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Balancing Act: Making Smart Risk Retention and Risk Transfer Decisions

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Deciding the appropriate amount of risk an organization should retain and how much it should transfer through insurance coverage has always been essential to sound risk management and good operational control. However, the recession has added new dimensions to this challenge.

To help sort through the issues risk managers face when dealing with risk retention and transfer, *Liberty Directions* spoke with Don Pickens,chief underwriting officer for the area of Liberty Mutual that serves large companies.

Liberty Directions: What are some of the factors that play a role in decisions on risk retention versus transfer?

Don Pickens: The critical elements of identifying, understanding, and selecting levels of risk retention, along with the ability to control or avoid risk, should all be present in the decision-making process. In this regard it's similar to the way underwriters determine their risk appetite, selection criteria, tolerance, variability, and capacity.

When you couple a company's operational willingness and financial wherewithal to retain potential losses with the economic, competitive, and regulatory forces that influence the company's environment, you can see how complex these decisions are. A risk manager's understanding of the interplay of these factors translates into the approach he or she takes when deciding to retain or transfer risk through the use of insurance products.

LD: How has the current economy changed the way organizations are making retention and transfer decisions?

DP: When the economy and the financial markets collapsed, there were significant repercussions for companies' revenues, cash flows, and profits. These in turn affected the traditional risk retention capacity guidelines, which are tied to working capital, current assets, operating income, or operating cash. Interestingly, under the new economic realities, the risk identification process revealed that the interplay of risk factors was too narrowly defined and that systemic risk was underestimated and therefore undervalued. By systemic risk, I mean the compounding nature of a series of events that cause a stacking of risks well beyond any

individual component analysis.

This caused many companies to redefine their tolerance for retaining or transferring risk. As companies de-leveraged and focused on reducing variable risk and cutting expenses, many risk managers had to modify their risk transfer arrangements. Their ability to retain risk or to buy more insurance had to be based on this new and drastically different reality. However, it's still wise for a company to have a stable and consistent risk approach and execute it over multiple years to optimize improvement. Disruption itself is a risk factor.

LD: How difficult is it to make these types of adjustments?

DP: A smart risk manager always has a feel for the organization's risk appetite. The key is to adjust risk transfer and retention to levels that are plausible, defensible, and sustainable based on current conditions and future unknowns. For instance, what's the financial outlook for the carrier you've chosen for risk transfer? An overly aggressive carrier may be financially sound now, but what about five years from now when a loss matures to a material level? Or what will be the impact of inflation on retained loss costs and what rate assumptions do you use for long-tailed exposures? The ability to manage and control the risk still matters and may remain the best approach even during these challenging times.

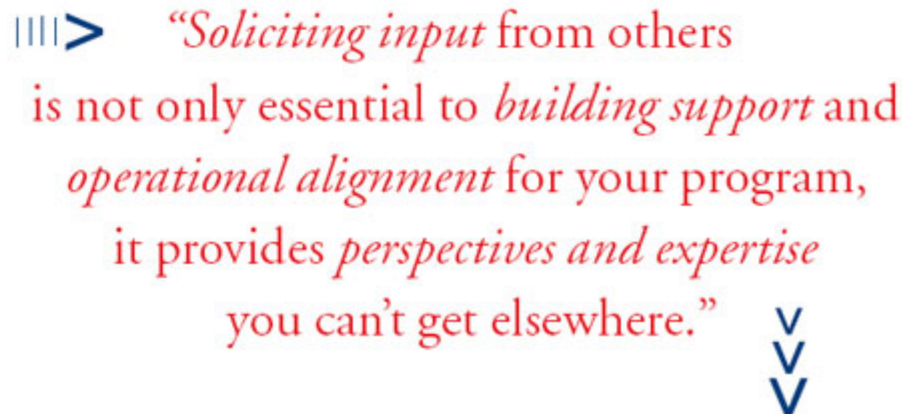
Another consideration for risk managers is the resources they have available. If they have to balance their programs with fewer people or with a lower annual insurance budget, then they need to drive their operations people harder to keep loss costs down, or convince their insurance carriers to reduce the price on risk transfer, just to maintain the program benefits.

LD: Should risk managers seek input from others in the organization when making these decisions?

DP: Soliciting input from others is not only essential to building support and operational alignment for your program, it provides perspectives and expertise you can't get elsewhere. This is especially true in parts of the company where insurance is not available. Risk managers should work across business disciplines to understand the impact of the risk retention/risk transfer goal. They especially need to work with business operations and human resources as companies manage their changing workforce needs.

LD: Does the soft insurance market play a role in risk transfer/retention decisions?

DP: Yes, especially in the short term. If an organization is comfortable with certain retention levels, it might explore options for reducing the retained amounts. Risk managers can compare the value they place on that change in layer versus the value a carrier would place. If the difference is material, then it might be worth reducing retention, but they should consider whether that change fits into a longer-term risk management plan and whether the value the carrier would place would be sustainable.



Not all risk managers will opt for the lower deductible, because they don't want to "dance" with the cycle. Even if the lower deductible makes short-term financial sense, modifying these programs too quickly could create extra administrative and operational costs. The key is to weigh the potential savings against internal costs and disruption related to the change, the timing of the benefit, how it will be viewed by the insurance market, and how it impacts the ultimate risk management and financial plans.

It's a different story if a company is not in a position to remain consistent with previous decisions. The recession has hit businesses hard, and some of them don't have the ability to retain as much.

LD: What is the best way to make sure retention levels remain appropriate?

DP: Risk managers should project retained risk amounts and then subject them to stress tests using as many risk simulations as possible. Standardized stress tests and "normal" standard deviations are not enough in today's world. Risk managers should run simulations, in particular those that include shock events, to make sure that any retention decision is measured and valued appropriately.

Projecting the past into the future never truly factors in the unforeseen and, therefore, isn't as predictive as people want to believe. If an organization that hasn't had a product liability loss of more than $250,000 in the past seven years decides to buy a $1 million deductible, the risk manager needs to consider what will happen if the organization incurs multiple losses of more than $250,000. Is the company comfortable with that possibility? Has it modeled, planned, and set expectations for
such a scenario?

If an organization is stable and has years of experience and data, risk retention and risk transfer decisions don't need to be complicated. However, if the company makes a lot of acquisitions or divestitures, is changing its business model significantly, is deal-ing with financial turmoil, or is investing in new or emerging technologies, a smart risk manager should work with a good
broker and an analytical carrier to help the organization consider a host of possible scenarios.

LD: Can you tell us more about the role the broker plays in helping risk managers make these decisions?

DP: Once you have the right program design in place, a sophisticated broker can help you look at alternatives and advise what is available in the marketplace. Since brokers work with many companies, they can provide benchmarking data on average retention levels and other metrics, and share alternative market approaches to funding losses. Brokers add value as

they identify and evaluate different options, and a good broker will always try to focus on options that optimize the client's program and financial returns. Of course, having the right carrier that can deliver the best outcome is essential.

LD: Do you have any parting thoughts?

DP: It's critical for a risk manager to be plugged into and understand the organization's overall business strategy and what the company is planning to do. These variables will have an impact on what the ultimate risk might look like.

Risk managers should also monitor a range of risk perspectives, for example, changes in science or technology, business culture, legal theories, environmental factors, political landscape. Each of
these represents a change in the risk profile. Making smart decisions on risk retention versus risk transfer depends on the ability to weigh these factors, and risk managers are better positioned than most in this regard. This is how a risk manager can demonstrate true strategic value to the organization, especially in these times, and most important, can showcase the critical role the risk manager plays in the company's success.

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