

I Like You as a Neighbor, But We're Not Sharing Checkbooks

Opportunities and challenges for public entity insurance groups

Humans, by our nature, desire control.

This is why we hate hospital waiting rooms, airline customer service lines and being in the passenger seat with a new driver. So it is no surprise that control is the primary reason public entities pursue self-insuring their risk. They want to be in the driver's seat.

Traditional insurance products can leave public entities wanting more control. Premium instability during market cycles, a disconnect between favorable loss experience and lower premiums, perceived operational inefficiencies, coverage limitations and lack of say over claims handling decisions are other motivators for considering self-insurance programs.

For public entities large enough to self-insure on their own, more control of their insurance program means assuming some of the insurance company's functions. Loss prevention, risk management, claims management and legal can be performed by internal staff of the public entity. Third-party vendors can also handle these and other functions to help public entities gain control.

However, for many smaller cities, counties, park districts, schools and other public entities, the cost of these additional staff resources and vendors can be cost prohibitive. In such instances, group self-insurance programs can provide more control and economic benefits than insured programs.

The number of public entities that are choosing to pool some or all of their property and casualty insurance exposures with other public entities grows every year. These groups face a number of key choices when structuring the group self-insurance program. Most of these choices relate in some way to increasing control over their insurance program.

This article examines some of the difficulties group public entity insurance programs face and program structure choices that can bolster each member's sense of control, help hold the group together and provide significant benefits to all members.

Organizational Types

One of the fundamental decisions public entity groups make in developing a self-insurance program is the type of organization they are forming. Many options exist, including group self-insurance programs, captive insurance companies and mutual insurance companies.

Group self-insurance programs can be comprised of public entities geographically close to one another. Common examples include schools, park districts or municipalities located in the same area within a state.

Other programs may be statewide in nature and offer coverage to all public entities of a given type (e.g. public universities, counties, sheriffs, etc.) These types of programs are

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common for property, liability, and workers' compensation coverages.

Advantages of programs like these include low collateralization requirements and regulatory oversight and the availability of excess coverage through a regulated carrier. Potential disadvantages include relatively high administrative costs.

Group public entity programs can also take the form of a group captive insurance company. For example, one large group of public entities joined together to purchase property insurance coverage through an existing group captive. The captive insurer provides property coverage to members of other casualty captives.

The funding and loss reserves for public entities in the captive are computed separately and distinctly from the other captive members. This approach provides tremendous geographic risk diversification, greater negotiating leverage and lower reinsurance costs.

Another structure available for group of public entities is a mutual insurance company. Mutuals are generally strengthened by greater regulatory oversight than other insurance mechanisms, as well as guaranty fund protections. Potential disadvantages include additional costs associated with complying with regulatory requirements and capitalization requirements that are typically higher than for alternative risk mechanisms.

Limits & Deductibles

Some of the most contentious issues in a group self-insurance program generally deal with differences between members. These differences can relate to the relative size of the members or to differences in historical loss experience. There are simple, but effective, approaches to dealing with these disparities.

An adjustment to limits and deductibles is a common approach to maintaining a sense of fairness between large and small members of a group program. This approach can be as simple as allowing members to select a deductible or self-insured retention (SIR) that meets their relative risk appetite.

For example, a program might allow smaller insureds to select an SIR of \$25,000 per occurrence for automobile liability coverage



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to control the amount of variability in their self-insured losses. Larger members might be able to select SIRs up to \$250,000 that allow use their greater financial strength to absorb greater loss volatility.

These deductibles provide incentives for all group program members to encourage loss prevention and reduce high frequency and lower claims severity. It also allows members with higher SIRs to benefit more directly from improving their loss experience.

Another effective approach to reflecting

the differences between large and small members is to vary SIRs directly with expected losses. In this approach, an actuarial estimate of expected losses is computed for each member of the group and this amount is established as the member's retention.

The self-insurance program coverage layer is often a fixed dollar amount above the SIRs, in our automobile liability example may be \$250,000 above the member SIRs. Adjustments can also be made for discounting to reflect the time value of money and/or risk margins to reflect higher levels of statistical confidence.

Of course, every member cannot have better-than-average experience. A key difficulty in maintaining the cohesiveness of a group self-insurance program is a member with consistently poor loss experience.

A solution is the use of aggregate deductibles. Aggregate deductibles force a member with loss frequency problems to meet a per occurrence deductible and also an annual aggregate retention before coverage commences. This approach forces a member to focus on the issues causing the loss frequency problem or face the direct consequences in their retained loss liabilities.

Rating Elements

Another key element in the design and maintenance of a group self-insurance program is the approach to developing indicated premiums. Self-insurance programs of any kind constantly strive to strike a balance between rates being responsive to member experience and being stable and predictable for budgetary purposes.

For public entity programs, the stability issues are particularly important due to the public scrutiny and restrictions of annual budgetary processes. The two most common approaches, experience modification and self-rating, are used to ensure that funding levels are responsive to member experience.

The experience modification approach compares the historical losses for each member to the extent of expected losses for that member. These expectations can either be based on industry benchmarks, such as loss costs from Insurance Services Office Inc. (ISO) or the

National Council on Compensation Insurance Inc. (NCCI) or proprietary benchmarks developed for the group in total or a similar group.

This approach responds to each member's actual loss experience and directly influences its premium levels. However, for group self-insurance programs with small members, even a single loss can significantly increase the experience modifier and the indicated funding need.

Using more years of experience can temper the sensitivity of experience rating. Smaller public entities can experience significant premium swings due to even a single loss if only three to five years experience is used.

Many programs choose to use five to 10 years of experience as the basis for their premium levels. Programs that use experience rating also should ensure that the total of the experience-rated funding levels match the overall funding need for the group. This approach allows the rates to be responsive to group experience and also the individual member experience.

Self-rating is a different approach that reaps similar results. Often this approach separately assesses a frequency loss layer and severity loss layer. The frequency layer has a relatively large number of smaller claims that result in stable historical loss levels and predictable future loss levels.

It is often possible to determine funding for members in this loss layer that fully rely on member experience. The severity layer has fewer, larger losses that fluctuate more and make predicting future losses more difficult. Often, reliance on industry benchmarks is necessary in this layer.

Since budget predictability is especially important for public entities, many programs apply caps to annual member rate changes to contain large premium changes. If a program's overall premiums need to increase 10 percent, the captive may decide that no member will have premiums that change more than 15 points above or below this level. That is, no increase will exceed 25 percent and no decrease will be lower than minus 5 percent.

An alternate approach is to use a credibility standard typically using a number of



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claims or exposures that identify if the size of risk is big enough to be self-rated without modification.

For example, a property program could assume that \$5,000,000 in annual total insured values is sufficient for 100 percent credibility based on 10 years of experience. This approach tempers the experience of individual members with less than the requisite number of exposures for full credibility with the experience of the group. This method can help avoid big swings in premiums from year to year.

Coverage Elements

Some public entity coverages can be modified or expanded in a self-insurance program. Difficult-to-insure coverages, such as pollution liability, terrorism, or prison liability can be placed into a self-insurance program. Coverage can also be modified to better protect the self-insured public entity.

One of the greatest risks public entities is the risk of mass torts exposing a per occurrence retention to a large number of claims. Mass torts, such as employment practices liability, wrongful acts, pollution liability, construction defect and police liability, can create situations where a large number of claims result in a large self-insured liability, even with a relatively small SIR.

One organization that administers several public entity programs proactively and innovatively addresses this vulnerability through product design. Its managers developed an approach to coverage triggers called "batching" that combines claimants arising from the same "nucleus of operative fact" into a single claim occurrence.

For example, if a school district's personnel director is found guilty of discriminating by only hiring attractive young females for the last 12 years, then a policy with batching considers this one occurrence and only the first policy from 12 years ago is triggered.

Traditional coverage could potentially treat each claimant as a separate occurrence and expose multiple policies and multiple occurrences with the policies to claims. The batching modification prevents exposing multiple limits over one or more policies to mass tort and class action losses.

This innovation has led to much lower-than-industry claim frequencies, improved claims handling protocols for this claim type and provided greater protection for members.

Public entity group self-insurance programs are using a variety of insurance structures, coverages and rating approaches to gain the control they have over their insurance program. Thus, what are you waiting for? Grab that steering wheel and take greater control of your insurance program. •