CFO

How High a Deductible Should Your Company Take?

The reality is that deductibles have tended to be more market-driven than is desirable for most corporations.

John Bugalla and Kristina Narvaez

Deciding the right level of a company's insurance deductibles depends largely on the organization's risk appetite and its financial strength — definitely territory for the CFO.

Risk appetite and financial strength must be considered when companies pit which risks should be transferred to an insurance company and which should be retained by the corporation itself. Nevertheless, executives at many organizations have looked to their in-house risk managers or outside insurance brokers to help them recommend deductible levels and to provide information that will help them quantify the impact of their retention decisions.

That's a tactical, rather than a strategic approach. Risk managers and brokers tend to discuss various deductible options as a normal part of the development of the insurance proposal, but few of them discuss in terms of a corporation's broader risk management goals. And the reality is that deductibles have tended to be more market-driven than is desirable for most corporations.

To be sure, astute insurance professionals typically assess both the corporation's attitude toward assuming increased financial risk via taking higher deductibles and its financial ability to respond to the potential losses it has chosen to retain responsibility for. But what's often missing is a financial analysis of the point at which the losses the company has chosen to assume could impact its earnings per share or its credit rating.

Consider product-liability claims for a pharmaceutical company or product recalls for an automobile manufacturer. Each organization will have a different outlook on its appetite for risk. Risk appetite is best defined as the total exposed amount that an organization wishes to undertake on the basis of risk-return trade-offs for one or more desired and expected outcomes. Risk-appetite statements may be expressed qualitatively and/or quantitatively and managed in terms of individual risks or the aggregate of risks assumed by the corporation.

In defining their corporation's risk appetite, CFOs should also discuss its risk tolerance. Risk tolerance is the amount of uncertainty a corporation is prepared to accept in total or within a business unit, risk category or initiative. Risk tolerance statements identify the specific minimums and maximums of how much a company is willing to lose. The range of deviation within the expressed boundaries would be bearable, but exceeding the limits might distress the achievement of the company's overall strategy and objectives.

Hungry for Risk

Risk appetite and tolerance are influenced by the nature of the organization and its industry. Companies with higher risk appetites generally are more focused on the potential for significant increases in value or earnings. Such companies are more willing to accept volatility and uncertainty. More conservative organizations focus on stable growth and earnings.

Another consideration for deductibles or retentions, especially when the number of claims could be high, is a company's internal risk management capabilities. If the company is facing claims that put its reputation at stake, claims management and crisis management are critical issues. Management should assess the difference between how the legal and compliance departments wants such claims managed and how the chief executive officer and CFO want them managed. The need for a unified approach becomes more critical when claims move to the litigation stage and are perhaps adjudicated in multiple jurisdictions.

Financial capacity is another consideration when deciding on the right level for deductibles. Analysis of an organization's financial condition should include its credit rating. That's because insurers often require corporations to post letters of credit or other forms of collateral to support the potential aggregate retentions, depending on a company's credit rating.

An assessment of past and present losses for at least three and preferably five years should also go into the mix. And a company's historical claims data should also be consistent over time: Changes in claim coding, claim information systems, third-party administrators, insurers or claims management could raise red flags with insurers or investors about the credibility of historical data. Such changes might skew a corporations predictions of of future losses.

During the insurance-renewal process, CFOs can help their companies get better deals by becoming involved and sharing with insurers balance sheet information, profit-and-loss and cash-flow statements, credit ratings and cash reserves. In that way, the company can get a more favorable premium quote by showing strong financial strength and thus the ability to retain more risk.

Certain losses are more predictable than others. For example, a manufacturer might see the same type of workers' compensation claims year after year but might not see a trend in its product liability claims. If losses are relatively unpredictable in terms of frequency, severity or both, high levels of retention generally are not advisable if adequate and acceptable insurance coverage can be bought at a reasonable price.

For their part, the current price and availability of insurance also play a critical role in determining how much risk to retain. There are many factors involved in the how an insurer prices insurance. Those include the insurer's own loss history, its ability to effectively assess new risks, its capacity to charge an adequate yet competitive rate, trends in the marketplace for the class of risk involved and its investment income.

Understanding where a company places itself on a risk-appetite scale and its ability to show financial strength can play a huge role in helping senior management to select the right level of deductibles for their insurance coverage. Thus, organizations willing to assume greater risk may have a wide range of deductible levels, and corresponding premium discounts, available to them.

On the other hand, a senior management team that's not comfortable with high levels of risk might not be ready for higher-than-average levels of deductibles, even if insurers offer sizable discounts for assuming them Each company will have a different outlook on how much risk it's willing to retain.

John Bugalla is a principal with ermINSIGHTS and Kristina Narvaez is president and CEO of ERM Strategies