Risk Financing 101

It is not unusual to hear one confidently proclaim, “Safety is job #1!” But is it really? After all, to be truly safe means avoiding any possibility of loss or injury; the only way to ensure an employee or the general public has absolutely zero chance of being harmed on the job site means keeping equipment idled and gathering dust. The number one priority for any company, therefore, is to complete quality work on time at spec while making a profit, and while steps can be taken to eliminate some risks and mitigate others, performing any job requires accepting some amount of unavoidable risk.

This risk of loss has long been understood and for thousands of years civilizations worldwide have been factoring in its cost. For example, the earliest form of insurance was recorded by Babylonian and Chinese traders. Knowing some ships might be lost to weather and treacherous waters, merchants would divide their items among various ships to limit the loss of goods merchants. Spreading risk in this fashion increased the odds that some of the goods would be lost, but it would also ensure that some or most of the goods would reach their intended destination. The loss of some goods along the way could be thought of as the world’s first insurance policy.

Over time, insurance became more sophisticated: the Code of Hammurabi, written around 1750 B.C., noted the first documented loss limitation method whereby a merchant receiving a loan would pay the lender an extra amount of money in exchange for a guarantee that the loan would be cancelled if the shipment were stolen. Around 600 B.C., both the Greeks and Romans formed the first types of government sponsored life and health insurance, providing care for families of deceased citizens. It was not until hundreds of years later, in Genoa in the 14th century, where the first standalone insurance policies were developed. These policies not only insured various types of risk, but they also charged different premiums based on the unique characteristics of those risks. Insurance has come a long way since ancient civilizations began spreading risk across fleets of ships, but the fundamental concept remains unchanged. Just like fuel, maintenance or labor, risk has a cost, and it can be financed in a variety of ways.

Traditional insurance

The simplest and best-known risk financing technique is through the purchase of a traditional insurance policy where risk is contractually transferred from one party to another. The insurance policy spells out the terms and limits of the policy and provided the conditions of a covered loss are met, the policy will compensate – or indemnify – the person or persons for the loss that occurred.

Traditional insurance is often referred to as guaranteed cost or a zero deductible policy, and in this scenario the insurance carrier benefits if claims and expenses are lower than the premium charged. While using this type of policy provides the insured with peace of mind, purchasing traditional insurance means being subject to the whims of an unpredictable insurance market where premiums cycle between “soft” markets – where insurance is readily available and relatively inexpensive – and “hard” markets – where insurance is often difficult to place and sometimes prohibitively expensive.

Self-insurance

On the other end of the spectrum from transferring risk is self-insurance, where an operator assumes all of a particular exposure. Self-insuring against certain losses may be more economical than buying insurance from a third party, however, a company would only want to self-insure if the exposure was well understood, the cost to retain that risk was tolerable (i.e., if the company understood what its worst-case scenario looked like) and it had the financial wherewithal to do it. Generally, the more predictable and smaller the loss is, the more likely it is that an individual or firm will choose to self-insure. For example, some tenants prefer to self-insure rather than purchase enters insurance to protect their assets in the rental. However, large companies with excellent balance sheets may sometimes prefer to pay fully out of pocket for certain types of loss, despite the uneven cash flows, rather than transfer a known risk to an insurance company likely to generate a profit on accepting that risk.

Deductibles

Deductible policies are a common option that provide some middle ground between traditional insurance and self-insurance. Deductibles allow an organization to take on a reasonable amount of risk while still insuring away most of the exposure, and they provide the immediate benefit of lower premiums upfront. However, the insured will pay out of pocket up to the cost of the deductible and this can cause cash flows to be uncertain. Also, as the insurance carrier is paying for the loss including any deductible amount to a third-party on behalf of the insured, the insurance carrier will often require collateralization in the form of cash or Letter of Credit. The balance sheet impact of collateral should therefore be factored in as part of the cost of risk. Finally, few deductible plans limit the worst-case scenario, so there is theoretically no limit to the deductible reimbursements a company may incur.

Captive insurance

The term “captive insurance” is often misunderstood and means many things to many people. However, the world of captive insurance is massive and long- established and for many, it is a viable risk financing method that can allow an insured to retain a palatable and predictable layer of risk while better controlling premiums subject to hard and soft market cycles. While there are nuanced differences between heterogeneous and homogenous captives, owned and rental captives, and group and single-parent captives, the fundamental concept of all captives is the same. In the captive arrangement, a portion of the insured’s premium is set aside in an investment account that functions much like a checking account, where losses up to a certain level are paid out of the investment account as they occur. If there are extra dollars in the account after all known claims have occurred and are paid, those funds are returned to the company along with any investment income accrued. Conversely, if losses exceed the amount in the fund, the company may need to contribute additional funds.

The most common captive approach for medium-sized operations is to band together in a group with like-minded, safety-conscious companies. In effect, the group is its own insurance company. This allows participating companies to exit the traditional insurance market – with its associated pricing whims – and recognize premiums more derivative of that best-in-class group. This also means the participating companies are no longer subsidizing the traditional insurance market, and this arrangement often produces better alignment with the fronting insurance carrier issuing the policy.

Of course, just like there are well run operators and poorly run operators, there are well run captives and poorly run captives. Captive participation requires a careful understanding of program obligations and being connected with those brokers and insurance carriers who have expertise in this area and a proven track record of success.

A world of possibilities

In a world of rapidly increasing claims severity and rising inflation, one cannot afford to take a lackadaisical approach to risk and insurance. The best operators not only strive to eliminate and mitigate as much risk as possible, but to understand the variety of risk financing techniques and tools available with which to retain, transfer and hedge the risks they face. Savvy operators understand that while some risk will always be present, intelligent risk financing is a competitive advantage.