ALTERNATIVE RISK FINANCING: THREE ESSENTIAL CONSIDERATIONS

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.

How confident are you that you know enough about them to make an educated choice? For that matter, do you understand the short- and long-term impact that your chosen insurance plan has on your business?

The savvy insurance buyer understands that there is, in fact, a significant amount of negotiation and customization that goes into any alternative risk financing tool. The buyer will use that knowledge to develop a plan that meets their long-term risk management and financial goals.

There are three high level concepts you should consider before evaluating which insurance approach is right for your business – especially one that incorporates alternative risk financing techniques. You should look beyond the plan you choose for your company and understand the impact that plan may have on the future of your business. With this foundation in place, you will be in a better position to evaluate and negotiate the alternative risk option best for you.

#1 – YOUR COMPANY'S GOALS & OBJECTIVES

The premiums for most of the alternative risk financing plans are reflective of your company's own loss experience, instead of being lumped together in a classification code with other organizations (and their losses) within your industry. As a result, there is a clear incentive to controlling losses and managing the cost of claims. To help figure out if your company would be a fit for alternative risk financing, you should understand:

- What is your company's tolerance for assuming risk, both for individual losses and for a program maximum?
- If you have the appetite to assume some of the risk and if your company has a safety culture to control losses?
- If your company needs to work on its safety program, are you willing to devote the resources necessary to improve your program?

Appetite for Risk

The cost of insurance is also directly related to the amount of risk that you are willing to assume. Simply put, the greater the burden that you ask your insurance company to assume on your behalf, the more expensive your insurance plan will be. There is nothing wrong with not wanting to assume risk and there are many reasons why that may be preferable. The key is to recognize what drives the costs of your plan and to construct it accordingly.

Controlling Cost

We recognize that cash flow is important to all businesses. If your company has excess cash that can be devoted to insurance, you can reduce expenses by funding your loss reserves. On the other hand, if your cost of capital is greater than what an insurance company will give you for those expense reductions, you might prefer to have greater control of your cash flow.

Finally, do you want to have more control in setting the costs for your insurance plan? Many types of alternative risk financing plans give your insurance program stability into the future and allow you to be insulated, to a degree, from the insurance market cycles.

#2 – COLLATERAL

All types of insurance plans treat cash flow in a specific way. Again, one important question for the insurance buyer is where do you think your available cash is best put to use? The trade-off for retaining the cash flow benefit is that you will most likely have to put up some form of collateral to offset the cash that the insurer is not going to receive until a later date. That collateral usually takes the form of a Letter of Credit.

Letters of Credit

Even if your company has no issues with posting a letter of credit, the letters of credit:

· Will "stack" over the years

· Generally won't peak until several years

· May affect future borrowing ability

If not monitored, the amount secured can rise to an uncomfortable level. It can then be challenging to convince your insurer to reduce the collateral requirement. So, it is important to recognize that it's not just security for one plan year, but for several years, and to take an active role in managing the collateral.

Some insurance buyers and their brokers don't fully understand the reasons why insurance companies require collateral or what is a reasonable amount. Once you become familiar with this, you will be in a better positon to negotiate the amount of the security that is both needed and reasonable.

#3 – MERGERS, ACQUISITIONS & PRIVATE EQUITY

Is your business growing by either expansion or an acquisition? Or, are you planning to consolidate or close locations? Both of these directions should be explored as they will affect whether or not you are willing to tie up your cash, or how much risk you agree to assume. This is particularly important with a potential merger as you may not want the complication of deferred claims on your balance sheet. It may be that a guaranteed cost plan makes more sense during a period of mergers and acquisitions.

If you are anticipating the involvement of private equity, either selling to a private equity firm or accepting their funding, guaranteed cost is almost always the better choice. Most private equity firms are not interested in assuming either your open claims or your outstanding letters of credit. In addition, adding this additional debt to the equation may limit your options.

Alternative risk financing may be a very cost effective option for your company and it is important that you choose a plan that is aligned with your company's financial objectives.

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