

Expert Commentary

Considering Alternative Risk Transfer

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The utilization of alternative risk transfer (ART) to create competitive pricing, not only in the current insurance marketplace, but also during more placid times, provides a multitude of opportunities within the insurance and noninsurance arena. A major premise of this insurance solution is based on the theory that the risk cost of insurance can be dramatically reduced, where the insured is willing to accept those losses, or in some instances coverages, that are expected.

"Expected" is defined, in its most simplistic form, as those losses that are reoccurring over a protracted period of time, excluding those which are catastrophic in nature. Further, "expected" losses in the actuarial sense are losses supported by the 55 percent loss forecast theory, which can be modified upward to 95 percent, for the purposes of projecting losses to ultimate or worst-case scenario.

Deductibles or Self-Insured Retentions

Two of the primary or rudimentary methods of utilizing ART are through the introduction of deductibles or self-insured retentions (SIR).

In the case of the deductible, the insured is simply retaining the difference between gross loss (which will require definition, e.g., if defense costs are or are not included) and the deductible amount. The size of the deductible, the number of claims, the nature and severity of loss and claims handling costs, and the financial stability of the insured will determine whether the insurer will require collateral to be posted guaranteeing the loss within the deductible. On the assumption that the insured's deductible contains "expected" losses, the reduction in overall premium will be significant.

For example, assume that an insured has X number of workers compensation claims, where a developed loss picture is X, but no individual claim exceeds \$200,000. The insured accepts a \$500,000 deductible each and every claim, with or without an aggregate stop; the cost of the program should basically include the nonrisk costs associated with the placement:

- Tax
- Boards and bureau fees
- Administration costs
- Profit
- Claims handling costs

Risk costs are solely the premium for statutory workers compensation, excess of the deductible.

Obviously, the example depends on the risk, classifications, rates, and the developed standard premium, as well as the insured's ability to engineer and contain losses.

The use of self-insured retentions is quite a bit different. Here, the insured not only assumes the difference between what will be defined as gross loss and the retention, but in the majority of instances, will also be responsible for the defense of claims and their attendant costs. Be mindful

that this will require the insured to obtain counsel, satisfactory to both insured and insurer.

As in the case of deductibles, the insurer may well require the posting of collateral to protect defined losses within the program.

A Brief Word on Collateral

Posting collateral has a two-fold purpose.

1. It creates a funding mechanism for the presumed loss in the case of either deductibles or self-insured retentions, or
2. It protects the insurer's balance sheet integrity, for statutory filings.

A word of caution, if a self-insured retention is utilized on a workers compensation program, you will find in most cases that the insured will be required to file as a self-insurer in those states where the program is effective.

Just as with the deductible approach, the overall pricing for this format will dramatically reduce costs by virtue of risk transfer. Both of these scenarios presume that the insured accepts those losses that are "expected." However, that isn't to say that both of these tools can be used, to a lesser degree, where the reduction in insurance costs will be equivalent to the ratio of loss containment versus overall risk.

Finite Risk Transfer

As alternative risk transfer becomes more sophisticated, where programs are multi-faceted, and perhaps international in nature, the programs can be as complex as the parties to the negotiations make them. Undoubtedly, the most simplistic ART technique is finite, where little, or in some instances, no risk transfer takes place. Here the prospective "insured" places a significant amount of funds with an insurer, for the purpose of providing for risk, which may or may not have occurred.

In general terms, programs of this nature will require compliance with accounting rules and regulations, as well as any federal or state regulations, if applicable. Venues for the placement of these programs can be either onshore or offshore.

In most of these schemes, the finite underwriter is actually more banker than underwriter. While the underwriter will need to gauge risk and loss potential, what is paramount is the decision on the amount of funds necessary to provide loss containment protection. The net remuneration will usually be the discounted value of funds in the insured's possession, including administration fees, with interest usually to the account of the insured.

An Example

Another example of how ART might satisfy the needs of insureds, and a project I am currently consulting on, involves a number of "homogeneous" entities with risks considered moderate to heavy, and where the overall potential premium is significant. A finite underwriter has agreed in principle to offer both an individual and aggregate position, subject to sufficient discounted funding, to provide adequate protection for this segment of the program.

The assumption by all so-called insurers is that all of these risks are well-engineered and losses are actuarially sound. There is a need for what will be described as a "primary insurer" who will issue policies, not as a front, but a risk taker, with varying risk transfer limits to the insured, whose program is knitted to the individual and aggregate position of the finite underwriter. The assumption is that the "program" will provide substantial "return premiums" predicated on the actual loss containment of each entity. Additionally, substantial savings in nonrisk costs are found,

especially since the need for facultative reinsurance is nonexistent.

Most ART programs can be placed either onshore or offshore, and can be adjuncts, for example, to owned captives or rent-a-captives, or in fact, to whatever program designation suits the methodology.

Conclusion

Conceptually, almost any method of risk retention that makes economic sense for all parties can be accomplished, the caveat being the ability to define risk, the size of risk, the projection of losses on an actuarial basis, and financial stability. These are keys to feasibility.

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