Appendix B

Risk Financing Considerations and Alternatives

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A crucial part of managing a public entity's risks is deciding how to finance those that it cannot avoid, reduce, control, or transfer by means other than insurance. Because no productive activity can be made entirely free of risk, virtually every operation undertaken by a public entity has a degree of risk that must be financed. To make informed decisions about risk financing, an organization must first identify its risk financing needs, then assess its ability to meet those needs through internal resources.

Like the broader risk program of which it is a part, no risk financing program can succeed without continuous monitoring and updating. Changes in the organization's services, operations, personnel, property, financial resources, and in the insurance market, among other variables, will require continual adjustments to the risk financing program. The costs and benefits of the risk financing program should also be regularly monitored. If costs of the current program outweigh benefits, the organization should research its options and make changes.

Risk financing methods fall into two broad categories: risk retention and risk transfer. Risk retention means that the organization maintains financial responsibility for all or part of a loss; forms of risk retention include self-insurance (planned and unplanned) and self-insured retentions or deductibles. As a risk financing (rather than a risk reduction) mechanism, risk transfer eliminates potential financial responsibility for a loss through purchase of an insurance contract. The public entity pays a premium; in return, another organization accepts responsibility for paying certain types of the entity's losses.

Risk Retention

Public entities retain risk when they plan to fund losses either wholly or partially with their own resources. Risk is wholly retained if there is no outside financing whatsoever for a loss; it is partially retained if, for example, (1) the organization secures coverage that includes deductibles or self-insured retentions,[1] or (2) the organization's potential losses exceed the limits of its coverage. Both deductibles and self-insured retentions specify the amount of a covered loss that the insured must pay before the insurance provider becomes responsible for any portion of a claim. Retaining some risk through a deductible or a self-insured retention generally results in lower premiums than are associated with insurance that pays the first dollar of any covered claim.

Risk may be retained for several reasons. A public entity may intentionally retain financial responsibility for some of its losses, especially losses of low severity, in order to reduce or eliminate insurance premiums. For example, a local government may decide that small and routine losses—such as damage to its motor vehicles—will be paid from a special fund set aside for this purpose rather than through insurance. Or it may decide to contract for insurance that carries a large deductible, which will result in lower premiums but still limit the losses that can arise from damage to a vehicle. Risks with unpredictable and potentially large damages, such as those resulting from personal injury, are less appropriate for complete retention; however, an organization may decide to accept a large deductible or self-insured retention in exchange for a significantly lower premium.

An organization may unintentionally retain risks simply because it has not identified them or is unaware that those risks are excluded from its insurance. Organizations in this potentially dangerous situation are described as uninsured "by default": they retain financial responsibility for risk without having considered how the potential losses may be avoided, reduced,

controlled, or transferred, and without having analyzed the possible impact of large losses on their financial stability or ability to deliver services. The risk identification and assessment process described in this guide is important precisely because it can help protect organizations from unknowingly retaining financial responsibility for potentially catastrophic losses. Equally important is the careful review of the organization's insurance policies, to ensure that the appropriate staff members are aware of the types of loss that are excluded from coverage.

Finally, risks may be retained because they are not insurable. For example, a local government cannot insure against the possibility that the state government will eliminate a major source of local tax revenue. This risk can be managed, however, through various means—such as identifying alternative revenue sources—or lobbying the state legislature.

Self-insured and uninsured organizations generally use one or more of the following methods to finance risk:

- Treating losses as expenses and funding them out of the regular operating budget or through the sale of assets. For losses that are uninsured by default, this may be the only possible course of action.
- Creating a special fund to pay for qualified losses.
- Obtaining a line of credit at a financial institution for a preapproved loan to pay for losses.
- Funding only a predetermined level of losses by purchasing insurance with a significant self-insured retention.

To make a decision about retaining insurable losses, an organization should first determine whether it is legally required to buy insurance. For example, many states require purchase of insurance for automobile liability and workers' compensation risks, although some states allow qualified self-insured plans that meet state-mandated requirements.

The organization must also identify and analyze its risks to determine which ones it is financially able to retain. This necessary but difficult task involves estimating the entity's potential losses before they happen. As a rough guide, it may be helpful to know that very few (if any) organizations can afford to completely self-insure; generally speaking, the most commonly self-insured risks involve low severity and either low or high levels of frequency—that is, risks that are predictable and pose little danger of catastrophic loss. Entities rarely self-insure against losses that could significantly affect financial stability or service delivery.

The organization should also compare the costs of insuring a risk against the costs of retaining it. For example, in addition to paying the amounts owed on claims, a public entity that retains risk must bear the cost of maintaining a staff (or hiring a contractor) to investigate and pay the claims; it may also have to obtain stop-loss insurance to protect against unusually bad losses. If an organization has a low-severity risk that is expected to produce a $2,000 loss twice over a ten-year period, but the annual insurance premiums for the loss would be $3,000 to $5,000, it may be more cost-effective to retain the risk than to buy insurance. On the other hand, if the severity of a loss can vary widely, the organization might consider purchasing insurance—perhaps with a high deductible or self-insured retention—to protect itself from an unexpectedly bad loss or series of losses.

Risk Transfer through Insurance

A public entity can transfer financial responsibility for some risks by purchasing insurance from commercial insurance carriers, from risk purchasing groups and associations, or from group self-insurance pools serving their area. Many public entities are required by law or administrative procedure to comply with certain procurement practices when purchasing insurance. These

requirements vary from state to state and may control how a public entity obtains quotes: how many quotes must be obtained; how the quotes are to be evaluated; which insurance carriers are eligible to do business with public entities; and whether a public entity can obtain insurance through one designated insurance agent or broker or must use the request-for-proposal process.[2] Before purchasing insurance, the appropriate staff must be closely familiar with the procurement laws applicable to their jurisdiction.

Commercial Insurance Carriers

Many public entities purchase some form of insurance from commercial insurance carriers. Some commercial insurance companies, known as "direct writers," sell insurance directly to the public. Although an agent or broker is not necessary to obtain insurance through a direct writer, it may be beneficial to hire an insurance advisor (an agent, broker, or consultant) unless the organization has independent expertise on staff about purchasing insurance and can determine whether the coverage and price meet the entity's needs. Other insurance companies work only through agents or brokers, who are usually paid a commission by the insurance company or a negotiated fee by the entity. Some types of commercial insurance can be priced, purchased, or both via the Internet, either from direct-writing companies or through agents or brokers. These services were originally available only for small, standardized risks, such as automobile liability, but their scope is expanding.

To make informed decisions about the organization's insurance program, the staff involved in selecting insurance must understand precisely what insurance will be provided for the premium paid. Because the policy terms, conditions, and exclusions can differ significantly among different carriers in some types of insurance, the policy with the lowest premium may not be the best value. The coverage provided by an inexpensive policy may be much narrower than that provided by a more expensive policy, or the carrier may be less financially stable. To ensure that the organization is receiving a good value, the responsible staff should (1) obtain proposals and a sample policy (or other description of policy provisions) from more than one source; (2) carefully examine the terms, conditions, and exclusions of each policy; and (3) research the financial stability of each carrier. One useful analytical tool (and demonstration tool, if the results will be presented to a decision maker who has the authority to purchase) is to create a table that compares, point for point, the important aspects of each proposal.

Ideally, a staff member who is familiar with the issues and who represents only the interests of the public entity can provide internal expertise on the purchase of insurance. An organization that does not have such a resource on staff can gather information from sources such as the following:

- The organization's insurance representatives—agents, brokers, or the broker's loss-control and safety engineers (typically free of charge; included in the premium).
- Outside or staff legal counsel (may involve a fee; may or may not have insurance expertise).
- An independent risk management consulting firm (typically a fee for service).
- Staff from surrounding jurisdictions who can describe how other public entities are addressing risk management and insurance issues (free of charge, and often very useful).
- Internet sites that offer information on risk management for public entities (some are free, some have a charge).

- Nonprofit organizations that address public risk management issues (some are free, some require membership or charge a fee).
- Local business and manufacturing community representatives with experience in insurance purchase.

An advisory committee comprised of representatives from some of the above categories can be very helpful to public entities without significant internal expertise.

If the organization is relying on the expertise of insurance agents, brokers, or independent consultants (third parties with no direct financial interest in the entity's program), it must have a good relationship and an effective channel of communication with these insurance representatives to ensure accurate transmission of information. More important, the organization must have trust in the representative's loyalty to the entity's interests and confidence in the representative's professional judgment.

Risk Sharing Pools

A public entity that is considering purchasing traditional insurance may also consider public risk-sharing pools. These are associations of public entities with similar functions that have banded together to share risks by creating their own insurance vehicles. Pools sometimes structure themselves or their programs as group insurance purchase arrangements, through which individual members benefit from the group's collective purchasing power. Members pay premiums, which (1) fund the administrative costs of operating the pool, including claims management expenses and (2) pay members' covered losses.

Pools can provide significant advantages to their members. For example, they offer insurance that is specific to public entities at premiums that are generally stable and affordable. Many pools also offer additional benefits and services at little or no extra charge, including advice on safety and risk management; seminars on loss control; updates on changes in the insurance industry; and property appraisal and inspection. Some pools offer members the opportunity to receive dividends for maintaining a good loss record.

Some membership organizations for public entities sponsor pools or endorse insurance products that are then marketed to their members. However, sponsorship or endorsement by a membership organization does not guarantee that the insurance is broad enough to meet the needs of a given entity or that the insurance provider is financially stable. A public entity must apply the same due diligence to a consideration of these programs that it would apply to a comparison of available commercial insurance programs.

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[1] The primary difference between a deductible and a self-insured retention is that a deductible amount counts against the total limits of coverage provided by the policy, reducing total coverage, whereas a policy that includes a self-insured retention provides limits of coverage in excess of the self-insured retention, so that the amount payable under the policy is not reduced by the amount of the retention.

[2] Preparation of requests for proposals and insurance specifications is beyond the scope of this guide. Risk managers for larger jurisdictions in the same state are a good source of information on requests for proposals and insurance specifications.