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UNDERSTANDING RISK MANAGEMENT

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One of the preliminary steps for a company deciding whether to form a captive insurance company is undergoing a feasibility analysis. The most important component of the feasibility analysis is often the independent risk assessment. The independent risk assessment is a deep dive into how the company operates. The end result of the risk assessment is to identify all areas of risk a company faces, and the likelihood each such risk will materialize into a loss and, if and when they do, the severity of those losses.

While the types of risk that a company faces can vary significantly depending on the industry in which it operates, when analyzing these risks from a commercial insurance standpoint, they can be broken down into 4 different categories.

The first category are those risks for which the company has purchased commercial insurance coverage. These typically include coverage for general or professional liability, property damage for any buildings the company owns or leases, automobile coverage, workers compensation, unemployment insurance, and EPLI coverage. Sometimes this may also include inland marine, directors and officers, and cyber coverage.

The second category are those risks for which the company purposely decided to self-insure. This includes deductible amounts where the company decided they wanted to be liable for claims of smaller dollar amounts. This also includes claims in excess of the coverage limits where the company decided it would self-insure risks above the amount covered by its commercial insurance. Finally, this includes risks that the company knew it could purchase insurance to protect against, but for one reason or another opted against purchasing such coverage. Typical reasons include the anticipated small likelihood that such a loss would occur or simply the cost of the insurance relative to the perceived risk of loss.

The third category of risks are those for which the company thought it had commercial insurance coverage, but it turns out it did not. The COVID pandemic has highlighted the largest and most widespread example of this: business interruption insurance. Most businesses that had purchased business interruption insurance believed such coverage would insure them against the lost income they experienced as a result of government shutdowns. However, as the vast majority of those businesses learned, standard business interruption insurance contains either an exclusion for pandemic related losses or requires a physical loss to your building or workplace facility, e.g., fire, flood, building collapse. To identify the areas of risk that fall into this category, one need only look to the exclusions section of a commercial insurance policy.

The fourth and final category of risks are those for which the business was unaware that it could purchase commercial insurance coverage. You may be surprised to learn that this is the largest category of risk and includes coverage for lost income and extra expenses associated with things such as administrative actions, regulatory and legislative changes, loss of key employee, litigation expenses, audit defense coverage, uncollectible receivables, and reputational damage, just to name a few.

All four types of risk can be properly insured through a captive insurance company. Typically, the first two categories, those risks for which the company is presently insured commercially and those risks for which the company has purposefully chosen to self-insure, are examined together. Often, we find that a company has an artificially low deductible, despite the fact that it would not put in a claim unless the loss significantly exceeds the deducible. For example, it is not uncommon to find that a company has a $5,000 deductible on the property insurance covering its building, even though the owners acknowledge that they would never submit a claim for less than $50,000 for fear that their commercial premiums would rise.

In that instance, they are encouraged to raise their deductibles and to then obtain a deductible reimbursement policy from their captive. The deductible amounts are periodically reviewed to see if they can be increased even further as the captive builds surplus and if claims history remains favorable.

The third category is extremely important to review for coverage that should be written through the captive. Beyond the business interruption noted above, some sample endorsements include exclusion for damages caused by subcontractors, exclusion for damages caused by mold and mildew, and exclusion for damages resulting for customer or tenant discrimination claims. All of these items can be insured through the captive insurance company.

The fourth category tends to be a goldmine for finding coverages that are appropriately placed in the captive. Some of these risks materialize in the form of losses to the company that are inconsistent from year to year. By incorporating coverage for them in the captive, we can smooth out the captive's cash flow year over year.

When the feasibility analysis is presented, the risk assessment is incorporated textually and in a so-called heat map, which is a visual representation of all areas of risk along an X and Y axis that represent the likelihood of the risk materializing into a loss and the severity of that loss if it does.

The risk assessment is an eye-opening tool that helps business owners better appreciate and understand the risks they face, and enables them to design a robust risk mitigation program that most often includes a captive insurance program.

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