the insured only pays in the amount estimated to be due at the first retro adjustment.
- The insured has the use of the unpaid funds.
- Collateral is usually required to make up the difference between the standard premium and the amounts paid during the year.
- This will normally be a letter of credit.

## Deferred Premium Retro



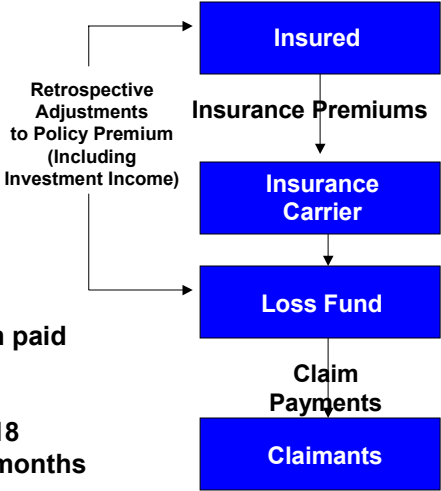
- Reduced standard premium paid during policy year
- Retro adjustments at 18 months and every 12 months thereafter

## Deferred Premium Retro

- Another variation of the Incurred Loss Retro Program.
- A fixed payment schedule over a number of years is agreed upon. Retro adjustments are not performed on an interim basis.
- A promissory note supported by a letter of credit is required as collateral.

### Investment Credit Retro

- No collateral required
- Full standard premium paid during policy year
- Retro adjustments at 18 months and every 12 months thereafter



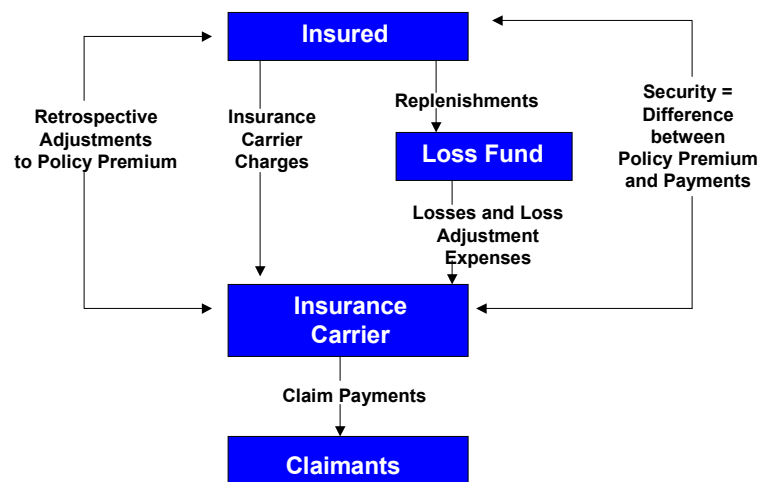
### Investment Credit Retro

- Variation of the Incurred Loss Retro Plan.
- Under this plan, the premium is split into two categories.
- The first category is for expenses, profit and excess insurance.
- The second category is the loss fund that will be used to pay claims.

## Investment Credit Retro

- The loss fund accumulates interest income until all claims are paid.
- No collateral is needed since the standard premium is fully funded.
- Retro calculations will be made in the normal fashion.

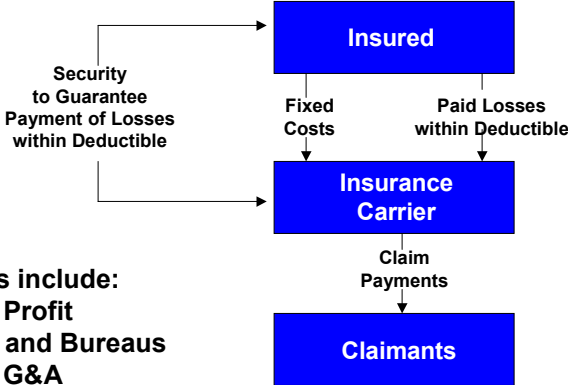
## Paid Loss Retrospectively Rated Plan



### Paid Loss Retrospectively Rated Plan Characteristics

- Insurer expenses and profit paid over 12 to 21 months
- Loss fund escrow = 3 months estimated paid losses
- Security = letter of credit or surety bond
- Retro adjustments at 21 months and every 12 months thereafter
- Tax treatment - expenses deductible as such/losses deductible when paid
- Letters of credit pyramid

### Large Deductible Plan



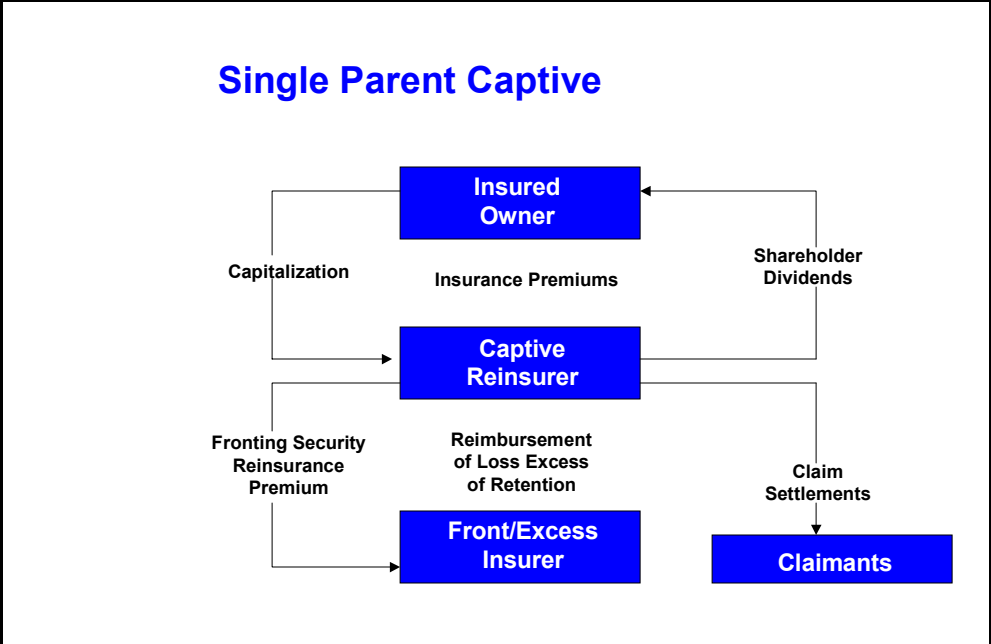
- Fixed costs include:
  - Insurer Profit
  - Boards and Bureaus
  - Insurer G&A
  - Reinsurance Premium
  - Loss Control Costs

## **Large Deductible Programs**

- Offers the insured many of the benefits of a qualified self-insured, without the increased internal costs.
- The insurance company provides all of the administrative services, including insurance certificates.
- The standard premium is reduced based upon the deductible amount, i.e., \$250,000 to \$1,000,000.

## **Large Deductible Programs**

- Since the insurance company is responsible for the first dollar of loss; it will require security to guarantee payment of deductible losses.
- The insured derives the benefit of not having to pay the expected deductible losses in advance.
- Mitigates some of the underwriting expenses, e.g. RML's and premium taxes.



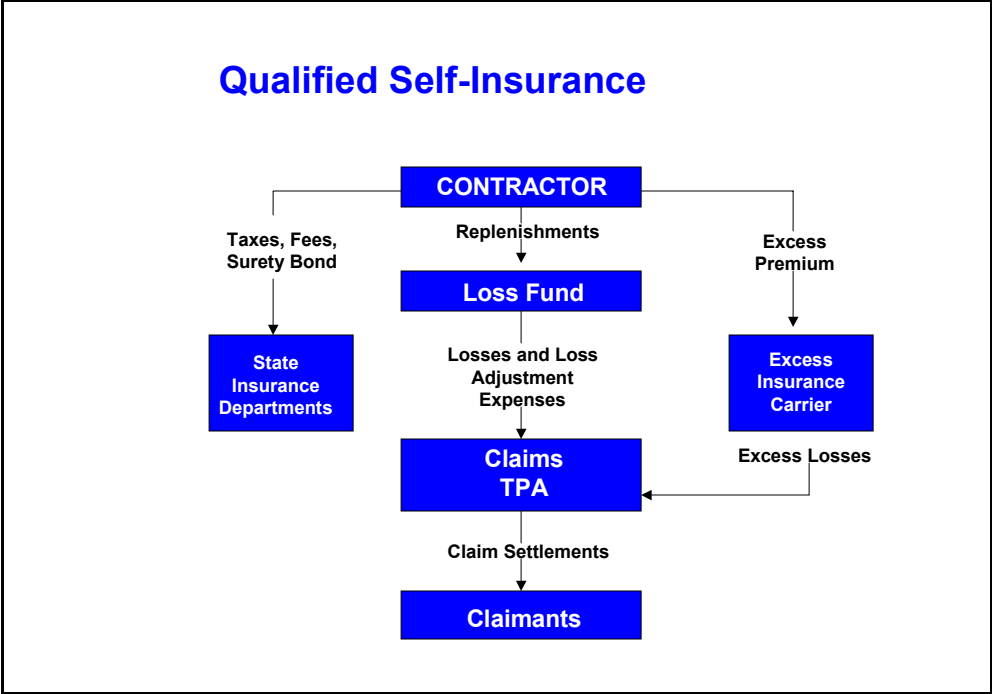
- ### Single Parent Captive
- An insurance subsidiary created by the insured that allows the firm to participate in the underwriting risk and investment profits associated with the firm's risk financing program.
  - The captive is capitalized and premiums are paid to the captive.
  - The captive will retain a level of risk and purchase reinsurance for limits in excess of its retention.

## **Single Parent Captive**

- **Tax issues:**
  - **Premiums generally deductible for federal income taxes**
  - **Dividends taxed similar to any stockholder's dividend**
  - **Return premiums taxed as ordinary income at the parent's rate**

## **Single Parent Captive**

- **Fronting issues:**
  - **Workers compensation requires a front**
  - **Certificate holders may require a front for liability lines**
  - **Fronting costs are similar to the basic charges in a retro plan down/runoff issues**
  - **Wind-down/runoff issues**



- ### Qualified Self-Insurance
- **Self-insurance requirements vary from state to state.**
  - **The self-insured is responsible for providing loss control, claims administration, data processing, etc.**
  - **A self-insured can either handle these functions internally or outsource to a vendor.**

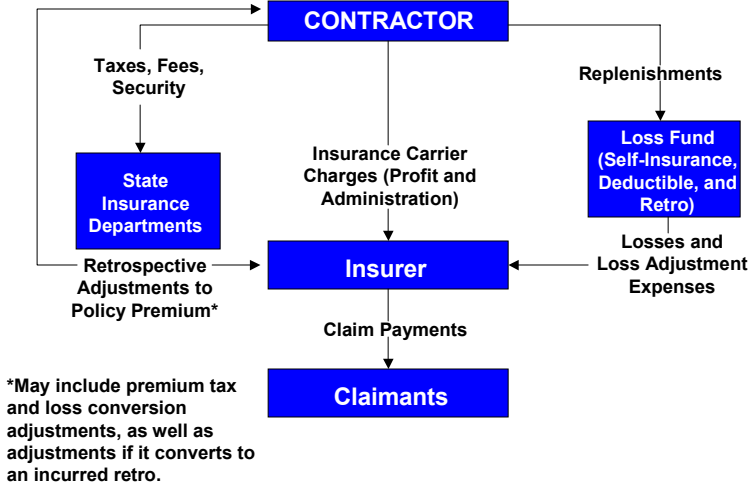
## **Qualified Self-Insurance**

- In most states, your risk retention limit will be approved by a state agency.
- The state agency may require the purchase of excess WC insurance and collateral.
- A firm must weigh the benefits of a self-insurance against the programs available through a Large Deductible Program.

## **Qualified Self-Insurance**

- **Important Considerations**
  - Taxes
  - Administrative
  - Regulatory
  - Admitted Paper
  - Qualifications

### Self-Insurance Wrap Around Program



### Self-Insurance Wrap Around Program

- This is an integration of the qualified self-insurance option and a large deductible or paid loss retro plan.
- Insurance company handles all of the administrative items for all states.
- Some states may be self-insured or insured.
- These programs are typically used by large firms that operate on a multi-state basis.

## Program Design Guide: Company Characteristics

	High Effective Tax Rate	High After-Tax Short-Term Cost of Borrowing	Cash Poor	Limited LOC Capacity	Contractual Requirements for Admitted Paper
Incurred Loss Retro	●			●	●
Depressed Pay-In Retro	●	○	○	○	●
Investment Credit Retro	●	○		●	●
Deferred Premium Retro		○	○		●
Paid Loss Retro		●	●		●
Single-Parent Captive	*				◆
Group Captive	*				◆
Rent-a-Captive	*				◆
Qualified Self-Insured	*	●	●		
Large Deductible	*	●	●		
Self-Insurance Wrap-Around	*	●	●		

- = High likelihood of premium deductibility/favorable program
- \* = Limited current tax-year deduction
- = Limited benefit from this program
- ◆ = Front required for admitted paper

## Tax Implications of Risk Financing

- **IRS Code Section 162 provides a tax deduction for ordinary and necessary business expenses.**
- **Treasury Regulation Section 1.162-1A makes it clear that insurance premiums are a deductible business expense.**

## **Tax Implications of Risk Financing**

- If risk is covered by insurance, the premium paid is deductible.
- If the amount paid is not for insurance, a deduction generally will be available under IRC Section 165 for the loss when it is incurred, but not for the premium when it is paid.

## **Tax Implications of Risk Financing**

- The issue for federal income tax purposes is one of timing, i.e., an attempt to take a deduction for funding losses at the earliest possible time, thereby receiving the greatest present value of the deduction.

## **Tax Implications of Risk Financing**

### **Guaranteed Cost Plans**

- Premiums are tax deductible.
- Any dividends or premiums refunded to the insured are includable as income under the tax benefit rule.

## **Tax Implications of Risk Financing**

### **Incurred Loss Retro Plans**

- The IRS has allowed deductions for the amount of the standard premiums.
- Premiums paid up to the maximum premium should be deductible.
- It must be recognized that an Incurred Loss Retro Plan will support a deduction only if it is not a disguised self-insurance arrangement.

## **Tax Implications of Risk Financing**

### **Paid Loss Retro Plans**

- There are many variations of the Paid Loss Retro Plans.
- It would appear that deductions for the basic premium and other expenses in the year are paid because:
  - the amount is not refundable and,
  - is paid to secure insurance coverage.
- Immediate deductions of amounts in excess of the basic premium and other expenses will depend upon the terms of the paid loss retro agreement and may be disallowed for not meeting the requirement for economic performance.

## **Tax Implications of Risk Financing**

### **Single Parent Captive**

- These programs have complex legal and tax implications that need to be researched fully.
- Recent IRS Guidelines provide a more favorable position.

## **Selecting the Best Risk Financing Techniques**

### **Decision Criteria To Be Used**

- Profitability Objectives
- Stability
- Continuous Operations
- Legal
- Humanitarian Concerns

## **Selecting the Best Risk Financing Techniques**

- Select a Single Technique
- Combination of Techniques to Achieve the Objectives

## **Plan Evaluation**

### **Development of a Plan Evaluation Tool**

- **Cost of Risk**
- **Service Enhancements**
- **Cash Flow Benefits**
- **Pivot Point Analysis at Various Loss Levels**

## **Implementing the Selected Techniques**

- **Contract with Service Providers**
  - **Insurers, Reinsurers, TPA's**
- **Scope of Service**
- **Checklist for Evaluation**
- **Documentation**
  - **Policies**
  - **Collateral, LOC's**
  - **Agreements, Retro, Fronting, TPA, Captive Management**

## Monitoring the Selected Techniques

- Allocating Costs to Divisions/Profit Centers
- Risk Management Information Systems
- Establishing Benchmarks
- Holding Service Providers Accountable for Quality of Services
- Reserve Adequacy, Loss Development, ALAE Analysis
- Safety Analysis

## Risk Financing

### Summary

- Risk Financing is a multi-disciplinary process that requires planning, organizing, implementation and monitoring. The Risk Financing Program needs to be flexible to address the cycles of the insurance market.