



# Self-Insurance: What Every Contractor Should Know

BY ROBERT D. HEUER

“Self-insured.” In the purest sense, it implies being big, powerful, and self-reliant. It also implies not being in the construction business.

This is because contractors must present evidence of insurance to specified limits and with carriers of a specified size and quality in order to be awarded projects, to set foot on job-sites, or to receive payment for their work.

So, why even discuss self-insurance with contractors? That’s a good question – and one whose answer requires a fuller discussion of what being self-insured really means.

## What Is Self-Insurance?

For the construction industry, self-insurance is typically used in the context of workers’ comp, so when CFMs say, “We’re self-insured,” chances are they mean one of the following:

- We’ve formed a captive.
- We’ve joined a captive.
- We’ve qualified as a self-insurer in a specific state.
- We’ve joined a self-insured group.
- Our insurance has just been cancelled!

But, what are they really saying?

## Self-Insurance: Several Options

### Single-Parent Captive

With this method, the contractor forms an actual, registered insurance company (usually offshore for ease of regulation and tax advantages). Capitalization requirements vary, but are typically \$120,000. The contractor then pays premiums into the captive and the captive pays any losses.

The captive frequently contracts with a traditional insurer to issue the required insurance certificates and to reinsure it for losses above specific and aggregate limits. “Unbundled” (independently purchased) claims and loss control services can also be contracted out. (Note: In the past 12 months, the hard market has made it increasingly difficult to find competitive fronting terms.)

### Group Captive

This method is similar to the single-parent captive. However, in this case, the individual contractor does not qualify financially on its own, so it partners with other companies to create the necessary “critical mass.” Group captive members may or may not be from homogenous industry groups, such as construction.

### Qualified Workers’ Comp Self-Insurer

With this method, a contractor gains state-approved status by **1)** meeting certain qualifications, **2)** maintaining excess coverage over agreed-upon individual and aggregate dollar value retentions, and **3)** purchasing claims handling services separately.

### Self-Insured Group

With this method, the group captive becomes a qualified workers’ comp self-insurer in a particular state, then admits individual companies of any size. These companies need not meet any stringent financial requirements.

### What All This Means

As you can see, being self-insured does not mean that a company opts out of purchasing workers’ comp insurance and “goes bare,” assuming all risks of loss.

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Rather it means that, either individually or as part of a group, a company has purchased insurance only to indemnify it for loss dollar amounts that exceed agreed-upon thresholds for individual and aggregate claims for a policy period.

### **State Requirements**

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So, how can your company become a self-insurer, qualified by your state (or states) to pay its own claims and to purchase insurance only to cover the largest claims? Start by finding out what it takes to qualify in your state.

### **Equity, Collateral, and Average Net Profits**

All states have minimum requirements in these areas. In California, for instance, prospective self-insurers must submit an audited financial statement showing \$5 million in shareholder equity and average net profits of \$500,000 for the last five years. (This may explain why, among the several hundred California self-insurers, fewer than 20 are contractors. Similarly, in Michigan, the number of self-insured contractors is less than 10.)

State agencies will also require collateral security (via a surety bond or an irrevocable letter of credit) for an amount determined by financial statement analysis and an initial estimate of open (not yet paid) reserves. Amounts are typically in the \$250,000 range; states will monitor collateral adequacy, but usually do not make annual adjustments to the amount required.

### **Administrative Requirements**

Other requirements present in virtually every state include the adequate administration of a benefits delivery system (medical and indemnity) and demonstration of an injury/illness prevention program. Both of these are audited periodically by state regulatory bodies.

Most self-insurers contract benefits administration/claims handling to third-party administrators (TPAs), who are outside specialists in workers' comp claims. TPA firms typically charge for their services on a "dollars per claim" or an hourly basis. There is usually one rate for indemnity claims, another for medical.

### **Excess Coverage**

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Once your company meets state qualifications, it should purchase excess or "stop loss" coverage to avoid having its entire balance sheet at risk in one catastrophic claim. (While rare, a single lifetime-care claim for a young employee with dependents can run into the millions of dollars.)

### **Determining the Attachment Point**

When considering attachment point options (the dollar value where your retention ends and insurance coverage begins), note that the specific retention or "stop loss" applies per occurrence – meaning that a single event involving injuries to more than one employee gets only one retention amount imposed.

Also when considering attachment points, think worst case. Take a hard look at your company's loss history and use the year when you had the highest number of big claims – then double it. Can your balance sheet sustain that number of hits?

Once the average annual incurred loss total is known, the company should examine its ability to pay that amount *each and every year* for however many years it is self-insured.

Beware: Even if your company has not experienced many years (if any) with multiple large-dollar claims, do not be lulled into concluding that this will never occur. The construction industry carries an above-average propensity for multiple-injury occurrences.

### **Imposed Constraints**

Prospective self-insurers are sometimes surprised that the excess market does not offer them an attachment point that meets their comfort level for assuming risk. Excess carriers will usually not attach at a point below \$250,000 per claim – at least not at a price that makes economic sense for your company! The choices are more likely to be between \$500,000, \$750,000 and \$1,000,000 than between \$50,000, \$150,000 and \$250,000 per claim.

What about an aggregate attachment point, that is to say, insurance to pay for all losses over a certain combined dollar total for one policy period? This is usually included in an excess policy at an attachment point that is typically a function of the standard premium (calculated as payroll by class multiplied by workers' comp rates).

For example, if your standard premium is \$1 million, your aggregate stop loss would likely be \$1-1.5 million. It is rare for an aggregate stop loss to be exceeded.

### **Still Want to Pursue Self-Insurance?**

Now you have a grasp on how self-insurance works and how to determine the qualifying requirements for your state(s). The next step is to take a serious look at your company's historical loss experience and learn how to use this data to *project future losses with the greatest possible precision*.

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This process is critical to achieving success as a self-insured contractor.

### **Self-Insurance Analysis Steps**

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Any contractor contemplating self-insurance must go through this process to accurately project incurred losses.

#### **Step 1: Obtain Your Company's Five-Year Pure (or Raw) Loss History**

Many contractors do not have a good handle on their claims history. To get that handle, ask your insurer(s) for a report of your company's loss runs for at least the past five years. This information will be used to create a summary of paid and reserved losses, broken out by year.

Refer to the next page as you read through the loss projection process. Step 1 shows the five-year pure loss picture of a growing construction operation. The total of the average annual medical (Med.), indemnity (Ind.), and expense (Exp.) costs is \$211,252.

Based on the information shown, the conclusion could be drawn that a prospective self-insurer with this loss picture could expect about \$211,000 in losses the following year. *That conclusion would be wrong!*

#### **Step 2: Apply the Industry Loss-Development Factors**

The next step is to develop those losses in order to most accurately project what's known in the industry as a "loss pic" or expected loss total for the upcoming year. "Loss development" is an innocent-sounding phrase; when imposed on a given loss history, however, it can quickly dampen the enthusiasm of any would-be self-insurer.

Step 2 shows the loss-development factors underwriters use to translate current paid/ reserved losses to ultimate total paid losses. When applied, these factors increase current and recent loss totals to reflect the statistical likelihood that the ultimate incurred loss figure will be higher than the current incurred loss figure.

This change is due to "incurred but not reported" losses combined with historic underreserving of existing claims (sometimes referred to as "incurred, but not enough").

#### **Step 3: Determine Your Company's Loss Rate**

Your company's loss rate equals the loss dollars incurred for every \$100 of payroll. (Payroll is used to calculate this rate because it is a measure of exposure to loss.)

Applying the loss development factors to the totals in the first chart will yield the results shown in Step 3 of the loss projection. The annual average of developed losses for our contractor is now \$275,531. Dividing that figure by the annual average payroll of \$15.4 million, a developed loss rate of 1.79 per \$100 of payroll results.

#### **Step 4: Create Your Company's Projected Loss Picture**

In our example, the contractor is growing. Consequently, we have projected a 2003 payroll of \$20 million. Applying the 1.79 expected loss rate to the \$20 million payroll estimate yields projected losses of \$358,000. That's a big difference from the "\$211,252" figure the contractor had been anticipating based only on its pure loss total!

Now you see why any contractor contemplating self-insurance must go through this exercise to get an accurate picture of projected incurred losses before making any decisions.

#### **Are There Better Alternatives Available?**

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Once you've got a handle on your company's expected losses, it's a good idea to take a look at traditional insurance products to see how they compare to self-insurance. Examine available guaranteed-cost and "retro" products. ("Retro" or "large-deductible" plans have premiums with pre-set minimums and maximums.)

Some alternative products may prove to be less costly than paying the expected losses, excess premium, and claims-handling expenses in a self-insurance program. However, as you look at alternatives, keep this in mind: In a soft market, such as the one that existed through most of the '90s, you may be able to find a less expensive alternative to self-insurance. But, when the soft market turns hard, inexpensive programs evaporate and self-insurance can become more attractive.

#### **Controlling Your Losses**

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Becoming an approved workers' comp self-insurer will be an expensive (and potentially balance-sheet threatening) undertaking, unless both the frequency and severity of your company's losses are reduced. Here are two ways to do that.

#### **Keep Good Counsel**

Understanding the workers' comp claims process is an integral part of loss control. You must be prepared to manage claims so that they don't spiral out of control.

Recognizing that most large-dollar claimants will be represented by legal counsel, your own claims counsel (which, as

## How to Develop a Projected Loss Picture

### Step 1: Start with your company's five-year pure (or raw) loss picture.

| Year           | PAID      |           |          | RESERVED |           |         | TOTAL           |                  |                | Run Date | Payroll |
|----------------|-----------|-----------|----------|----------|-----------|---------|-----------------|------------------|----------------|----------|---------|
|                | Med.      | Ind.      | Exp.     | Med.     | Ind.      | Exp.    | Med.            | Ind.             | Exp.           |          |         |
| 2002           | 15,418    | 21,450    | -0-      | 20,000   | 40,000    | -0-     | 35,418          | 61,450           | -0-            | 12/02    | 17m     |
| 2001           | 72,110    | 42,500    | 3,450    | 20,000   | 155,000   | -0-     | 92,110          | 197,500          | 3,450          | 12/02    | 19m     |
| 2000           | 9,544     | 17,500    | -0-      | -0-      | 15,000    | -0-     | 9,544           | 32,500           | -0-            | 12/02    | 16m     |
| 1999           | 52,881    | 136,662   | 2,588    | 12,500   | 62,500    | 5,000   | 65,381          | 199,162          | 7,588          | 12/02    | 13m     |
| 1998           | 77,880    | 244,500   | 14,776   | 15,000   | -0-       | -0-     | 92,880          | 244,500          | 14,776         | 12/02    | 12m     |
| Total          | \$227,833 | \$462,612 | \$20,814 | \$67,500 | \$272,500 | \$5,000 | \$295,333       | \$735,112        | \$25,814       |          | \$77m   |
| Annual Average | \$45,567  | \$92,522  | \$4,163  | \$13,500 | \$54,500  | \$1,000 | <b>\$59,067</b> | <b>\$147,022</b> | <b>\$5,163</b> |          | \$15.4m |

**Total of Average Annual Incurred Pure Losses: \$211,252**

### Step 2: Apply the industry's yearly workers' comp loss development factor to the current/recent loss totals.\*

| Year   | 2002 | 2001 | 2000 | 1999 | 1998 |
|--------|------|------|------|------|------|
| Factor | 1.64 | 1.45 | 1.25 | 1.21 | 1.17 |

\* From NCCI, as reprinted in "Risk Financing: Strategies for Insurance Cash Flow and Alternative Funding, Volume 1," International Risk Management Institute, Inc., Dallas, TX

### Step 3: Use the developed losses to determine your company's loss rate (average total incurred ÷ payroll).

| Year           | PAID      |           |          | RESERVED |           |         | TOTAL           |                  |                | Run Date | Payroll        |
|----------------|-----------|-----------|----------|----------|-----------|---------|-----------------|------------------|----------------|----------|----------------|
|                | Med.      | Ind.      | Exp.     | Med.     | Ind.      | Exp.    | Med.            | Ind.             | Exp.           |          |                |
| 2002           | 25,285    | 35,178    | -0-      | 32,800   | 65,600    | -0-     | 58,085          | 100,778          | -0-            | 12/02    | 17m            |
| 2001           | 104,560   | 61,625    | 5,003    | 29,000   | 224,750   | -0-     | 133,560         | 286,375          | 5,003          | 12/02    | 19m            |
| 2000           | 11,930    | 21,875    | -0-      | -0-      | 18,750    | -0-     | 11,930          | 40,625           | -0-            | 12/02    | 16m            |
| 1999           | 63,986    | 165,361   | 3,131    | 15,125   | 75,625    | 6,050   | 79,111          | 240,986          | 9,181          | 12/02    | 13m            |
| 1998           | 91,120    | 286,065   | 17,288   | 17,550   | -0-       | -0-     | 108,670         | 286,065          | 17,288         | 12/02    | 12m            |
| Total          | \$296,881 | \$570,104 | \$25,422 | \$94,475 | \$384,725 | \$6,050 | \$391,356       | \$954,829        | \$31,472       |          | \$77m          |
| Annual Average | \$59,376  | \$114,021 | \$5,084  | \$18,895 | \$76,945  | \$1,210 | <b>\$78,271</b> | <b>\$190,966</b> | <b>\$6,294</b> |          | <b>\$15.4m</b> |

**Total of Average Annual Incurred Developed Losses: \$275,531**

**Company Loss Development Factor: \$275,531 ÷ \$15.4 million = 1.79 per \$100 of payroll**

### Step 4: Apply your company's loss development factor to its projected payroll to calculate projected losses.

**Loss development factor of 1.79 x \$20 million projected payroll = \$358,000 projected losses**

a self-insurer, you are free to select) is an important partner to your adjuster. There are two important considerations:

- 1) Your counsel should be a workers' comp specialist, and
- 2) Your counsel should be a "bulldog" who will effectively represent your interests, settling legitimate claims expeditiously while resisting illegitimate ones ferociously.

#### Think Safety

The other key element to effective loss control is actively working to reduce the number of claims. This requires cultivating an environment in which the emphasis on, and the

priority of, doing the job safely permeates the organization from the top down. This is, perhaps, the most challenging element of being self-insured.

Contractors have a relatively transient labor force, with many new hires and layoffs occurring in a given year. Each new hire represents not only a new potential accident, injury, and claim, but also a higher-than-average exposure to such losses.

Remember, new hires are generally less experienced, less accustomed to your work procedures, and less likely to have employer loyalty stand between them and a marginally

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legitimate (or downright fraudulent) claim. For this reason, comprehensive safety orientation for new employees is critical.

A commitment to safety as a priority, accompanied by a constant search for new and innovative ways to encourage and motivate employees and supervisors, is an absolute must for the contractor wanting to become self-insured.

### **To Self-Insure or Not to Self-Insure?**

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To borrow from Hamlet, this is not really the question. For contractors, the questions (and there are several) should be:

- 1) What do we expect our loss dollars to be (based on a careful analysis of our past losses and a projection of our labor costs over the next 12 months)?
- 2) What will our costs be to pay those losses and to purchase excess insurance to cover catastrophic losses and satisfy the insurance certificate requirements of our customers?
- 3) How do those costs compare to what the guaranteed cost insurance market will charge for a first-dollar policy and how is the cost of first-dollar coverage likely to fluctuate over the next several years?
- 4) Are we willing to invest the time and effort to make safety, loss control, and claims management programs translate to lower loss dollars?
- 5) Given positive answers to these questions, are we better off becoming a state-qualified self-insurer? Or might we be better off simply purchasing a large-deductible or retro plan or by forming a captive insurance company?

### **A Few Last Words ...**

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The advantages to being self-insured include lower fixed costs, maximum use of cash, control over claims, and no need to remarket insurance coverage each year. Also, self-insured companies enjoy the “time value of money” advantage. With guaranteed cost coverage, 100% of the insurance cost is paid over 12 months. Self-insurers pay, perhaps, one third of that amount (in excess and first year claim costs) and the balance over three years or more.

The disadvantages include governmental regulations, a higher degree of risk, a long-term commitment, and challenges in multi-state employment situations.

In the final analysis, self-insurance will not allow you to thumb your nose at the underwriters. They’ll continue to have their say, by virtue of their excess quotes and attachment point minimums. But, self-insurance can help smooth out the bumps created by a fickle marketplace. **BP**

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