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ALTERNATIVE RISK FINANCING: ACTUARIAL ASSESSMENT IS CRITICAL

Retro plans, large deductibles and captives - potential cost savings to your current plan. These concepts all fall into the category of alternative risk financing and they very well may be a good choice for your business.

In our two previous alternative risk financing articles we've provided you an overview of the concepts to consider before evaluating which insurance program is right for your company, as well as a deeper look into the tools that could potentially save you money compared to traditional insurance programs.

As the final article in our series, we address the importance of an actuarial assessment and how it will help you determine if alternative risk financing makes sense for you. We'll cover:

- Loss forecasting
- Retention levels
- Collateral requirements
- Financial statement liabilities

In some cases, businesses may be able to save money using alternative risk financing instead of traditional insurance. Alternative risk financing is most typically used for worker's compensation, but it can also be a solution for general liability and auto liability.

How can you evaluate whether alternative risk financing is appropriate for your business?

RETROSPECTIVE RATING PLANS (RETROS)

Also known as Loss Sensitive Plans, they allow for the premium to be adjusted "retroactively" depending on your losses, subject to the plan's minimum and maximum premiums. The plan is simply a mathematical formula and all plans share five similar components:

1. Your losses, which are typically capped at a specific amount.
2. Claims handling expense to handle those losses.
3. The insurer's administrative and overhead costs.
4. Excess premium which is the "risk sharing" component of the plan.
5. An amount to pay state premium taxes.

These components are all embedded in an insurance company's premium for traditional insurance plans. The difference is that these costs are based on the insurer's entire book of business so they are far less negotiable.

Retros can also be based on either paid losses or incurred losses. With paid losses, you reimburse the insurer for only the losses they have actually paid. With incurred losses, you advance funds for both the paid losses and the claims reserves that are estimated, but may be paid at a later date. The excess premium amount will vary depending on the individual losses, as well as the plan's minimum and maximum. In other words, the more risk you assume, the lower the cost.

START WITH A LOSS FORECAST

The key component of any form of alternative risk financing is your own losses. So, a loss forecast — an estimate of your expected losses — is a critical calculation. Rather than their own independent analysis, most insurance buyers rely on an insurance company's calculation. However, an analysis performed by an independent actuary will be the most objective.

Simply put, your forecasted losses are calculated based on your past loss history. At least five years of actual losses are needed. Those losses are then measured against five years of exposures. Payroll and sales are the industry accepted standard. The losses are trended and developed to put them into today's dollars. he annual payroll or sales are similarly adjusted for inflation, also to give them the equivalency of today's dollars. This analysis is simply a mathematical formula comparing five years of adjusted payroll to five years of trended and developed losses to determine a rate of loss. Multiplying this loss rate by the renewal payroll or sales will determine your renewal expected losses.

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SELECT A RETENTION LEVEL

Many companies choose the size of their retention based on premium alone. A retention level analysis uses this same loss forecasting methodology, and would limit the amount of an individual claim at different levels. This analysis can show you which retention level can reduce your total cost of risk, based on your actual loss history. Using an analysis helps you balance money spent on premiums and money spent paying claims. In addition, this will help you measure the impact and return on investment of new loss control and risk management initiatives. These can be weighed against the actual savings as losses decrease.

NEGOTIATE COLLATERAL REQUIREMENTS

That same loss forecast drives collateral requirements. The collateral amount should be based on losses that are yet to be paid to the insurance company and should be determined by a mathematical formula. Understanding how the collateral amount is calculated gives you and your broker the tools needed to effectively negotiate the collateral amount.

The collateral amount is based not just on current loss reserves, but applies to outstanding collateral from old plans as well. The more losses you assume, the greater the likelihood that your collateral requirement will be higher. It's important to have a solid command of both your current loss reserves and outstanding collateral from previous plans. This will give you the confidence to effectively negotiate collateral requirements and ensure the requirements are not excessive.

ESTIMATE FINANCIAL STATEMENT LIABILITIES

When you use alternative risk financing, you want to be comfortable in your ability to estimate financial statement liability for your retained losses. It's important to be able to accurately estimate the future liability to your balance sheet for losses that you have a future obligation to pay, but have not yet been paid to the insurance company.

If you pay premiums for traditional insurance, the risk of loss is handled by the insurance company and you don't have to worry about the impact on your financial statement. But if you use an alternative risk financing method, you are responsible to pay losses within a retention and that creates a future liability for your company.

The loss forecasting methodology discussed above, would be adjusted for your company's payout pattern – how your actual losses are paid over time. This can help you determine what your future liabilities will be.

CONCLUSION

An actuarial analysis gives you the tools to make an educated decision and the confidence to negotiate the best plan for your company. Is alternative risk financing a good choice for your company? If so, which option makes the most sense?

For more information, please visit johnsonfinancialgroup.com or give us a call at 800.236.5546.