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Risk Management Quarterly RMQ

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From the Chairman

by Patricia A. Hannemann, CPCU

■ **Patricia A. Hannemann, CPCU,** is the new national CPCU Society chairman for the Risk Management Section. Her insurance career consists of more than 20 years' experience working in agencies and companies. Currently, she is working with The Insurance Society of Baltimore in promoting and teaching various insurance classes. Hannemann served as the CPCU Society's Maryland Chapter president and chaired both the Public Relations and Good Works Committees. The Maryland Chapter's CPCU Excellence Award was presented to her for spearheading the Good Works Committee and establishing the chapter's scholarship fund in connection with the SADD organization. Serving on the CPCU Society's Chapter Awards Task Force, she helped create and judge the current Circle of Excellence Award. Hannemann received her CPCU designation in 1987 and holds bachelor's and master's degrees in music from the Manhattan School of Music and a master's degree in business from Johns Hopkins University.

At the CPCU Society's 2004 Annual Meeting and Seminars in Los Angeles, it was my honor to become the chairman of the Risk Management Section. It is with great enthusiasm that I do so and look forward to the opportunities for implementing new ideas and programs. Your section committee met at the recent Annual Meeting with the outgoing chairman, **George J. Kolczun Jr., CPCU, ARM, AAI,** presiding. Kolczun provides a brief summary of this meeting on page 2 of this issue of *RMQ*.

■ ***To truly gain the benefits of your Risk Management Section membership, it is important you be involved.***

Within our Risk Management Section we have a multitude of available resources and knowledge, but the challenge is to share and communicate this knowledge. One of the best ways we accomplish this is through our *RMQ*. This edition of the *RMQ* is published with the assistance of our new *RMQ* editors, **James W. Baggett Jr., CPCU, CIC,** and **Jane M. Damon, CPCU, CPIW, CIC,** with **Walter G. York, CPCU,** assisting as co-editor. The articles represent a variety of topics including a look at one style of leadership, a loss control article showing the economic value of having it, some viewpoints on the constant question as to who should review client contracts, and risk shifting to privately owned captive insurance companies. The authors of these articles are **Demmie Hicks, Maureen H. Hunter, Ph.D., Hamid Mirsalimi, Ph.D., Daniel J. Dekowski, CSP, Donald S. Malecki, CPCU,** and **Andrew J. Barile, CPCU.** Through these and subsequent *RMQ* articles, we hope to bring you "food for thought," keep you abreast of interesting topics, and perhaps even report something new.

To truly gain the benefits of your Risk Management Section membership, it is important you be involved. One way is to contact your section liaison at the chapter level and find out if your chapter has any ideas to present or articles to publish. If you are interested in joining the Risk Management Section Committee to help shape the future of the Risk Management Section, please contact **John Kelly, CPCU, ARM,** or me.

In closing, risk manager is usually thought of as a title for a specific career path, but risk management disciplines and knowledge transcend all career paths in the insurance industry. Our task is to share our vast knowledge, encourage more people to become interested and involved, and together the Risk Management Section will flourish. It really is true, the more you share your knowledge and experiences, the more you learn. ■

Notes from the (Past) Chairman

by George J. Kolczun Jr., CPCU, ARM, AAI

George J. Kolczun Jr., CPCU, ARM, AAI, is account executive and chief operating officer of Rooney Insurance Agency. He has earned a bachelor of arts degree from Heidelberg College; and the Chartered Property Casualty Underwriter (CPCU), Association in Risk Management (ARM), and Accredited Adviser in Insurance (AAI) designations. He recently served as chairman of the CPCU Society's Risk Management Section Committee, and has served on many governmental and charitable boards of directors.

Well, these last three years have gone by fast! I have thoroughly enjoyed leading your section committee in serving you. I hope we have met your expectations.

Typically, we are to deliver to you four issues of *RMQ* a year. During my chairmanship, it was decided to deliver three to assure that they include the quality you expect. I believe this has been done. I hope you agree.

We also have embarked on our charge to set up an informative web site. I had hoped we would have had it up and running by the time I stepped down as chairman of the section. I didn't meet that goal, but the plans are in the works and I am confident you will be pleased with what is planned.

Risk management encompasses all of the disciplines of insurance. Therefore, it is our responsibility to embrace as many of our peers as we can.

This year the Risk Management Section co-sponsored a seminar with the Information Technology Section at the CPCU Society's Annual Meeting and Seminars. It was a great success. Seminars are an integral part of the Annual Meeting, therefore, your committee will strive to either sponsor or co-sponsor seminars at each or every other Annual Meeting going forward.

The membership in the Risk Management Section is still on the decline. I ask that each of you visit with any of the new CPCU candidates you know and suggest to them that when they are given the choice of sections that they choose the Risk Management Section. Risk management encompasses all of the disciplines of insurance. Therefore, it is our responsibility to embrace as many of our peers as we can.

Patricia A. Hannemann, CPCU, has accepted the responsibility for the leadership of your Risk Management Section for the next three years. She has great ideas and I am confident she will deliver to you not only what you expect from the section but more. She and I have discussed some of her ideas. I look forward to her introducing them to the section committee members and to you.

Thanks for permitting me to work for you. I will continue to serve as a member of the Risk Management Section Committee for another term. I wanted to stay to complete my goals and to help Trish raise the bar in delivering the quality of information you expect and deserve. ■

Client Contracts: To Read or Not to Read?

by Donald S. Malecki, CPCU

Donald S. Malecki, CPCU, is chairman and CEO of Donald S. Malecki & Associates, Inc. He is an active member of the CPCU Society, serves on the Examination Committee of the American Institute for CPCU, and is an active member of the Society of Risk Management Consultants.

Editor's Note: This article originally appeared in the September 2004 issue of *Rough Notes* and is reprinted here with permission.

Is reading client contracts and acting upon coverage requirements within an agent's traditional role?

The time has come and the decision must be made. Should agents read their clients' contracts and act upon the coverage requirements, or should they reject those client requests as being beyond their traditional role?

No doubt some agents have taken it upon themselves to read contracts for their clients and to fill the insurance orders. In fact, some of those agents even go so far as to suggest the wording of some contracts!

Many other agents—probably the majority—have been avoiding this type of service and adhering strictly to the role that they can do best—obtaining the coverages requested.

Merely taking insurance orders and nothing more, while still no easy task today, is without a doubt a lot safer. If it turns out that the coverage requested does not materialize into the protection perceived by the buyer, order taking may not totally eliminate an allegation of error or omission, but the burden should weigh more heavily on the buyer.

Those agents who do offer the services of reading contracts and filling contractual coverage requests are elevating their standard of care and increasing the chances of being viable targets for allegations of errors or omissions.

What Is So Different Today

The agent's dilemma of how far to proceed in assisting clients with their insurance needs prescribed by contract has always existed, but the conditions are much different today in relation to two especially controversial subjects: contractual liability and additional insured status.

Both subjects cause agents to roll their eyes because of the constant demand for broad additional insured coverage, and the general reluctance of a growing number of insurers to supply that demand.

However, in 1986, when ISO introduced the new Commercial General Liability (CGL) policy, it automatically included contractual liability coverage, broad enough to include the sole fault of the indemnitee (the person transferring the financial consequences of its liability to the other party, known as the indemnitor).

Under that edition, when it came time to determine the applicability of contractual liability coverage, for example, all that was necessary for the insurance company claims person to do was to (1) get an understanding of the allegations, (2) read the contract to determine the nature of the liability being assumed by the indemnitor, (3) determine whether the state law permitted the degree of liability assumed, and (4) conclude the extent to which coverage for bodily injury or property damage applied.

No one had to read contracts prior to a claim.

More recently, the common practice has been to not worry about the contract provisions until after something happens. In fact, the first person often to read a contract after it is executed is the insurance company claims person!

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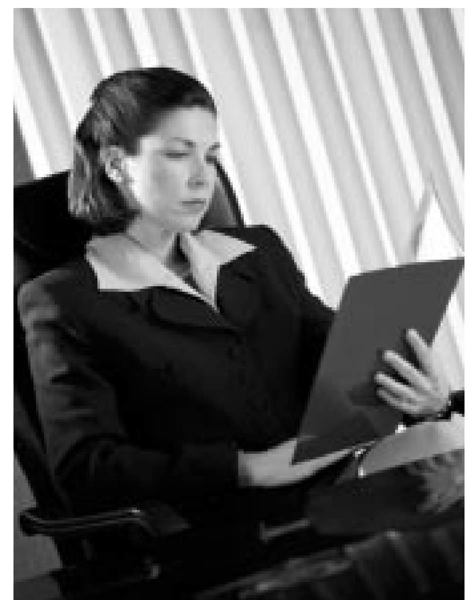

Client Contracts: To Read or Not to Read?

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Unbeknownst to some agents and their clients, however, has been the practice of some insurers in 1988, and possibly earlier, to issue an endorsement cutting back on contractual liability coverage. The tool to do this is Contractual Liability Limitation Endorsement, CG 21 39. When issued, this endorsement eliminates coverage for tort liability assumed with the exception of five so-called incidental contracts (easily remembered thanks to the acronym LEASE) as follows: **L**—lease of premises, **E**—easement agreements, **A**—agreements required by municipalities, except work performed for them, **S**—sidetrack agreements, and **E**—elevator maintenance agreements. Coverage for the assumption of an indemnitee's tort liability is eliminated!

What ISO has done now is to introduce yet another endorsement amending contractual liability coverage. It is referred to as Amendment of Insured Contract Definition Endorsement, CG 24 26. This endorsement takes away less coverage compared to the preceding endorsement, CG 21 39, but is more limited than broad form contractual liability coverage automatically provided by the CGL policy.

If either one of these limiting endorsements is issued, it is important that the insurance buyer be cognizant of this since, if the buyer agrees to assume another's tort liability for, say, sole or joint fault, coverage may fall drastically short of the mark. Surprisingly, the issuance of Endorsement, CG 21 39 has been quite prevalent, leading to the conclusion that no one is minding the store. Then, again, this condition of having a more limited contractual liability coverage applicable through the use of a narrowing endorsement has not been a particularly worrisome situation, because broad additional insured endorsements have been available, often pre-empting the need to read contracts and to rely on contractual liability coverage.

The situation is different today, because ISO has introduced some new additional insured endorsements in an attempt to eliminate the traditional broad coverage. With the use of "arising out of" phraseology, these standard endorsements have been almost consistently interpreted by the courts as including coverage for additional insureds, even when named insureds are totally blameless for injury or damage.

Back when standard policies were first introduced in 1941, insurers expressed the intent that coverage for additional insureds should be limited solely to their vicarious liability; that is, when the only reason an additional insured is getting sued is because of something the named insured did. An example is where a contractor (named insured) injures a passerby who, in turn, brings suit against the property owner for failing to provide a safe place to work. The property owner, in this case, did nothing but still could be held accountable for what someone else did.

This idea of limiting additional insured coverage to vicarious liability did not last long. In light of competition, the demand for broader additional insured coverage, and the willingness of insurers to accommodate the demand, it was not too long before broader coverage was provided.

Insurers now want to go back to those former days when additional insured coverage was more limited in scope. In fact, many insurers have already begun to do so through the use of their blanket additional insured endorsements. ISO's procedure also is in the works. ISO is in the process of filing for the approval of more limiting additional insured endorsements. While the intent of these endorsements is to cut back coverage, at least in terms of sole fault, they are not totally limiting coverage to the additional insured's vicarious liability.

It is too early to tell how these endorsements will be interpreted by the courts, but a cursory review of the one commonly relegated for use in the construction business, Additional Insured—Owners, Lessees or Contractors,

CG 2010 07 04, reveals some features that go beyond vicarious liability.

This particular endorsement states, in part, that coverage applies to liability for injury or damage caused "in whole or in part by named insured's acts or omissions," or "the acts or omissions of those acting on the named insured's behalf" in the performance of the named insured's ongoing operations.

What this means is that, unless the named insured is at least partially at fault, the only coverage available to the additional insured is vicarious in nature or, in other words, when liability is imputed to the additional insured because of the acts or omissions of the named insured.

If it turns out that the named insured is partially at fault, then the additional insured also will be covered to the extent of its fault. Note that there are no percentage of fault restrictions. This means that the ratio of fault could be 1 percent on behalf of the named insured and 99 percent on the additional insured's behalf.

The problem that is likely to generate a great deal of litigation is the second part of this endorsement limiting coverage caused, in whole or in part, by the acts or omissions of those acting on the named insured's behalf. If the additional insured ultimately is determined to have been acting on behalf of the named insured, the additional insured will have coverage for its partial fault, when the named insured also is partially at fault, or for its sole fault when the named insured is blameless.

In any event, the point is that standard ISO additional insured endorsements may no longer be as broad as they once were. This means that where sole fault assumptions are still permitted by state law, the additional insured endorsement will not be sufficient to cover the resulting liability, if it turns out that the allegation against the additional insured is sole fault.

Other insurers may include, if they have not done so already, the same ISO provisions in their independently filed endorsements. As pointed out earlier, some insurers are already cutting back on additional insured coverage in their blanket additional insured endorsements. (Whether some insurers will continue to accommodate demands for a price remains to be seen.)

The only recourse left in this event would be to turn to contractual liability coverage. As discussed earlier, however, even this coverage for an indemnitor (one who assumes the financial consequences of another's tort liability for injury or damage) may also fall short in light of recent cutbacks on coverage.

Good Risk Management Sense

Getting back to the agent dilemma of whether to read client contracts and act upon the coverage requirements, if the agent decides to avoid client requests to read contracts, the question is how it can be done diplomatically without losing the account. One possible approach is to explain to the client that coverage cannot be prescribed simply by referring solely to the insurance provisions of contracts (even though this often is the case).

Instead, the entire contract must be read, since coverage references often appear throughout a contract. Agents, therefore, should explain that the contracts should be read entirely by attorneys, in relation to existing law, who can then confer with the agents for purposes of obtaining coverage. Some agents also are able to convince their clients to hire the services of an insurance consultant to perform this role for a fee.

Unquestionably, many insurance buyers do not want to spend anything more than what they already pay for their insurance and often confront their agents to either perform this additional service—or the client will go elsewhere. This, then, is a big decision; but some agents who have spent weeks of nonproductive time in the courts confronted with errors or omissions litigation have no difficulty in deciding what to do.

If agents want to extend their services by reading contracts and counseling their clients on what coverages to request, or what coverages need to be obtained as requested, it may take time. But many continuing education courses, seminars, and workshops are conducted for this purpose, coupled with countless articles and some books in specialized areas.

Whatever the situation may be, the time is ripe for making some important decisions. ■

Inside-Out Leadership

by Demmie Hicks, Maureen H. Hunter, Ph.D., and Hamid Mirsalimi, Ph.D.

- **Demmie Hicks** is a business strategist and consultant serving her clients at the board level. She is president and CEO of DBH Consulting, a firm specializing in growth strategies and organizational development for the insurance industry. She also founded A Woman's Initiative, a learning community unique in its mission to support the personal and professional needs of women business owners, executives, and practitioners.

- **Maureen H. Hunter, Ph.D.**, is a founding principal and consultant with DBH Consulting. She has spent the past 25 years working with organizations that strive to enhance their effectiveness and their capacity to fully engage their people. She works primarily with Fortune 100 companies, and has an interest in supporting start-up businesses and non-profits.

- **Hamid Mirsalimi, Ph.D.**, is a founding principal and consultant with DBH Consulting. He is also on the faculty at the Georgia School of Professional Psychology at Argosy University, where he teaches a variety of courses including group psychotherapy, psychodynamic psychotherapy, and research and evaluation. Mirsalimi also practices privately in Atlanta where he engages in psychotherapy, executive coaching, and consultation work. He has more than 10 years of teaching experience in the area of human growth and development.

- **DBH Consulting** is a firm specializing in growth strategies and organizational development including: leadership development (with a specialty in leadership development for women), perpetuation planning, and executive coaching.

Are you a "doing" leader or a "being" leader?

Much emphasis is placed on action in today's leadership environment—goals, directives, analysis, decision-making, action plans, tactical maneuvers. A lot of "doing." But this is not the entire story of leadership!

Leaders who cling to this "doing" model may have a hard time anchoring themselves firmly enough to withstand the tempest of change and other external circumstances that pelt leaders on a daily basis: If one's leadership style is rooted solely in action, the ride—for the leader and the team—will likely be quite bumpy.

Great leaders emerge not through "doing," but through who they are as people—their "being." You have likely experienced this with someone you admire. They are centered, focused, and unflappable. They draw people in, they create strong alliances, they motivate through their very presence. They seem to exude leadership qualities without even trying! You may have noticed that great leadership begins inside a person and flows outward to others. Leadership built on a solid core of "being" will stand firmly rooted, no matter what external forces exist. Action-oriented leaders manage well. But "being" leaders inspire others to greatness.

Will you merely manage? Or inspire?

One way that we enhance our being is to practice self-knowledge. Before we can influence others, we must understand what motivates them. But first we must understand ourselves.

Great leaders have a keen awareness of:

- Their core values and beliefs.
- The impact they have on others.
- How their communication style influences others.
- Their use of personal power, relational power, and hierarchical power.
- How their presence draws others in.
- The power of their internal dialogue.
- The source of their unique personal strengths.
- What it takes to maintain life balance.
- Their ability to make choices.
- Great leaders possess the ability to observe their own behavior, are aware of their own actions, and are well-connected to their own thoughts and feelings.

Self-awareness takes practice. If you stop for just a minute and look quietly inward, asking yourself what you are aware of right here and now, you may not notice much at first. But you will notice something, a physical sensation, a distant sound, a murmur of feeling within. If you practice this often, you will eventually begin to notice a great deal more, and will become increasingly aware of your thoughts, feelings, and sensations. You may even start to notice that this heightened awareness creates choice.

In general, people tend to make good choices in life only when they are aware of what choices are available to them. Individuals are often unaware of their choices, often pushed and pulled by forces that make them think, feel, and behave the way that they do. To the extent that people are not happy with who they are, or with their lives, or to the extent that they desire to more fully love their lives, they owe it to themselves to explore and become more aware. Only then may they become more fully aware of the bounty of choices that they have in life, and choose what is right for them in awareness.

So take stock in your own leadership style. Are you following the "doing" model, focusing only on a set of external behaviors and techniques? Ideally, you have tapped into your inner core—your essence—to fully understand who you are, what choices are available to you, and what value your "being" contributes to those around you. They key to effective leadership comes from the inside out. ■

The Economic Value of Insurance Loss Control (How Much Is Loss Control Worth?)

by Daniel J. Dekowski, CSP

Daniel J. Dekowski, CSP, is a graduate of the Johns Hopkins University with a degree in industrial engineering. He entered the insurance loss control profession upon joining Aetna Casualty and Surety Company in 1963 and has worked for Alexander & Alexander and Fireman's Fund Insurance Company as regional loss control manager until founding his own loss control firm, Insurance Engineering Associates, in 1991. Dekowski is the author of the book *Insurance Engineering: The Secret to Profitable Underwriting in the Property Casualty Insurance Industry.*

Editor's Note: Daniel J. Dekowski, CSP, has been an insurance engineer for the past 40 years and invites comments and questions regarding this or other loss control topics. He is a loss control consultant and the author of the only book on risk selection: *Insurance Engineering: The Secret to Profitable Underwriting in the Property-Casualty Insurance Industry,* which can be found at www.insuranceengineering.com. He can be contacted at (410) 557-9652, e-mail: insureng@iximd.com.

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Safety pays. The benefits are fairly obvious: As insurance premiums go down, employee morale goes up and the employers see direct and indirect cost savings.

Does loss control (and accident prevention) pay off for insurance companies too? You bet! Loss control makes great sense not just for employee safety but all lines of insurance. But how much?

Every insurance company should ask itself if the cost of its loss control operation is justified or perhaps valuable as a profit center? Most insurance executives would be surprised to find out how much economic value there is in loss control even when not structured well or not utilized effectively. Seldom though does anyone measure that value.

Risk Improvement

There are three ways in which insurers profit from their loss control operations. The most obvious was the reason insurers started hiring safety engineers about 100 years ago. People with knowledge of engineering and scientific methods were the obvious choice to go into industrial plants and look for safety hazards. Recommending machine guards was just one of the many ways safety engineers helped their clients prevent costly injuries to the benefit of the companies for which they worked. The concept is now thought of as **risk improvement.** Risk improvement works not only for workers compensation coverage but fleet safety as well and other lines to a lesser degree.

Value-Added Service

When insurers reduce claims costs through loss prevention, insurance buyers usually save money as well. **Good will** follows naturally. The good will is considered by many to be the result of **"value-added service."** This promotes loyalty from customers and helps retain business. Depending on the quality of claims and loss control service, competitors need to be as much as 15 percent cheaper than renewal pricing. This is more likely to occur while loss experience is improving and the customer is impressed with reduced costs.

Good **loss control service** is thought by many to be worth up to 10 percent of premium at renewal. This allows an insurer to get a significantly higher premium once an account gets accustomed to quality service. High quality loss control service generally runs 3 to 5 percent of premiums. Most insurance companies that have loss control operations are spending about 1 percent of premiums. At that level they cannot provide much risk improvement service and should not expect much good will.

There is a down side to value-added service. As loss experience improves, premiums decrease over time when risks are experience rated. Time dims memories and the value of the value-added services somehow loses luster. "What have you done for me lately?" becomes more important—especially when key contacts retire or move on.

Risk Selection

The most common way that insurance companies invest in loss control is by means of **risk selection.** Quality risk selection involves engineering assessments of risk characteristics that compare specific risks to class averages so underwriters can rate risks in a statistically logical way.

There is a unique set of factors (hazards) that make up every insurance risk. Each risk (insured) is somewhat different than all others. A substantial number of insured businesses share enough hazards and they get grouped into one of numerous rating classes. The concept of **risk selection** is to differentiate each risk by comparing it to the average risk in its class.

The risk rating must be integrated into the underwriting process to achieve maximum value. If **risk selection** is limited to mere inspection of existing hazards, a risk can be less than desirable even though it looks nice.

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The Economic Value of Insurance Loss Control (How Much Is Loss Control Worth?)

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Comparison of risk to class characteristics is difficult for many people to comprehend. Formal training of insurance engineers is required to teach risk assessment.

The principles of **risk selection** are easily understood by a majority of engineers and science majors, especially those with an understanding of statistical probabilities. The problem for practitioners is that underwriting factors must also be understood. This requires some underwriting knowledge or training.

An example for the workers compensation line of business: in round numbers, about 10,000 businesses (companies), on average, share each workers compensation class. There's a number of hazards in common among the businesses that share the same class (rate). If a loss control consultant understands how to compare the hazards of a specific risk to the hazards for the rest of the insureds sharing the class, he or she can grade the quality of each risk quite accurately.

The most obvious example of this is for window washing (except in Florida where there are two separate classes). Some window washers never leave the ground while using poles to reach one-story-high windows. Another group of window washers work from scaffolds on high-rise buildings. The differences in risk are obvious.

Combination of Benefits

When insurance engineers are competent at risk selection and risk improvement, there is a combination of savings that include "values added" for customers. The total value of their financial contribution to cost savings is substantial.

Some Examples of Measuring Loss Control

There are multiple ways to measure the financial value of loss control. A few examples follow:

Acuity Insurance (Case 1)—One sizable all-lines, mutual company in the midwest, Acuity Insurance, whose engineers rate the quality of risks that they survey on a scale of 1 to 10, has measured the potential value of loss control. Acuity's Loss Control Director Larry Kammerzelt compared the pure loss ratios of all accounts graded by his consultants. The pure loss ratio (premiums versus losses) for the accounts that the loss control people like the best (Grade 10) was measured to be **41 percent.** At the other extreme were accounts that were judged exceptionally poor (Grade 1). These accounts had an average loss ratio of **238 percent.**

Between these extremes is a smooth but somewhat skewed curve for the loss ratios of the account grades assigned by the consultants. As would be expected in any **normal distribution,** there are relatively few 10s and 1s compared to those in the middle range. But even between the 2s and 9s there is a large difference in loss ratios.

Below average risks are likely to have loss ratios **50 percent** worse than the **good risks. Average risks** are likely to have loss ratios only **15 percent** worse than **good risks** (regardless of underwriting credit). As can be expected statistically, the differences become much greater at the far ends of the curve (populations).

At Acuity Insurance, risk selection is the primary mission of the Loss Control Department, which works closely with the underwriters. In 2002, Acuity had a combined loss ratio of 90.9 percent, a loss ratio much better than the average for the industry.

PDP Loss Control Services (Case 2)— Since its founding more than 20 years ago, PDP has specialized in insurance for new automobile dealerships. The PDP Loss Control Department specializes in dealership loss control and has been a big part of the formula for success at PDP. The Loss Control Director Lou Dicker is a renown expert in dealership loss prevention.

He was approached by a major insurer and given a contract to get control of the physical damage and theft losses for the insurer's entire book of policyholders' new car inventories. His mission was to reduce the growth of loss trends to zero from the 10 to 14 percent annual growth in losses. In 1997, he and his staff began visiting the worst 20 percent of dealers. The losses were running about $25,000,000 per year. By the end of the third year, the losses had been reduced to $13,000,000 annually.

The payback to the insurer was $12,000,000. The cost of the program was $500,000. The savings to the insurer was 24 times the cost but only if you don't consider the loss trend that caused the insurer to hire PDP. The actual payoff was much greater than 24 times the expense. Wouldn't it be nice to find a bank that paid interest of 2,400 percent annually?

Because nothing other than the loss control service changed during the three years, it is safe to attribute the savings to the intervention of PDP Loss Control Department.

Louisiana Workers Compensation Corporation (LWCC) A WC Only Carrier (Case 3)—This major insurer of workers compensation provides a case study in the line of insurance that has the highest frequency of claims. In general, the greater the frequency of losses in an insurance line, the greater the impact of loss control intervention. A complicating factor for workers compensation is that benefits change from year to year. Although it is not appropriate to assume that all reductions in claims costs are caused by the influence of loss prevention, it is possible to track the numbers of accidents. The frequency is affected more by loss prevention, or lack thereof, than almost any laws and benefits changes.

In this example, the company had no meaningful loss prevention service for its customers and their employees prior to 1992. When new management took the helm that year, a new loss prevention

director with excellent knowledge and experience was hired to organize the Loss Prevention Department. The department began providing meaningful risk improvement services to policyholders. Due to limited resources, loss prevention service was provided to accounts with premiums of $25,000 or more and certain other policyholders.

During a 12-month period in 1992–1993, the insurer provided 157,250 policy-months of coverage (the equivalent of 13,104 policyholders). The total number of accidents reported was 10,765—for an average of **0.068458** accidents reported per policy-month. During that period the average cost of a reported accident was $8,087.

In a similar 12-month period in 1996–1997, during the fifth year of loss prevention service, the number of policy-months increased to 365,550 (equivalent to 30,463 policies). And the total number of accidents reported was 10,582—for an average of **0.028942** accidents reported per policy-month.

Had the number of accidents reported continued to increase proportionally to the growth of business and the average cost of each claim remained the same, the cost of claims would have gone from $87,060,000 to an estimated $202,389,000 (232 percent). In actuality, the average cost of accidents went down during the same period presumably because of several other factors.

The actual savings to the company and its policyholders in the fifth year of loss prevention operations, based on the then-current average cost per accident, was $89,575,000. The total loss prevention budget for the same year was considerably less than $2,000,000.

In this case, the insurance company was able to reduce premiums several times, became highly competitive, and thus grew rapidly. Some of the growth probably accounted for a reversal in adverse risk selection that had probably been a factor initially.

Why Does Loss Control Have Such High Payback?

The question that comes to mind is: Why is this not common knowledge? Paybacks of 24 to 45 times the expense just don't seem realistic in spite of the proof to the contrary. If this wasn't such a well-guarded secret, insurance companies would be lining up to invest some of their cash in the loss control money-making machine. Unfortunately, the idea that you can spend one dollar and save 20 or more seems illogical. Why does this work? There are several reasons.

One reason for such high returns from loss control operations is called **technical expertise. Competent** insurance loss control engineers accurately analyze risks and determine strategies for controlling hazards and exposures that reduce the overall degree of risk by 20 percent and more in most cases.

Another reason that insurance engineers can be so effective is that they ***inspire*** positive change. They motivate customers to take control. Insurance policyholders are responsible for making the actual improvements required to reduce losses. The work of the insurance engineer is magnified by a process called **leverage.**

An engineer's role is like that of a CEO who simply determines a plan of action and has others carry out his or her plan. Why are corporate leaders paid such big bucks? They don't do the actual work any more than insurance engineers do. They spend a few thousand hours a year and accomplish the equivalent of millions of hours of work. A major difference is that executives have enormous power in applying their leverage to their organizations. Insurance engineers have only their wits, expertise, sales skills, and the backing of their underwriters (and sometimes agents) in convincing policyholders to prevent and control losses.

Most insurance companies get much lower returns on their loss control investments than in the examples above. In the three cases cited, the loss control directors were more competent than average. But even incompetent loss control operations are worth more than their cost.

As there has been scant training of engineers in more than 20 years, there are few engineers remaining who are fully trained. Hardly any even know that training materials are available for this purpose. The only way that insurance companies can expect to employ competent engineers is to provide the training needed to instill the knowledge and skills required for excellence.

Measuring the Value of Loss Control

In the cases described above, the measuring was easy when loss control operations were superimposed on existing books of business. The results can be calculated from the loss data routinely collected and tabulated. To collect data that doesn't already exist in loss control reports and company records means making a commitment to gathering and manipulating additional data. It takes time and effort. Computing premium and loss data for loss control purposes requires the cooperation of the information technology (IT) staff.

Not many insurance companies or their loss control executives measure the value of their loss control operations. The typical excuse is: "You can't measure something that may never happen." Of course, it is possible to measure loss prevention just as easily as it is to measure anything else.

The difficulty comes in organizing the existing data and determining what information is needed. With the widespread use of powerful computers and PCs, insurance companies can gather information in many ways. To determine the best way for each of them requires some ingenuity in using the information available. An outside consultant can assist in measuring the value and can suggest ways to increase the effectiveness of any loss control operation. ■

Strategic Insurance Solutions Using the 501(c) and 831(b) Captive Insurance Company by Corporation Owners

by Andrew J. Barile, CPCU

Andrew J. Barile, CPCU, has been in the insurance industry for more than 40 years in the United States. His experience covers all types of insurance coverages, and all forms of insurance entities. Barile has developed all varieties of insurance programs, from development to implementation and execution stages. His articles have been published in numerous insurance trade journals, and he is a frequent lecturer at seminars throughout the United States.

The purpose of this article is to provide information about privately owned insurance companies that are owned by corporations that are seeking new risk management solutions and are providing unique insurance coverages for their business owners.

Corporation owners, such as construction companies, want to purchase construction defect coverage; PEO owners want to buy litigation defense insurance coverage, casino operators want to buy economic recovery insurance, in all cases transferring the economic risk of loss, and its exposure, to an insurance company owned by the corporation's stockholders.

It should be noted that owners of these captive insurance companies are organizing them pursuant to certain sections of the IRS Code; therefore, it is important that a qualified tax attorney be part of the team conducting the feasibility study for this type of insurance company. However, the tax attorney should not render insurance coverage advice that should be left up to the insurance professional. And the insurance professional should not render tax advice or make comments such as "organized pursuant to IRS 501(c)(15), etc."

Risk shifting and insurance concepts of these private insurers are very important to corporation owners. Many of these owners have no other insurance solution to implement except for these types of insurers. As my tax attorney colleagues tell me, under present tax law a property and casualty insurance company is exempt from federal income taxation if its net written premiums or direct written premiums do not exceed $350,000. In addition, a company can elect to be taxed only on its taxable investment income if its net written or direct written premiums exceed $350,000 but not $1.2 million. The establishment of an insurance company should be used to address the financial implications of the exposure, not to provide tax benefits.

To reiterate, the feasibility study should focus on the insurance exposure.

Understanding the Feasibility Study for a 501(c)(15) or 831(b) Captive Insurance Company

The focus of this captive insurance company should be on insurance coverages not available in the traditional insurance marketplace. This can be expanded to include costs for insurance in the traditional market whereby it's not economically feasible for the corporation owner to purchase. Simply put, should a medical doctor own a captive to cover his or her professional liability exposures when the cost becomes prohibitive?

Major insurance work should be accomplished to design the manuscripted insurance policy. For instance, workmanship liability insurance for a contractor. Pricing, coverage forms, and loss reserving for the policy should be included in the feasibility policy.

The feasibility study for a 501(c)(15) captive insurance company should include exploring various overseas domiciles who employ people with the insurance experience necessary to perform management functions.

Additional areas would be:

- Determine the amount of adequate initial capital for the captive insurer.
- Structure a comprehensive reinsurance program.
- Determine the amount of insurance risk exposure.
- Analyze the pricing of the unique exposure . . . how much should construction litigation insurance coverage cost, and how was the price determined.
- Analyze a five-year pro forma of the captive insurer's results.
- Determine the actuarial firm.
- Determine the legal and tax counsel.
- Determine the Board of Directors.
- Explore the possibility that the financial performance of the captive insurance company be shared with the various insurance rating organizations.
- Show how this is a true insurance company not writing traditional insurance coverages.
- Assure risk shift from the corporation to the captive insurance company.

When the local or traditional insurance market does not meet the needs of the corporation owner, then 501(c)(15) and 801(b) captive insurers may be feasible to provide the sophisticated insurance solution.

Let us look at some additional insurance solutions. Suppose you are an Indian software solutions provider looking to provide business process outsourcing services for high-profile clients in the United States. A feasibility study to provide a financial guarantee from the Indian company's captive insurance company can provide the high-profile U.S. client with greater assurances as respect to the outsourcing relationship. The privacy-related risks with offshore outsourcing can be insured in the captive insurance company financed by the offshore vendor, whether it be India or Pakistan. Look at insuring the issue of losing control (over data), especially if it's a third party. This is a novel approach for a captive insurance company.

Many of these small insurers had abused the tax rules and were set up by tax lawyers and CPAs without insurance expertise. Changes will be made to seek changes in the small-company tax rules to prevent the creation of "shell" insurance captive companies that exist largely to earn tax-free investment income.

The use of closely held captive insurance companies are formulated with the feasibility study providing the corporation qualifying as an insurance company. Offshore domiciles have created specific insurance company regulations adopted after many of the National Association of Insurance Commissioners regulations.

Simplistic questions such as quantifying the amount of initial capital and judging whether the captive insurer can pay claims should be handled by traditional experienced insurance consultants, not tax lawyers.

Conclusions

Let us review some of the traditional roles for closely held insurers:

(a) **Health Care Operator**—writes nursing home professional liability insurance.

(b) **Contractor**—writes general liability for construction defect coverages.

(c) **PEO Owner**—Provides reinsurance of workers compensation coverages.

(d) **Indian Outsourcing Company**—provides errors and omissions coverage in its captive.

(e) **Newly Formed Corporation**—writes directors and officers liability insurance for the new directors.

I look forward to hearing your reaction at abarile@abarileconsult.com. ■

(Left to right) Patricia A. Hannemann, CPCU; Kathleen A. Murphy, CPCU; Walter G. York, CPCU; Jane M. Damon, CPCU, CPIW, CIC; Cheryl L. Topham-Coffee, CPCU; and George J. Kolczun Jr., CPCU, ARM, AAI; gathered in Chicago, IL, where the Risk Management Section Committee held its 2004 Mid-Year Meeting.

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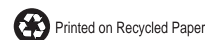

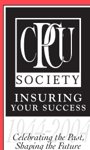

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