

## Risk Financing

Risk imposes costs in two broad forms – loss costs and the costs of uncertainty. Risk financing attempts to mitigate the impact of these costs by structuring the availability of funds to pay claims, aid recovery and enable the organization to maintain financial stability as it moves forward towards its mission.

**How** risk financing occurs can vary. At one end of the scale, fully self-insured entities retain responsibility and, if risk-related costs arise, the entity directly bears those costs. At the other, fully-insured entities transfer the direct responsibility for bearing risk to an insurance company, trading regular losses (the premiums paid) to avoid the potential of large and irregular losses (claims payments). CIS' pooling programs occupy a middle ground. They enable entities to retain losses up to some pre-determined level; then to share the cost of losses within a mid-layer, and then to transfer risk above the pooled layer by securing reinsurance up to available limits. In reality, most local governments finance the cost of risk through a combination of retention, sharing and transfer.

By design or default, a local government entity's risk-financing portfolio will almost always contain a self-financed component. Losses within stated sub-limits or above the overall limits of coverage are retained by the entity. They may also choose to retain lower levels of risk. For example, members in current CIS pools reduce their contribution levels by using various deductible levels, from \$1,000 to \$125,000, to pay the first part of some or all losses.

In reality, what is being shared or transferred is the timing risk associated with a loss. Most conventional risk transfer (insurance) or risk sharing (pooling) programs provide a smoothing effect that protects an entity from the risk of not having sufficient funds on hand at the time a loss occurs.

**When** risk financing occurs – before, during or after resources are needed - is another variable. Guaranteed cost insurance is an example of a *prospectively* funded risk transfer device. Average expected losses for a group are the basis for premium or contribution calculations. Cost will not change regardless of actual loss experience during the coverage period. Some self-insured entities fund on a *pay-as-you-go* basis without any pre-funding. On the other hand, entities with credible loss data may be *retrospectively* rated, i.e. their actual loss experience plays a large role in determining their ultimate price for the coverage period. Others have initiated lines of credit that allow them to draw on funds after an incident if existing reserves are inadequate to finance losses.

CIS pooling programs have a retrospective feature in that contributions and other revenue in excess of losses and operating costs remain in the pool to be used in ways that benefit the contributing members.

## **Risk Retention, Risk Sharing, Risk Transfer**

The degree to which risk retention is attractive to a public entity is related to the control that the government can exert over the risk; the level of predictability associated with that risk; and the entity's financial capacity to both bear the risk and to withstand variations from the expected. As an entity reviews whether to retain or pool risk, the following considerations are relevant:

### *The cost of financing options*

Your pool contribution is based on estimates of average expected losses to be paid out, the cost of adjusting and settling claims that give rise to those losses, and other operating expenses. Pool members protect one another by smoothing the impact of large losses on individual members. Since an individual entity's contribution will reflect its share of the entire group's loss experience, the contribution may, or may not, track closely with its own loss expectations. A judgement has to be made about the value of this protection and the likelihood that the entity may incur large losses.

### *The quality and value of services offered*

The "overhead" of the pool is not necessarily a dead weight since it is likely to include services needed by the public entity regardless of how it finances risk. With CIS, in addition to claims handling, it also includes a wide array of risk management services aimed at helping members prevent or minimize losses.

### *Opportunity cost of capital*

Any funding method that includes funding reserves for coverage such as liability and workers' compensation that have a long pay out period, will consider the value of investment earnings in pricing. At CIS, we are able to invest long-term funds at higher rates of return than most local governments can earn. These proceeds are retained within the pool and benefit our members by reducing the amount we need to collect from member contributions.

## **Pooling**

By pooling resources and risks members can not only acquire additional leverage as a member of a group; they can also reduce uncertainty. Risk financing pools structure financing arrangements to provide a stable flow of dollars into the pool, funds that are sufficient to cover the sporadic outflows that occur due to losses. While a public entity risk financing pool may serve one or several functions, there are four basic types of pools:

- A. Risk Sharing Pools – members pool risks and funds and share the cost of losses and program expenses including the purchase of reinsurance. This describes the existing CIS Trust. Risk sharing may occur at the *primary* level or at an *excess* level where only large losses are financed from pool contributions.

- B. Insurance Purchasing Pools – members pool funds or resources to purchase commercial insurance products. This describes the CIS Benefits program where contracts are negotiated on behalf of members with Regence, Kaiser, The Standard and other carriers for employee health and benefits coverage and associated services.
- C. Banking Pools – an individual entity’s funds are not co-mingled but kept in separate accounts. Losses are paid on the member’s behalf and funds can be loaned to other members experiencing high losses. The loan is then repaid to replenish pool accounts. This structure offers some unique advantages to larger entities.
- D. Claims Servicing Account Pools – the pool manages separate accounts for each pool member, paying the losses of that member and assessing the member a contribution amount to bring the account back into balance. Larger entities, wary about sharing risk, may find this kind of pool attractive.

Pools originate from cooperative agreements among members to provide for many of their risk management needs through a program that is jointly owned by the members themselves. The impetus to establish the various CIS pools was prompted by earlier “hard market” conditions - rapidly escalating insurance costs and reduced coverage. In part, these conditions were fueled by the flight of public entities away from traditional carriers to embrace deals that seemed to be too good to be true, and ultimately proved to be so!

The desire to create stable programs tailored to the needs of Oregon local government entities that would operate under more favorable terms and conditions than commercial insurers offer was also a key ingredient in pool formation. Like many pools, CIS started out as a risk financing pool but is emerging into a resource sharing pool that provides a broader range of risk management services aimed at not only reducing uncertainty but also enhancing capacity at the entity level.

### **City County Insurance Services (CIS)**

CIS was established as a risk financing pool. Our sponsors are the League of Oregon Cities (LOC) and the Association of Oregon Counties (AOC). CIS membership is open to all LOC and AOC members, and to certain other local governments who maintain associate membership status with LOC or AOC. Currently all but six cities and twelve counties have a direct involvement in one or more coverage lines offered by CIS. We also work closely with our sister organization, The Special Districts Insurance Services Pool, which provides similar services to Oregon’s legion of special districts.

CIS members combine resources for their common advantage to jointly finance the cost of losses and the cost of risk management efforts. Members can

participate for one or several coverage lines. Currently, contributions and other resources are held in three separate “joint funds” or trusts administered by a common Board of Trustees:

EBS Trust. Formed by LOC in 1958 to fund and administer employee health and benefits plans for city employers and employees.

AOCIT. A similar trust, formed by AOC in 1960 to fund and administer employee health and benefits plans for county employers and employees.

CIS Trust. In 1981 AOC and LOC jointly established a risk sharing pool to provide property, liability and workers’ compensation coverage and related risk management services to their members.

### **Financing Mechanisms for Pools**

The trusts administered by CIS were initially capitalized by establishing annual contribution schedules that were equivalent to the amounts members were then paying for commercial insurance. There was no capitalization surcharge involved and subsequently, “new” members have not been surcharged either. As an added protection, the liability pool is assessable in the event that losses exceed available funds. No assessment has ever been considered. To the contrary, the trusts’ have returned millions of dollars to members in the form of dividends or rate stabilization. Contributions are calculated using a rating system based on the pool’s own loss experience, adjusted where appropriate by each member’s own individual loss experience.

The various pooling structures outlined earlier can facilitate the accumulation of funds to cover anticipated losses so that legal, budgetary or political barriers that make it difficult for individual entities to accumulate funded reserves are satisfied.

### **Philosophy and Objectives of Pool Members**

Sharing a common philosophy regarding the pool’s goals and objectives is a key ingredient for the success of any pool. The commitment to participate on a long-term basis is essential for members to build an “ownership” stake in their own pool. It is a different relationship than the more casual “customer” experience with an insurance company. Multi-year commitments, together with restrictions on the return of equity for departing members, are ways to stabilize rate fluctuations by ensuring a continuous flow of revenues into the pool.

In a pool situation, members “own” the risk they retain; they “share” part of the risk within the pool’s retention level and benefit from the “transfer” of higher levels of risk to re-insurers. The importance of loss control standards is elevated, not only to help reduce overall pool losses, but also because conformance with those standards can influence an individual entity’s annual contributions to the pool. Pool members face a rate mechanism that is usually more responsive to each member’s loss experience than insurance company rating systems.

Diversification of risk management services is probably the most obvious development in pools over the last five years. Training and education, risk control tools and resources, lobbying, resource pooling, strategic planning and a host of other services are helping pool members to be better managers of risk.

A shared claims philosophy and a willingness to share information to help improve overall pool performance are also common objectives in a pool. Recognition that there has to be a balance between requiring all members to comply to common elements and individual tailoring to suit particular members is an inherent challenge in designing a pooling structure.

### **What a Pooling Structure Can Offer**

#### *Ability to better define scope and terms of insurance coverage*

In a pool, levels of deductibles, coverage and various insurance and risk management terms and conditions can be developed to suit the specific needs of members. There is greater latitude to decide on the risk exposures that contributions cover than might be available through commercial insurance.

#### *More stable coverage*

CIS came into existence as insurance companies withdrew coverage during a hard market. All LOC and AOC members, not just those in CIS, have benefited from CIS' presence because the commercial market has had to compete with CIS to maintain rather than reduce coverage. Reinsurance market adjustments aside, pools like CIS are generally not as prone to react to hard and soft market swings.

#### *Management and Administrative Services*

CIS selects providers in each service area and can choose from the best qualified to provide specific services. For example, if legal defense or claims handling is not being performed to a desired level of service, changes can be made without impacting other aspects of the program.

#### *Broad Range of Services*

CIS has an extremely broad mandate to help its members manage risk. We define *risk* as "a possible loss or other adverse event that has the potential to interfere with a public entity's financial stability or ability to fulfill its mission." We focus our services on those that benefit the pool as a whole, while addressing the specific needs of individual members for tailored advice and assistance.

#### *Improved Cash Management and Investment Earnings*

A pool like CIS is able to accommodate different flows of funds and financial objectives. We can adjust contribution payment schedules and invest pool reserves to benefit members (often at rates of return better than the individual member can obtain). Without a profit motive, we can use investment earnings

and surplus funds to offset operating expenses or poor loss performance, reduce future rate increases or return a dividend to members.

#### *More Rational Basis for Cost of Coverage*

Pool members are able to more readily link contribution adjustments, be they up or down, to specific causes, e.g. poor loss experience of the group, increase in reinsurance rates, changes in Oregon's legal environment, etc.

#### *Better Risk Management Programs*

CIS helps its members identify priorities for cost effective risk management through the development and implementation of individually tailored risk management plans.

### **Evaluating the Pooling Option**

When considering pooling, individual entities should consider the following items:

1. Is the driving factor in your entity's search for an alternative the need to better manage and control risks, or is it finding a less expensive means of financing losses? Risk management and control more or less drives the cost of risk financing, i.e. no financing solution will work if loss-generating activities are not controlled. Hopefully, the alternative sought offers the potential for improvement in both of these areas.
2. When comparing pools and commercial insurance, do an "apples to apples" comparison. It is likely that a full-service risk management pool will offer a wide range of services, including risk control, while an insurance contract with a commercial insurer may only offer a financing arrangement.
3. With regard to financial performance, the most critical issue is the pool's ability to pay claims. It has, after all, committed to respond to an event that may or may not occur, where the time, location, amount and detail are uncertain. The ability to pay claims is related to:
  - The amount of contributions the pool collects from its members
  - How it manages and invests those contributions
  - How it manages claims and settles losses
  - Its ability to absorb unexpected losses
4. Pool coverage may be quite different to that provided by a commercial insurer. Be aware of the differences. In a pool setting, the ability to craft manuscript policies or coverage documents is likely to be greater.
5. For many of your employees, citizens and taxpayers, contact with claims adjusters is the only contact they will have with the pool. The manner in which claims are handled and settled reflects back on your local government so you need to be satisfied with the philosophy and experience of the claims

management team and the degree to which you can be involved in the disposition of claims.

6. Risk management service awareness is important, particularly if the pool rewards your good risk management practices. It would seem important to know, for example, how risk management services are made available to members, how they are financed, how your adoption of these services relates to the cost of financing and the demonstrated effectiveness of these services.
7. Reviewing the governance structure of the pool can help to determine if there is a “fit” between the pool and your local government. Access to trust agreements, bylaws and other governance documents will help determine member obligations and opportunities for involvement in pool operations.

### State Regulations Governing CIS Pooling

ORS 30.282 specifically authorizes local governments to purchase liability insurance, to self-insure against such liability or to join with other local public bodies to jointly provide liability protection by intergovernmental agreement. ORS Chapter 190 authorizes local governments to enter into agreements with other local governments to perform any of their lawful functions. CIS is an intergovernmental entity formed by LOC and AOC under the provisions of ORS 190.010 (5).

In Oregon, public bodies as defined in ORS 30.260, that either individually or jointly establish a self-insurance fund for **tort liability** in accordance with ORS 30.282, or for **property damage**, are exempt from application of the Insurance Code. (ORS 731.036).

CIS’ **Workers’ Compensation** Group Pool qualifies as a self-insured employer under ORS 656.407 and has been so certified, in accordance with ORS 656.430, by the Director of the Department of Consumer and Business Services (DCBS).

The Director of DCBS has certified CIS’ **employee benefits** trust as an eligible group policyholder under ORS 743.526 (2). The CIS Board of Trustees determines the coverage and benefits to be included in Trust plans. The Board selects one or more carriers from among those licensed by DCBS to provide “group health insurance” as described in ORS 743.522, to issue a group health policy to the trust. As a policyholder, CIS is neither an “insurer”, as defined in ORS 731.106, nor a “carrier” as defined in ORS 743.730. Provisions of ORS 743.730 to 743.773 relating to small employer health benefits plans apply to carriers, i.e. Regence and Kaiser, rather than to CIS. However, if CIS were to self-insure health benefits it would then be subject to provisions of the Insurance Code.