

Workshop T2

Tuesday, November 3, 1:30–3:00 p.m. and 3:30–5:00 p.m.

UNDERSTANDING RISK FINANCING OPTIONS

Presented by

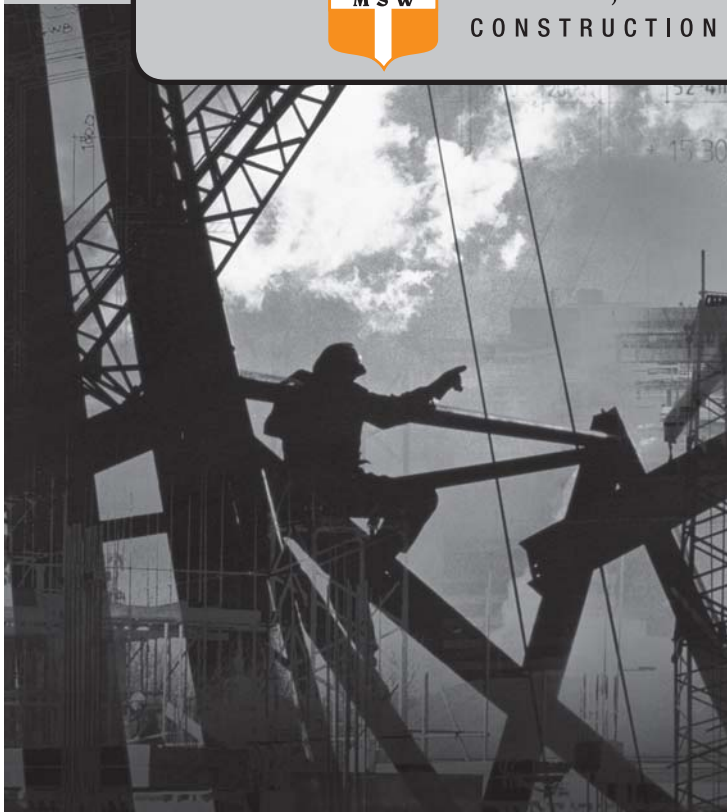


Michael J. O'Neill
Executive Vice President
American Contractors Insurance Group, Inc.

As contractors anticipate an eventual hardening of insurance markets, many are looking beyond the comfort of guaranteed cost insurance programs and reevaluating alternative risk financing options that involve varying degrees of risk retention. This session will review the various risk financing alternatives available to contractors, including incurred loss and paid loss retros, investment credit retros, deferred premium retros, large/matching deductible plans, self-insurance, and group and single-parent captives. Pros and cons of each method will also be addressed.



McGriff, Seibels & Williams, Inc.
CONSTRUCTION RISK SERVICES



**WE STAND
BETWEEN YOU
AND YOUR RISK
EXPOSURE**

INSURANCE BROKERAGE

RISK MANAGEMENT

PROGRAM DESIGN

CAPTIVES

SURETY

SAFETY CONSULTING

CLAIMS MANAGEMENT

BEST PRACTICES

ATLANTA

BIRMINGHAM

DALLAS

HOUSTON

NEW ORLEANS

PORTLAND

SAN ANTONIO

ST. LOUIS

www.mcgriff.com/construction

Michael J. O'Neill, CPCU, ARM
Executive Vice President
American Contractors Insurance Group, Inc.

Mr. O'Neill is presenting Workshop T2, "Understanding Risk Financing Options," on Tuesday afternoon. He has been involved in the construction insurance industry for more than 30 years. He is executive vice president of American Contractors Insurance Group, a construction industry owned insurance organization in Dallas. Mr. O'Neill is a frequent speaker for construction industry trade associations; he has spoken 20 times at the IRMI Construction Risk Conference, and is a recipient of the IRMI Words of Wisdom speakers' award. 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*.



Risk Financing Options for Contractors

Presented by:
Michael J. O'Neill, CPCU, ARM
Executive Vice President
ACIG Insurance Company
Dallas, TX

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**

3

Risk Control Techniques



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

4

Risk Retention Techniques



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

5

Risk Transfer Techniques



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

6

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 cost-efficient funding of losses**

7

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**

8

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.

9

Step 1: Loss Forecasting



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**

10

Loss Forecasting—Data Requirements



- **Loss data—all lines for past 5 years**
- **Historical payrolls for past 5 years**
- **Ground up losses**
- **Loss stratification**

11

Loss Data—General Liability



<u>Policy Year</u>	<u>Loss & ALAE</u>	x	<u>Trend Factor</u>	=	<u>Trended Loss & ALAE</u>	x	<u>LDFs</u>	=	<u>Ultimate Loss & ALAE</u>
2003	\$ 450,392		1.34		\$ 603,525		1.308		\$ 786,141
2004	685,932		1.276		875,249		1.380		1,207,843
2005	214,322		1.216		260,683		1.58		413,704
2006	282,444		1.158		327,070		2.46		804,593
2007	155,482		1.103		171,496		4.61		790,940
	\$1,788,627				\$2,238,023				\$4,003,221

12

Historical Payrolls



<u>Policy Year</u>	<u>Audited Payroll</u>	<u>Loss Rate Per \$100 Payroll</u>
2003	\$ 21,372,460	3.678
2004	25,349,065	4.765
2005	23,890,319	1.730
2006	26,352,772	3.053
2007	<u>23,736,420</u>	<u>3.332</u>
	\$120,701,036	3.317

13

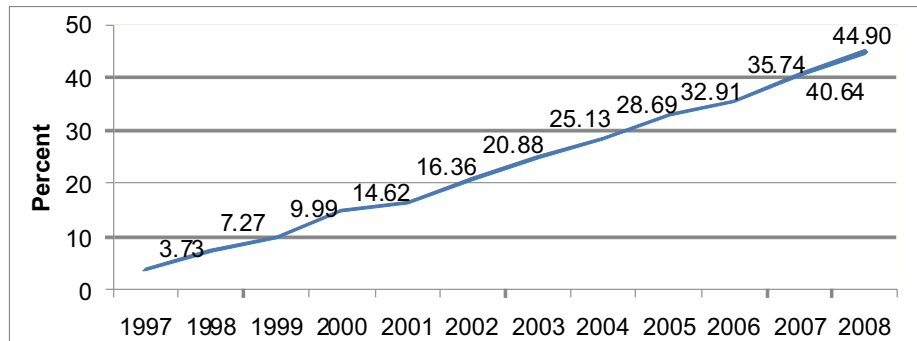
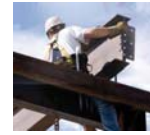
Loss Pick Choices



<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

14

Casualty Insurance Composite Trend Index



Source: Tillinghast-Towers Perrin

15

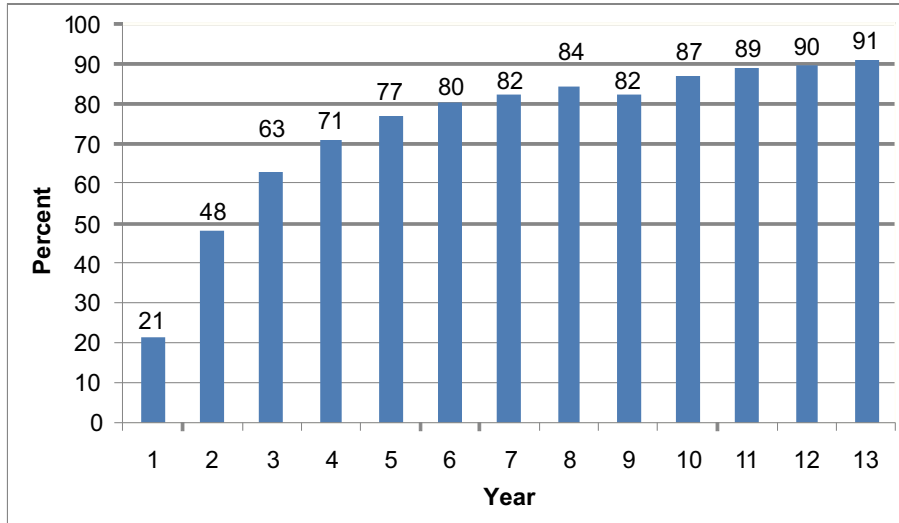
Loss Payout Patterns



- **Insurance company charges premium for exposures in the 2009-10 policy term**
- **Losses will be paid out over time and will vary by line of business**

16

Workers Compensation Payout Profile



17

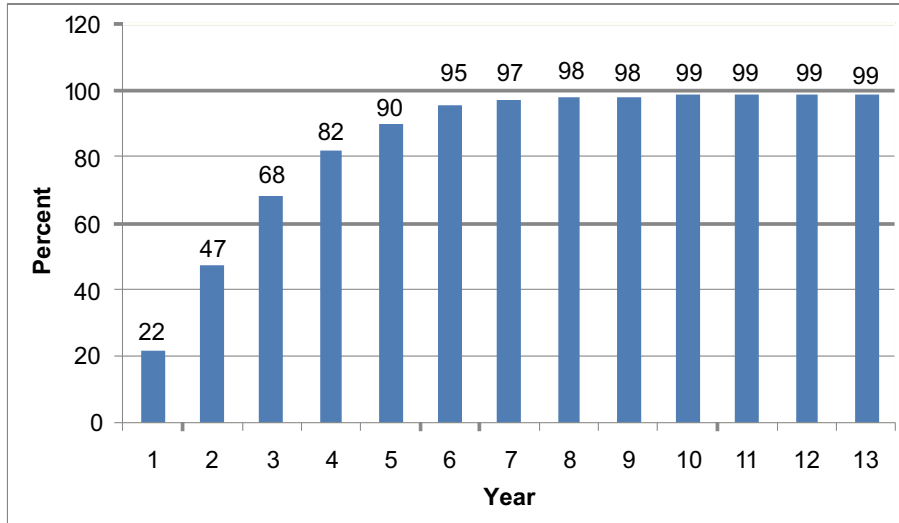
Workers Compensation



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

18

Automobile Liability Payout Profile



19

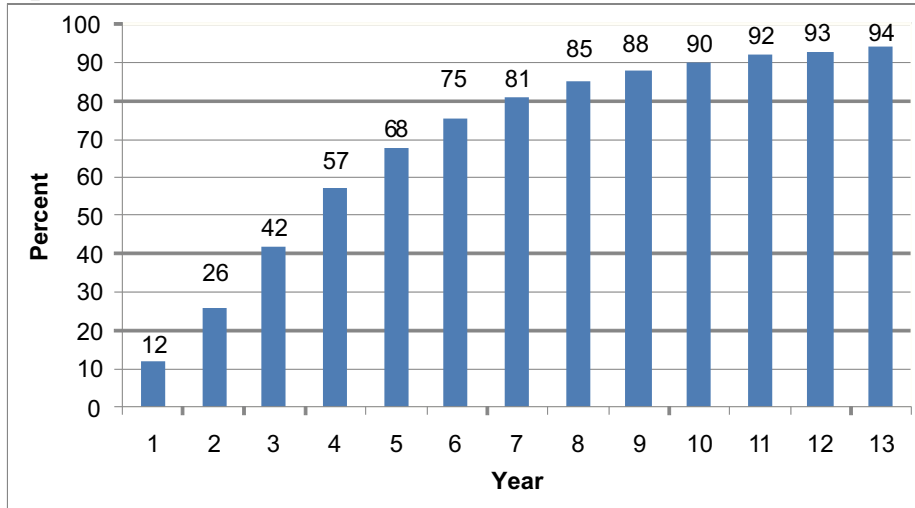
Auto Liability



- **Losses are paid out quickly**
- **Few late reporting/IBNR issues**
- **22 percent paid out after Year 1**
- **90 percent paid out after Year 5**

20

General Liability Payout Profile — Including Products/Completed Operations



21

General Liability



- **Slowest to pay out**
- **Longest tail/Most IBNR**
- **Late reporting, litigation, multiple parties, and protracted discovery**
- **12 percent paid out after Year 1**
- **68 percent paid out after Year 5**

22

Payout Pattern Caveat



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

23

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**

24

Risk Retention Basics



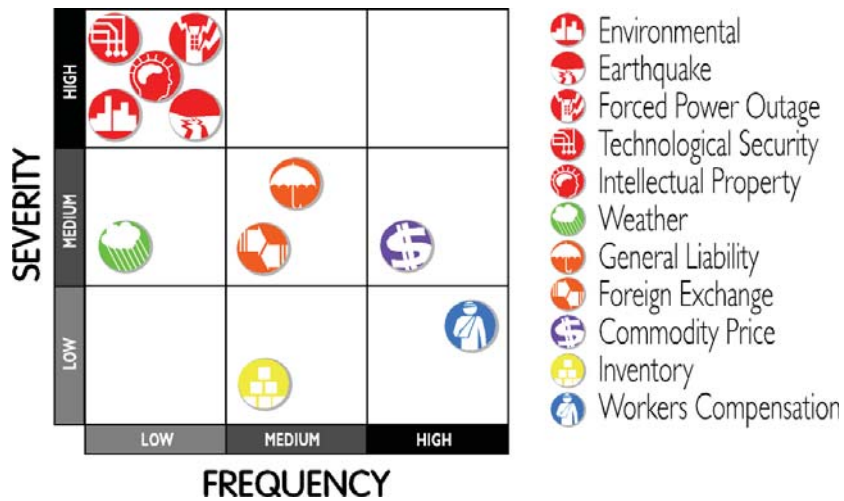
- Retain predictable losses
- Avoid catastrophe risks

25

Qualitative Risk Map



QUALITATIVE RISK MAP



© 2009 International Risk Management Institute, Inc.

26

Risk Retention Example Workers Compensation Loss Content by Layer



6%	xs of \$1MM
10%	750,000 xs 250,000
84%	0 – 250K per occurrence

27

Risk Retention Analysis Guidelines



- 1. Working capital method**
 - 2–5 percent of working capital
- 2. Total asset method**
 - 1–5 percent of total assets
- 3. Earnings/surplus method**
 - 1–8 percent of average pre-tax earnings over a 5-year period
- 4. Sales budget method**
 - 1/2–2 percent of annual sales
- 5. Annual premium method**
 - 10 percent of annual premium
- 6. Operating cash flow method**
 - 2–5 percent of operating cash flow

28

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**

29

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**

30

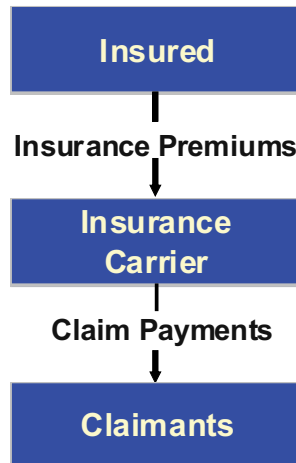
Examining Alternative Risk Financing Options



- **Paid Loss Retro Plan**
- **Large Deductible Plan**
- **Single Parent Captive**
- **Group Captives**
- **Qualified Self-Insurance**
- **Self-Insurance Wrap-Around**
- **Risk Retention Groups**

31

Guaranteed Cost Plan



32

Guaranteed Cost Program



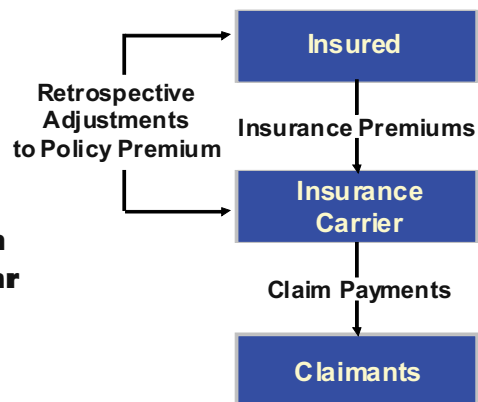
- **Most common program.**
- **Prospective plan where the premiums for the year are determined based upon insurance industry data.**
- **These policies are subject to premium audit based on payrolls, revenues, etc.**
- **Insured's experience modifier is applied to modify the manual premium.**

33

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**



34

Retrospective Rating Program Elements



Basic Premium Components

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

35

Retrospective Rating Program Elements



Excess Loss Premium (ELP)

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

Limited Losses

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

36

Retrospective Rating Program Elements



Loss Conversion Factor (LCF)

- **This charge is applied against the limited 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.**

37

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.**

38

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., 25 percent minimum.**

Maximum Premium

- **This is the most that will be charged; it is also expressed as a percent of standard premium, i.e., 135 percent maximum.**

39

Retrospective Rating Program Elements



Retro Adjustments

- **These are calculated 6 months after the policy expiration and annually thereafter. These may be commuted at a specified date, e.g., 66 months, with any further risk accepted by the insurer.**

40

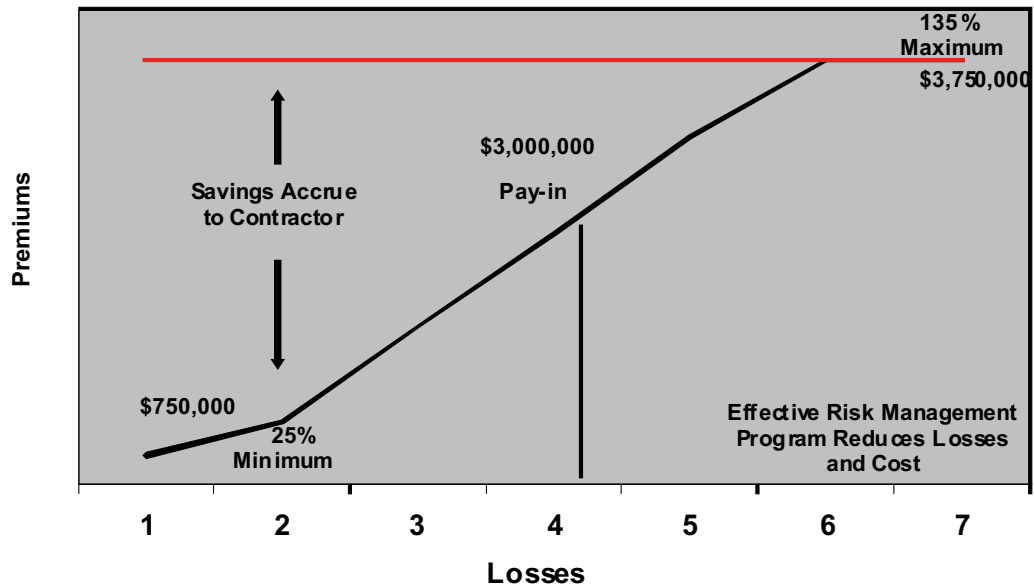
Retrospective Rating Formula



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

41

Risk/Reward Analysis

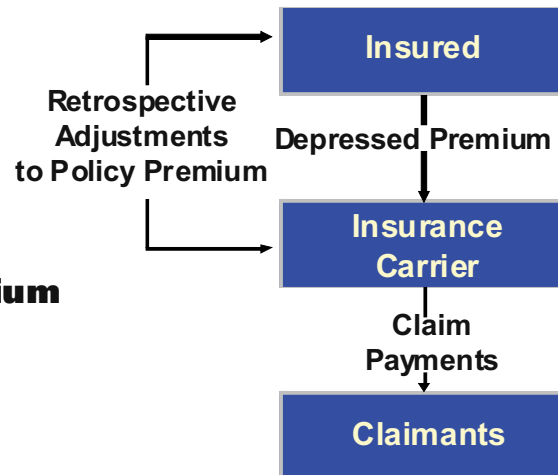


42

Depressed Pay-In Retro



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



43

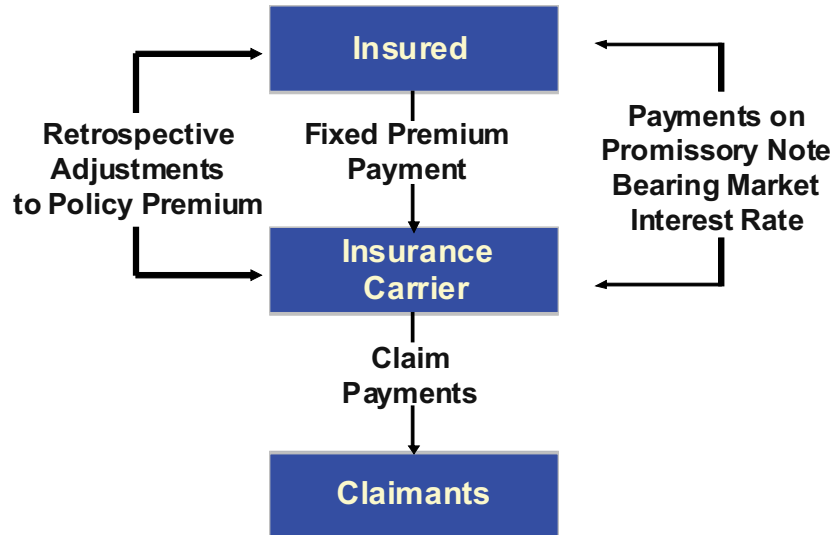
Depressed Pay-In Retro



- **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.**

44

Deferred Premium Retro



- Reduced standard premium paid during policy year

45

Deferred Premium Retro



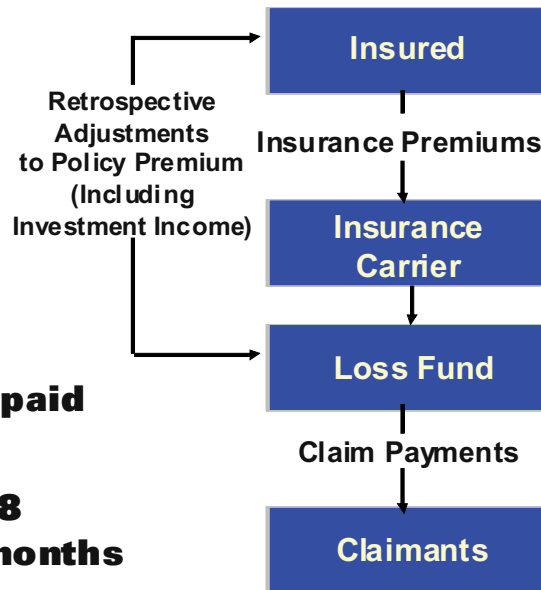
- **Another variation of the incurred loss retro program.**
- **Typically a 3-year program.**
- **A fixed payment schedule over a number of years is agreed upon. Retro adjustments are not performed on an interim basis.**
- **A promissory note supported by a letter of credit is required as collateral.**

46

Investment Credit Retro



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



47

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.**

48

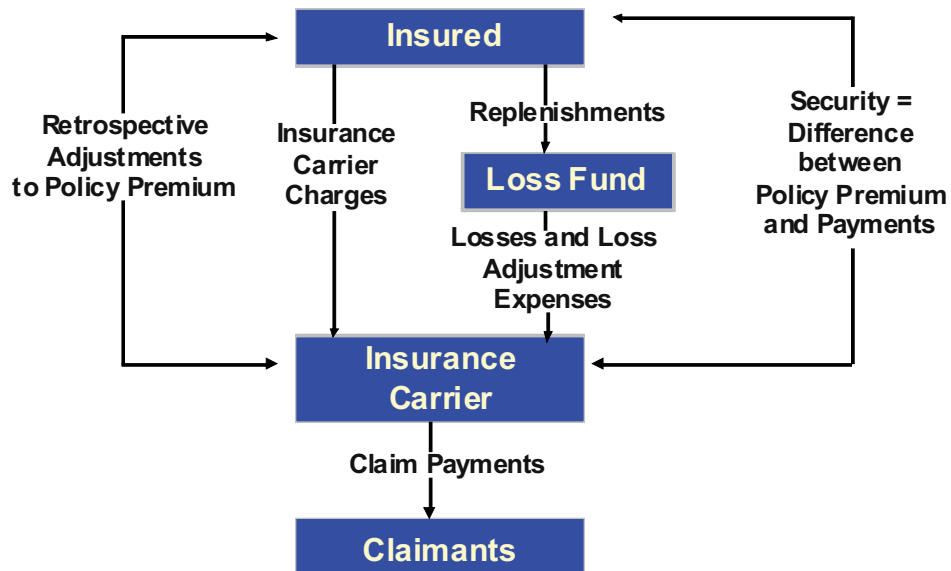
Investment Credit Retro



- **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.**

49

Paid Loss Retrospectively Rated Plan



50

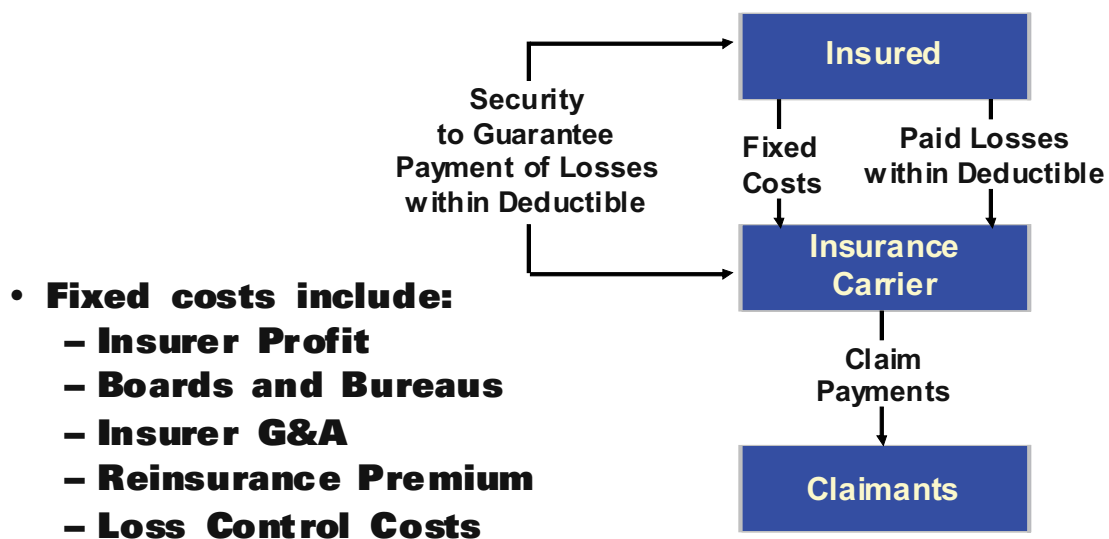
Paid Loss Retrospectively Rated Plan Characteristics



- **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**

51

Large Deductible Plan



52

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.**

53

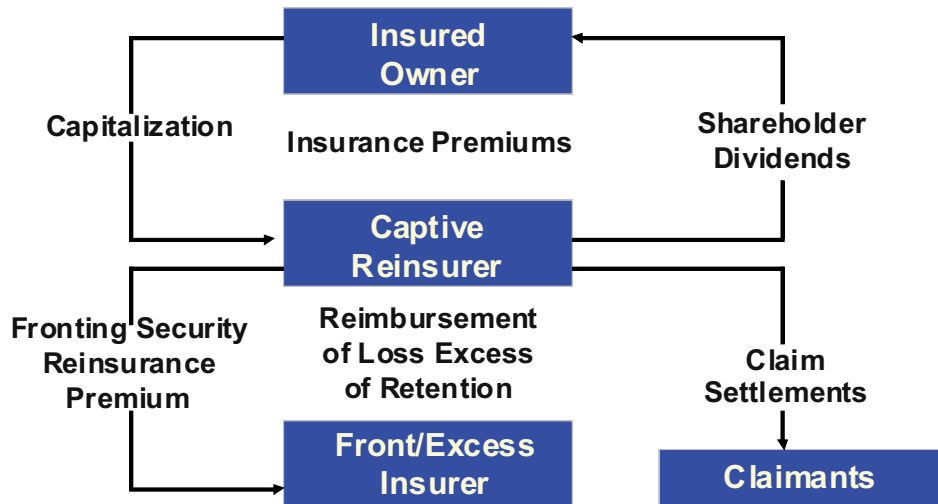
Large Deductible Programs



- **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., RMLs and premium taxes.**

54

Single Parent Captive



55

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.**

56

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**

57

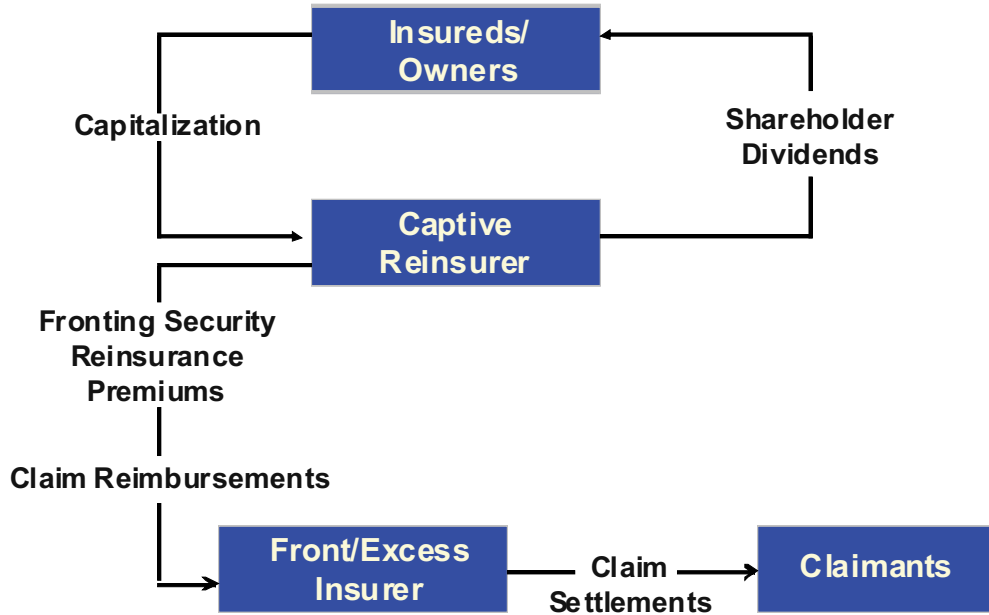
Single Parent Captive



- **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**

58

Group Captive



59

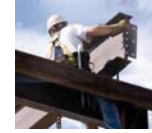
Group Captive



- **Homogeneous captives, insureds all from a specific industry, e.g., all contractors.**
- **Heterogeneous group captives have insureds from diverse industries, e.g., contractors, car dealers, retailers, restaurants.**

60

Group Captives Risk Sharing



- **\$2,000,000 limit**

Risk Transfer	\$ 1,000 M xs \$1,000 M
Shared Risk Pool	\$ 750 K xs \$250 K
Insureds Retention	\$ 250 K

61

Other Types of Captives



- **Rent a Captive**
 - **Captive owned by an organization that is not an insured**
 - **Broker, reinsurer, or fronting company**
 - **Initial capital requirements are low**
 - **Not much flexibility**
 - **Share in a portion of the underwriting profit and investment income**
 - **Risk sharing**

62

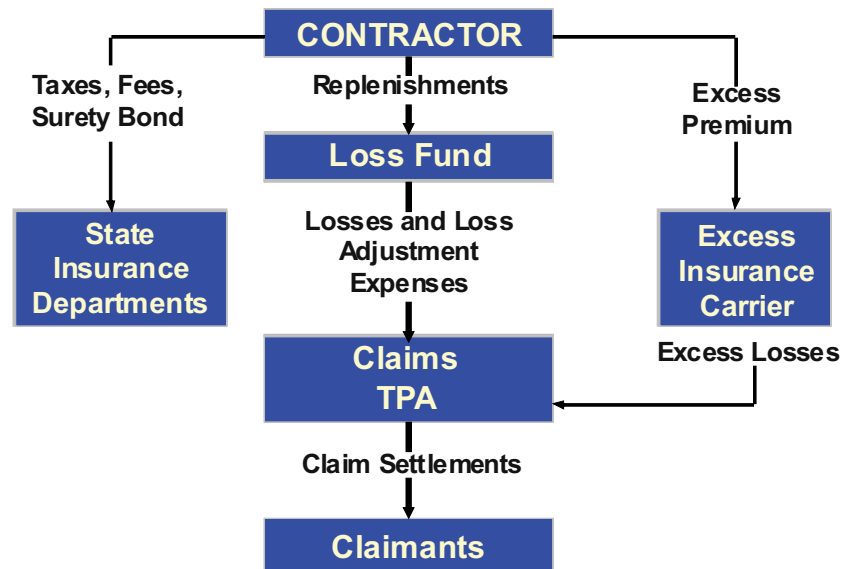
Other Types of Captives



- **Protected Cell Company (PCCs)**
 - **PCCs allow for segregated accounts each insured is legally protected from liabilities of others**

63

Qualified Self-Insurance



64

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.**

65

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 self-insurance bond.**
- **A firm must weigh the benefits of self-insurance against the programs available through a large deductible program.**

66

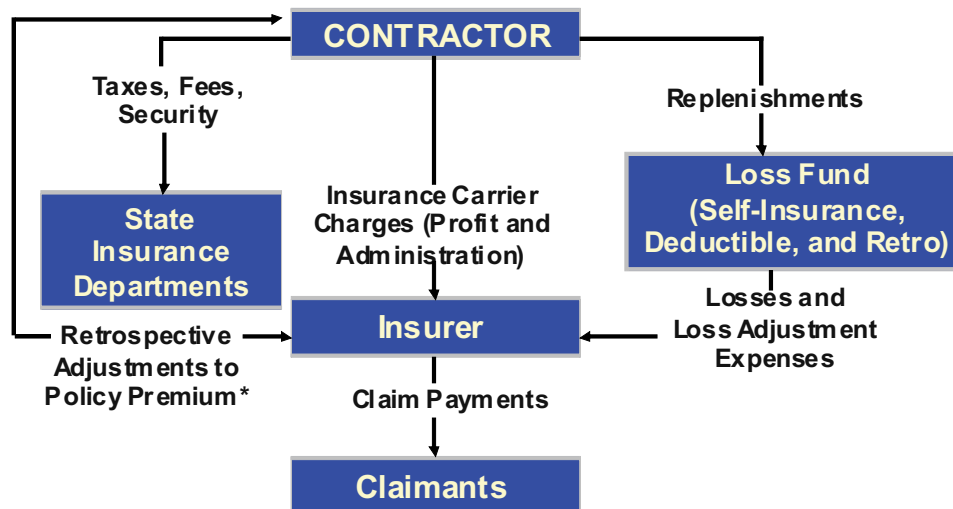
Qualified Self-Insurance



- **Important considerations**
 - **Taxes**
 - **Administrative**
 - **Regulatory**
 - **Admitted paper**
 - **Qualifications**

67

Self-Insurance Wrap-Around Program



*May include premium tax and loss conversion adjustments, as well as adjustments if it converts to an incurred retro.

68

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.**

69

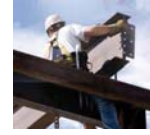
Risk Retention Groups



- **Late 1970s and early 1980s "Liability Crisis"**
- **Authorized by federal legislation**
- **Product Liability Risk Retention Act of 1981**
- **Liability Risk Retention Act of 1986**

70

Risk Retention Group



- **Original 1981 Act was very limited**
- **Only applied to product liability and completed operations**
- **Designed to preempt state insurance laws**

71

Risk Retention Group



- **1986 expanded to liability insurance of all types, e.g., general liability, auto liability, and malpractice**
- **Unregulated as to form and rate**
- **Exempt from state insolvency and guarantee funds**
- **At 12/31/08 there were 254 risk retention groups**

72

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

© 2009 International Risk Management Institute, Inc.

© 2009 International Risk Management Institute, Inc.

73

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.**

74

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.**

75

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.**

76

Tax Implications of Risk Financing



Guaranteed Cost Plans

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

77

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.**

78

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.**

79

Tax Implications of Risk Financing

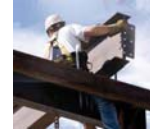


Single Parent Captive

- **These programs have complex legal and tax implications that need to be researched fully.**
- **Recent IRS Guidelines provide a more favorable position, e.g., *Kidde Industries vs. Internal Revenue Service*.**

80

Selecting the Best Risk Financing Techniques



Decision Criteria To Be Used

- **Profitability objectives**
- **Stability**
- **Continuous operations**
- **Legal**
- **Humanitarian concerns**

81

Selecting the Best Risk Financing Techniques



- **Select a single technique**
- **Combination of techniques to achieve the objectives**

82

Plan Evaluation



Development of a Plan Evaluation Tool

- **Cost of risk**
- **Service enhancements**
- **Cash flow benefits**
- **Pivot point analysis at various loss levels**

83

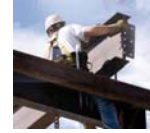
Implementing the Selected Techniques



- **Contract with service providers**
 - **Insurers, reinsurers, TPAs**
- **Scope of service**
- **Checklist for evaluation**
- **Documentation**
 - **Policies**
 - **Collateral, LOCs**
 - **Agreements, retro, fronting, TPA, captive management**

84

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**

85

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.**

86