PARKER | SMITH | FEEK

COMMERCIAL INSURANCE
EMPLOYEE BENEFITS
PERSONAL INSURANCE
RISK MANAGEMENT
SURETY

PRACTICE GROUP:
# CONSTRUCTION

SEPTEMBER 5, 2019

## HERE COMES THE HARD MARKET - RISK FINANCING OPTIONS FOR CONTRACTORS

Todd Wheeler | Principal, Vice President, Account Executive

After years of a soft insurance market characterized by low rates, relaxed underwriting standards, and ample carrier and reinsurance capacity across all lines of coverage, the pendulum has started to swing in the opposite direction. A hard insurance market is coming; for many contractors, depending on geographical location and industry sector, it has already arrived. Property, difference in conditions, auto liability, general liability, and excess liability coverages have all been targeted by insurance carriers for significant rate increases.

A hard insurance market[1] is characterized by premium increases, with underwriters asking more questions and becoming less willing to negotiate rates, terms, and conditions. Demand remains high for coverage, but supply is lower and restricted in a hard market, which drives rates and premiums higher. Increasing catastrophe claims costs from wildfires, hurricanes, tornadoes, and floods over the past three to five years have also significantly contributed to the hard market. Now faced with adverse renewal conditions due to a hardening market, contractors should be diligently exploring all available risk financing options in order to control their annual insurance spend, which after labor costs, is often their highest line-item expense.

Risk financing options available include the traditional guaranteed cost, large deductible, retrospective rating, and self-insurance programs. Alternative risk financing mechanisms include captives, risk retention groups, and risk purchasing groups. Below we take a quick look at each.

### GUARANTEED COST

The traditional insurance transfer program where a contractor pays an annual fixed premium based on exposures, regardless of loss activity during that policy period. This premium can be adjusted if exposures increase or decrease, but not if there are losses.

### DEDUCTIBLE PROGRAMS

These are loss sensitive programs where a contractor both assumes some level of risk, yet still transfers the majority of risk to the insurance carrier. The higher the level of assumed risk (deductible selected), the lower the premiums charged.

### RETROSPECTIVE RATING PLANS

A retro is a loss sensitive program where the total premium is directly affected by loss activity during the policy period. At policy expiration, the initial paid premium is adjusted up or down based on the contractor's actual loss experience during the policy period. Retros are typically utilized for workers' compensation coverage.

continued >

## SELF-INSURANCE

This is a risk management option for large, well-capitalized contractors who retain the risk and set aside funds to pay for future losses that would normally be covered by an insurance carrier. By self-insuring, contractors save the premium normally paid to a carrier, but assume 100% of the associated risk. Generally, the insured must meet certain state-specific and/or financial requirements, then submit an application for approval to its respective state's division of insurance. In Alaska, for example, to self-insure workers' compensation, a company must:

- Be in business at least five years
- Have at least 100 employees
- Have a net worth of at least $10,000,000
- Provide claims services internally or through a third party.

## CAPTIVES

Captives are an extremely popular alternative risk financing mechanism, especially in a hardening market. A captive is an insurance company that provides insurance to and is controlled by its owners.[2] There are numerous captive options depending on the contractor's size (e.g. single-parent, group, association, rent-a-captive, etc.). Due to the self-insurance component, a distinguishing feature of captives is that they are long-term plays for best-in-class companies with low loss activity, a strong safety commitment and culture, and a willingness to assume some level of risk. Typical coverages included in a captive include workers' compensation, general liability, and auto liability/physical damage.

## RISK RETENTION GROUPS

Formed by groups of related insureds, a risk retention group is an insurance company that only provides liability insurance to its owners and must be domiciled in the United States. All owners of the group must be insureds. While workers' compensation coverage is excluded from risk retention groups, most commercial liability coverages are included. Typically, risk retention groups are regulated as captive insurance companies, but for groups domiciled in states without captive laws, they are regulated as traditional insurance companies.

## RISK PURCHASING GROUPS

In contrast to a risk retention group, which acts as an insurance company and requires its members to fund the group, a risk purchasing group purchases insurance directly from an insurance company and doesn't require capitalization from its members. Like a risk retention group, a risk purchasing group is made of similar businesses that share common risk characteristics.

In summary, when the insurance market is soft and underwriters are annually offering maximum credits and tossing in coverages for no additional premium, a traditional guaranteed cost program is a great option for contractors. However, that reality has drastically changed. As contractors now venture into a hard insurance market that many have never experienced, it behooves them to consult with their brokers to develop a hard market strategy and uncover all available options in order to remain competitive and control their total cost of risk, especially their annual insurance spend.

## References and Resources

1. Preparing for a Hardening Insurance Market, https://www.psfinc.com/articles/preparing-for-a-hardening-insurance-market/
2. What is a Captive?, https://www.psfinc.com/blog/what-is-a-captive/