Cavignac

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Risk Tolerance

How Much Risk Should You Take?

By Jeff Cavignac CPCU, RPLU, ARM | President

Should You Choose a Deductible or Self-Insured Retention (SIR)?

Deductibles and self-insured retentions are often used interchangeably and while they are similar, there are significant differences.

With a deductible, the Insurance Company will typically pay the clamant the entire amount of the claim, and then seek reimbursement from the insured for the amount of the deductible. The Insurance Company retains control of the defense from the start, including choice of counsel, and has authority to settle a claim with or without the consent of the insured.

The purpose of insurance is to transfer the risk of accidental loss to an insurance company in exchange for a premium. When done correctly, this “risk transfer” will reduce financial uncertainty and make accidental loss manageable.

Not every risk should be insured. Some risks should be retained, and others should be avoided. Below you will find a Risk Quadrant. Claims that have low severity whether frequent or not, should be retained. It generally does not make sense to involve your insurance company on small dollar matters for a lot of reasons. High frequency and high severity exposures should be avoided. They will likely be uninsurable and unmanageable from an insured’s standpoint. The ideal exposure for insurance is low frequency and high severity.

Nearly every insurance policy has a deductible or a self-insured retention (SIR; see side bar). This is the amount the insured retains before the insurance company is obligated to pay on a claim. Retentions can be quite modest. Many property insurance policies may have deductibles as low as $500 or $1,000. Retentions can also be significant. It is not uncommon for a mid-sized company (100-500 employees) to have a $100,000 deductible or SIR on their Employment Practices Liability policy. How much Risk you retain is a factor of your risk tolerance, as well as the cost differences between the various options.

In order to determine how much risk you are comfortable retaining, you should complete the questionnaire below. This will enable you to decide on appropriate deductibles, retentions or alternative risk transfer techniques.

Deductibles also typically erode the available limit of insurance. For example, a $1,000,000 policy with a $100,000 deductible would only leave $900,000 in true insurance protection.

Self-insured retentions are available on liability policies only. SIRs allow the insured to control its own defense, and choose counsel for claims within the SIR. In addition, the SIR typically does not erode the limit of liability. On the flip side, the Insurance Company is not obligated to indemnify or provide a defense until the SIR is exhausted. In the event of a claim, the claimant would have to collect the SIR from the insured. The Insurance Company would only be responsible for paying the difference between the settlement and the SIR.

SIRs are only available on larger retentions. It also requires the insured to be more actively involved in the actual defense of a matter from the start.

Please rank each question 1 through 4. The higher the number, the more you agree with the question. Your total score will provide insights into the level of risk acceptance or avoidance that makes sense for your company.

1 = Disagree;
2 = We may consider this;
3 = Somewhat agree;
4 = Absolutely, this is what we do.

The answers to these questions will help us determine the appropriate deductibles or retentions that should be considered in your insurance program. (See Figure 1, Page 2)

So, what is your total? The Risk Tolerance Scale below will give you an idea of where you stand.

Figure 1

	Questions	Score
1.	We are willing to risk potentially high "out-of-pocket" costs for property and liability losses in exchange for savings in our insurance program.	
2.	We have a favorable credit rating that will not be seriously affected by the need to provide a Letter of Credit (LOC). Future credit needs are not in jeopardy because of an LOC.	
3.	Large, unexpected loss-related expenses can be easily covered from available capital.	
4.	We are willing and able to set funds aside for claims and losses without the need to use those funds.	
5.	We have an active loss control program in place to protect plant, people, and contents from injury or damage. This is supported by upper management.	
6.	Every employee is well trained in the job they do (and cross-trained when necessary). Also, the employee is versed in all loss control and risk management procedures.	
7.	All safety and security systems are well maintained and regularly inspected to make sure they are operating as they are supposed to.	
8.	We make full use of contractual risk transfer and proactively transfer risk to other parties when it makes sense to do so. We also review all of our contracts to make certain we are not assuming any risk that we should not.	
9.	Our claims (property and casualty) are relatively predictable within a narrow margin from year to year.	
10.	We currently take an active role in managing our claims. We have the staff and are not opposed to taking a more active role in the future.	
11.	We are willing to learn and comply with all statutory requirements necessary to manage our own claims and losses.	
12.	We have access to, and a relationship with, counsel well-versed in insurance law and property and casualty insurance claims management.	
	Total	

Risk Tolerance Scale (cumulative points):

• 12-24: Low. Seeks to avoid risk. You would want to seek out a traditional or guaranteed cost insurance programs with moderate deductibles.

Many insurance companies like to control the defense of a claim from the start, and most companies will insist on a deductible for smaller retentions.

• 25-36: Medium. You should look into higher deductibles, and may need to be willing to consider some type of retrospective rating plan or other loss sensitive alternative.
• 37-42: High. You are willing to consider a high deductible or loss sensitive program with some form of stop loss. You might consider a Shared Captive type arrangement.
• 43-48: Risk Taker. You will consider high deductible programs with or without a stop loss. Captives and other loss sensitive options will be strongly considered.

Several other questions you should ask yourself:

• How much risk/capital are you willing to retain on any one claim?
• How much risk/capital are you willing to retain in any given year?

Regardless of where you fall on the scale, you should always consider options when evaluating your insurance coverages.

Figure 2

		Frequency	
		Low	High
Severity	Low	Retain	Retain
	High	Insure	Avoid

The preceding material is provided for informational purposes only. Before taking any action that could have legal or other important consequences, speak with qualified legal and insurance professionals who can provide guidance that considers your own unique circumstances, including applicable employment laws.