Pennsylvania Lumbermens Mutual
INSURANCE COMPANY

# THE INSURANCE BUYING PROCESS

## PART 1: "THE TRANSFERRING OF RISK"

Are your premiums going up? Have you recently asked yourself what you can do to influence the cost of your insurance? If you haven't asked yourself this question, you should! In many cases, the cost of your insurance coverage is directly related to your procedures for controlling, avoiding, or retaining the "risk of loss" associated with your day-to-day operations. Before we delve more deeply into these questions and statements, let's step back and take a look at "insurance", why you buy it, and what you are trying to accomplish.

Whether you are required to buy insurance coverage (Workers' Compensation and Commercial Automobile, in most states, or Property coverage by your mortgage company) or whether you are simply trying to protect your business or yourself from the "risk of loss", what you are actually trying to do is transfer that "risk of loss" to a third party - in this case, the insurance company. Many insureds look at the amount of premiums they pay to an insurance company and assume that this is the cost of this "risk transfer".

But is it?

Well, the answer is not as simple as it appears and you may be surprised to find that the topic is more complex than you had originally thought.

Insurance premiums are only a part of the costs you pay for this transfer. Just as clearly, there is a cost – in many cases, of a substantial nature – that you and your organization must absorb. What are these other costs?

- A simple example is a deductible that you may have on your property or automobile physical damage coverages. A deductible is really a sharing of the "risk of loss" between you and your insurance carrier. You have agreed to retain the risk and absorb the cost of that part of the exposure to loss that the deductible covers and in turn, your insurance company charges you less premium.
- Loss of productivity when a worker is injured is another example of the "cost of risk" that you retain. There is substantial indirect loss of productivity as a result of a loss (those conversations around the water cooler?) that occurs any time there is an accident of any magnitude. The fact of the matter is that you are footing the bill for this as well. If you think about it, this cost may in fact be much bigger than you first believe, whether it is due to an injured worker, a loss of a vehicle or a piece of operating equipment.
- With your company being serious about controlling your losses, you'll find yourself spending dollars on safety material, mechanical safety devices, employee protective devices, and losing productivity from down time that occurs when you are running the necessary safety programs (driver training, new employee orientation, fire drills, etc.).
- Looking at the overall insurance premium itself, are you paying it all up front as opposed to on installments? Has your broker financed it with a third party (most companies today will give you either free financing or installments with a minor charge per installment)?Again, added costs that need to be considered in your overall evaluation of the cost of this risk transfer.

- How about those uncovered losses due to "gaps" in your insurance program or the failure to transfer your risk to a third party outside the insurance vehicle (Hold Harmless Agreements, Indemnity Clauses and Contracts, Exculpatory Agreement, Waivers of Subrogation, etc.). Again, these can result in added costs.

These are all examples of costs associated with your overall "risk management program" that need to be added to the insurance premium in considering how much you are spending on insurance. When it comes to managing your risk, there are some basic tenets that are important to keep in mind:

- Don't risk more than you can lose.
- Don't risk a lot when you can spend a little to transfer the risk.
- Understand the probability of loss events and what you can do to reduce that probability.
- Don't substitute your personal involvement in an ongoing active loss control program by attempting to transfer the risk to an insurance carrier!
- In the end, the cost to your organization when considered in their totality, will be significant.

The point is that evaluation of your costs from a risk management standpoint is in fact a complex and detailed process. Simply looking at the cost of your insurance coverage is not the answer.

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## PART 2: “DIVIDENDS”

When considering the price of your insurance, it is appropriate to evaluate whether or not there are potential dividends to be paid based on loss experience.

While some will suggest that you consider the dividend as a separate issue, the reality is that a potential dividend offered by an insurance company based on the loss experience of your individual account or group program is part of the pricing mechanism and should be considered as part of the overall pricing.

Comparing dividends from one proposal to another is not an easy task. There are, however, some rules of thumb to consider to help you wind your way through this comparison. First, make sure you understand whether the dividend will be paid based on "group" experience or on your individual account experience. If it is a group dividend, find out what the average dividend paid over the last three to five years was, to give you some type of feel for what you might expect back. If it is based on your experience provided to you with your quotation, don't fall into the trap of looking at the potential dividend payouts at either end of the "payout schedules". Insureds tend to look at what dividend payout will occur if they have no losses; when in fact, this is an unrealistic approach. Rather, take a look at your loss experience during the last three years using an arithmetical average (dropping out, at most, one significant loss if you honestly feel that it cannot occur again) and use that figure as your benchmark for comparing dividend proposals. If you want to look at a couple of different alternatives, increase and decrease the average "expected loss" that you are using by 10% to 15% and compare the schedule payouts once again.

Keep in mind that dividends are not guaranteed and legally cannot be guaranteed by an insurance company. So, it is important to understand a company's history concerning declaring dividends?  The question to ask is a simple one: Has the company ever not declared and paid a dividend when there was one that should have been paid? If in fact this has ever happened, you should be wary of placing too much credibility in considering the impact of a dividend to the overall pricing of a particular insurance proposal.

It is also important to understand when a potential dividend is going to be paid. Some carriers will pay them in as little as 90 days after the expiration date of the policy, while others will wait eighteen months or more. Keeping in mind the "time value of money", you will have to do some "net present value discounting" on potential dividends to understand what their impact is to the overall premium charge.

In any event, dividends can ultimately lower your insurance costs, but a thorough knowledge of how the company distributes and administers these dividend programs is needed to truly evaluate their effectiveness and value to you.

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## PART 3: “CHOOSING YOUR INSURANCE COMPANY”

Another critical step in your insurance buying process is to understand the company with whom you choose to do business. Keeping in mind that the intent of an insurance contract is to transfer your risk to a third party, I think you'd agree that it is pretty critical to understand whether or not that third party - in this case the insurance company - is going to be around when the time comes to pay your claim and perhaps, just as importantly, understand whether or not the claim is going to be paid promptly. This requires a little due diligence on your part about who the company is.

Start by inquiring whether the carrier understands your industry and, just as importantly, your particular business. Does the carrier have a long history of servicing businesses such as yours, or are they just getting into it? The difference: a new entry into a marketplace may be pricing its product to gain market share, and while this will be favorable to you in the short term, it could have other consequences over the long term.

Delve into this topic specifically regarding your own account. Did the company do any preinspection work or were you required to provide a good deal of information up front? Were there follow-up questions by your broker to you regarding the information? You want the company involved to have completed the "underwriting process" before developing your quotation so that there are no surprises after coverage is bound. Keep in mind that great coverage, great service, and great price do not add up to much if 45 days after the coverage has been placed, the company decides to relieve itself of your business by sending cancellation notice because they really didn't understand your business or found, as a result of their subsequent physical inspections or a review of their underwriting submissions, that your business really doesn't live up to their expectations.

Understand the financial strength of the organization you are dealing with. The premier rating agencies in today's financial services sector for insurance companies are A.M. Best and Standard & Poor. A quick look at these firms' websites can give you a financial rating of the company in question.

The bottom line is, when choosing an insurance carrier, make sure they understand your business. Do they bring some industry specific expertise to the loss control, claims and underwriting process? Will they be there down the road when I need them? It’s a critical decision and an important component in the insurance buying process.

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## PART 4: “THE FINAL DECISION”

In order to make your final decision in the insurance buying process, there are certain steps that need to be taken. Obviously, you should consider and control your overall costs. Hopefully the previous articles have caused you to pause and consider this issue from a different perspective. Following are some other steps that need to be taken:

1. Have your broker complete a risk management evaluation of your organization. Yes, it will take time (another hidden cost, by the way) but the intent is to identify exposures that need to be considered in your day-to-day operations. Once each of these exposures is identified, you will need to consider how you wish to handle it - either by retaining that risk, transferring it on a non-insured basis to a third party, or purchasing insurance to cover that risk.

2. Evaluate your current coverages with a comparison of what you have versus what you need. This is something that you can do at any point in time during your fiscal year but it is surely something you want to do in detail when you are considering alternative insurance proposals. Make sure you understand what is important and what is not. Don't let the "bells and whistles" that many brokers and companies build into their coverage fool you. Coverage is meaningful only if you have an exposure and otherwise, should be discounted when considering the overall proposal. Have your broker create a spreadsheet between various insurance proposals that they put forth, outlining the coverages and comparing those coverages to the exposures that exist in your organization.

3. Compare service. Again, identify which ones you need and which ones you don't and focus on the ones that you need. Understand who is going to provide those services (Broker, insurance company, or a third party), whether you are going to need to purchase them outside the insurance transaction or whether they will be provided at no additional charge. Primary areas of focus that most insureds want to consider include:
   - Loss control services – what is available and who will perform them.
   - Brokerage services – What meaningful services are available? Explore what the Broker can provide to you other than the Property/Casualty coverage. Understand what costs may be associated with those services.
   - Claims handling. Who will do what, when, and where? Again, get all of these issues down on paper so that you have a clear understanding of the difference between proposals and the true costs of the programs you are looking at.
   - Remain focused on those services you need and use. When comparing service levels, ask for references at each step of the process and check them out. Ask for a list of some of the Broker and insurance company's current clients and see what they have to say!

4. Look at the pricing, but don't do it in a vacuum. Make sure you understand the price in relationship to what you are paying for from a coverage and service standpoint. Just as when you buy a new car or make any other type of major purchase, you get what you pay for. Neither the cheapest nor the most expensive program will necessarily be the best deal for you.

5. Lastly, when considering the price, consider the payment options from two angles. Add to the premium any service fees or interest costs that might be charged and then recognize any cash flow issues as well.

Once you have wound your way through the entire insurance buying process, have made your decisions, implemented your programs, and purchased your insurance coverage, you are probably thinking that it is time to put it away and wait for next year. Nothing could be further from the truth! Managing your risk, controlling your losses, is an everyday occurrence at successful businesses. Successful businesses today understand that the costs of controlling risks go far beyond the cost of their insurance premiums. They insist on both the broker and carrier performing the services that they indicated they would provide, but perhaps more importantly, they stay involved in the active day-to-day loss control programs that have been set up.