Through Liability Insurance Deductibles and Self-Insured Retentions

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Reduce Your Insurance Costs

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In today's hard insurance market, insurance buyers are looking for alternatives to reduce costs. A greater self-assumption of risk is often the first place companies are looking to accomplish just that, with an eye toward ultimately becoming less dependent on commercial insurance. Deductibles and self-insured retentions have always been available, but were frequently overlooked in the height of a soft insurance market.

For many, first-dollar coverage has now become a luxury they cannot afford. As a result, more emphasis is being placed on catastrophic protection and, at the very least, a greater self-assumption of risk for smaller claims. When there is a high frequency of manageable claims, purchasing first-dollar coverage just doesn't make financial sense, regardless of the insurance market conditions. Insurers collect premiums to cover such expected losses, add the costs associated with allocated claim expenses as well a charge for their profit. This results in a trading of dollars for these claims, and the insurers usually come out ahead.

In virtually all cases, taking responsibility for your own moderate level of claims will be cost effective in the long run. Emphasis here is on the long run. Decisions to accept more risk should be made based on long-term projected results. Businesses assuming more risk must understand that there will be years when they benefit from retention and others years when they will not be so fortunate. You should not be dissuaded from continued retention of losses simply because of one or two bad years of experience. Be assured that had those unexpected losses been insured, you would have to pay for them on a dollar-plus basis the following year.

What's the difference?

When considering deductibles or self-insured retentions, it is critical that you understand just what it is you are bargaining for. Inasmuch as some insurance buyers may be inexperienced with the ins and outs of risk assumption, many sellers of insurance seem to be as much in the dark, thereby creating the potential for bad decisions.

When deciding to accept more risk through deductibles or self-insured retentions, you must first understand the basic difference between the two approaches. Insurance policies written with deductibles provide that the insurer will pay the defense and indemnity costs in connection with a claim, and then charge or bill back the deductible amount to the insured. The responsibility for the defense and settlement of each claim rests solely with the insurer, which therefore maintains full control of the entire claim process.

Policies written with self-insured retentions, on the other hand, place a large degree of (if not the entire) responsibility for claim payment and settlement on the shoulders of the policyholder. While language may vary, the insured is typically required to pay the defense and other allocated expense costs as well as indemnity payments until the amount of the retention is paid, after which the insurer assumes full responsibility for the claim.

Care must also be taken to fully understand the extent of risk being assumed. Whether you select a deductible or self-insured retention, be sure to understand if it applies to each occurrence or each claim. An occurrence deductible or self-insured retention is preferred since both eliminate the catastrophic exposure potential of numerous claims arising out of a single occurrence.

In addition, aggregate protection is desired for deductibles or self-insured retentions, thereby limiting the number of claims or occurrences you may be responsible for in any single policy term. Expect credits for deductibles or self-insured retentions to be greatly diminished when aggregate protection is afforded.

Some self-insured retentions require the policyholder to pay allocated expenses in proportion to the amount of the indemnity claim, often calling for the payment of some allocated loss expenses above the retention level.

Pros and cons

What are the advantages and disadvantages of deductibles and self-insured retentions? On the positive side, SIRs allow the policyholder to control the defense and settlement of smaller claims, thereby keeping them out of their experience rating. A word of caution is needed, however, since some policies may still require the insurer to be informed of all claim payments falling within the SIR. In addition, policyholders are typically not obligated to accept a demand for settlement within the SIR (an aspect of SIRs that concerns insurers believing that policyholders may gamble with the insurance company's money).

On the downside, administering the claims within an SIR may be more costly than anticipated and may involve more staff time and costs than planned. Depending on policy language, the insured is also likely to be responsible to defend and indemnify "additional insureds" added to their policy until the SIR has been met.

The main advantage of deductibles is the fact that only the indemnity portion of each claim or occurrence is billed back to the policyholder, thereby taking away any uncertainty with respect to allocated loss expenses. An often-cited disadvantage of deductibles is the perception that the insurance company will be more likely to settle claims within the deductible level rather than spending money to defend the claim. The fact is, liability claims adjusters are not likely to even know that a deductible applies. In addition, insurance companies have a basic fiduciary responsibility to protect the rights of the policyholder.

Many companies experience another advantage with regard to both deductibles and SIRs. Bringing the responsibility for claim payments and allocated loss expenses in-house gives a whole new awareness of loss control, which can translate into improved loss experience. When it's your company's money — not the insurer's — actually paying the claimants, you are likely to be more interested in preventive measures.

Understand risk and responsibility

When deciding to accept more risk through deductibles or self-insured retentions, it will be necessary to conduct an analysis of your claims history in order to determine the level of retention that makes the most sense financially and/or to evaluate the credit an insurer may be offering for your acceptance of a deductible or self-insured retention.

Detailed loss runs will be needed to conduct this analysis. If you are evaluating the cost effectiveness of a self-insured retention, loss runs including details on allocated loss expenses on a per-claim basis may be extremely valuable. When evaluating small SIRs involving frequent but low-severity claims (where outside legal counsel rarely will be needed and other allocated expenses will be minimal) the need to know the allocated expenses in connection with past claims is not as important.

Policyholders selecting a self-insured retention must be aware of the incident and/or claim reporting requirements in their insurance contracts. Some SIR endorsements actually amend the loss-reporting requirements that are contained in the basic policy and these should be clearly understood.

Often, a claim will need to be reported only if it appears that it will exceed the SIR or a stated percentage of it.

Whether considering a self-insured retention or deductible, there are enough differences among policy and endorsement provisions that a complete review of all contract language is essential before accepting either. Understanding the risks involved and the administrative responsibilities are critical to the success of any loss-retention program.

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