CFO

How CFOs Can Curb Insurance Costs

Finance chiefs can slash their companies' property-casualty premiums by linking effective risk management to insurance buying.

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For many companies, property-casualty insurance represents a large cost, and thus strategies for renewing their policies can be a crucial matter. We were both brokers in the past, and we know from working with insurance underwriters that an organization's risk management practices don't often figure into the insurance-renewal process. But we believe they should, and CFOs should be aware of how establishing a link between overall risk management and insurance buying can help their companies reduce their premiums on renewal.

In any case, the process often amounts to annual angst. Although a fair portion of insurance programs are said to renew on April 1, most commercial insurance renewals for U.S. companies are on January 1. Insurance renewals typically match up with their calendar-year financial reporting. That suggests that finance chiefs have a strong reason to focus on how well and cost-efficiently their companies are protected against potential loss. Surveys conducted by the Risk and Insurance Management Society (RIMS), in fact,continue to find that the corporate-insurance function reports up and through the finance function to the CFO. In fact, 60 percent of finance chiefs are the principal insurance buyers at small to medium-sized companies, a CFO survey found.

Depending on an organization's size, complexity and loss history, the annual renewal process begins three to six months prior to the date. The reason for lengthy prep time is a combination of industry practices, the coverage required by the organization, and financial considerations. CFOs who haven't been very involved in the renewal process should consider greater involvement from an executive leadership and communication perspective. They can make a difference.

How Insurance Gets Renewed

At the beginning of the renewal process, insurers look at your actual loss history and at current events in your industry to determine their pricing. Further, they probe your industry's economics, your financial statements and your payment history. Very few companies buy ground-up, or "first-dollar," coverage, since that's a lot more costly than retaining some of the risk yourself.

Most companies that have a predictable history of insurance claims and adequate internal expertise, manage their claims in-house to keep their costs down. If they lack the in-house smarts, they often hire a third-party administrator (TPA) to service those claims.

But handling even predicable claims can represent an ever-escalating expense if they're not managed properly. Insurers worry whether clients on the hook for the costs of thousands of claims will be able to pay for them. Over the years the cost of the aggregate build-up of thousands of retained claims can be enormous.

As a result, as a part of the renewal process, insurers closely check the credit ratings of their corporate clients by Standard & Poor's, Moody's and other rating agencies. Companies that have an investment grade rating will always get better risk-financing options from insurers. Companies with a non-investment grade rating will often be asked for collateral against the self-insured portion of their risk. In that way, insurers try protect themselves against the risk of having to pay for the self-insured parts of claims that customers can't pay.

Because of their broad perspective of company operations, personnel and financial resources, however, CFOs are in a unique position to make the company's case as a good risk, highlighting good performance in its safety and loss prevention practices and in its crisis and supply-chain management.

Risk-Financing Alternatives

Driven by investment performance and market conformity as well as catastrophes, insurance is a cyclical business. Some CFOs may come to believe that their companies are swept away in the cycles and not given enough credit by the insurance marketplace for their good performance in risk management.

Such finance chiefs might do well to consider the potential risk management and financial benefits of an alternative risk-financing vehicle. For example, they might consider forming a wholly owned captive insurance company to insure or partly insure their companies' own risks.

CFOs should regard the decision to form a captive as a strategic-level choice for their corporations. In making that choice, a CFO must contemplate a longer-term operation than the mere buying of insurance every year.

In doing so, they'll need to mull the captive's administrative expenses, funding requirements and tax consequences. Some companies expand the scope of their captives and decide to make it a profit center that insures the risks of other organizations. An example of this is the approach taken by Snap-on Inc., a tool manufacturer.

The company has a mobile van franchise operation in which every franchisee must carry auto insurance. Over the years, the company had gathered a great deal of data about the loss experience of its franchisees. Snap-on determined that it knew more about the automobile risk than commercial insurers did and could thus do a better job of gauging the proper cost of the franchisee's risk. Snap-on then started a captive to insure part of the risk. It has since evolved into a profit center.

Enterprise Risk Management

Ever since the Securities and Exchange Commission codified the risk oversight responsibilities boards of directors in 2010, publicly traded companies have been setting up various forms of ERM. Many of the ERM programs in place are administered within the corporate finance group and thus overseen by the CFO.

Since finance departments have been incurring the costs of ERM programs, it's time for CFOs to consider establishing a link between effective overall risk management practices and insurance buying. While the overall insurance market is not prepared to hand out premium credits on every line of insurance for an in-place ERM program, there is one line of coverage that CFOs should consider establishing such a link – directors and officers liability insurance.

Talking with D&O underwriters about how the ERM program is being used can provide the CFO with a benchmark as to what constitutes an improved risk profile. In turn, such a discussion can help finance chiefs to persuade insurers to provide credits against the company's insurance premiums.

Several years ago the New York Independent System Operator, a non-profit electricity company, created a presentation for their D&O underwriters that compared their previous risk profile with a new risk profile after NYISO's ERM program was implemented. The new risk profile showed improvement and, because of that, NYISO was able to negotiate a substantial premium reduction in its D&O program.

By improving their risk management practices, many companies are improving their risk profiles. That should translate to reduced insurance costs. CFOs should not expect their D&O underwriters to initially embrace the concept of directly linking risk management practices to premium credits. However, rather than seeing their companies lumped together peers in the same business sector that have inferior risk management programs and their insurance programs driven by market forces that are macro in nature, CFOs can begin to drive insurance markets in a more rational direction.

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