

Finite Risk Insurance:

A New Product Based on an Old Standard



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Does your company have areas of risk that you would like to finance via an insurance policy, but the costs are too prohibitive, or the coverage is too restrictive or totally unavailable? Finite Risk Insurance may be a tool for financing risk of this sort. Some of these areas might include:

- Customer Warranties
- Work in Process
- Intellectual Property
- Trade Credit and Political Risk
- Environmental Cleanup

What is Finite Risk Insurance?

In dealing with financial risk, most companies want to retain a measure of control while minimizing unfavorable results. Finite Risk insurance addresses this concern by combining strategic risk assumption and financing over a period of time. Finite Risk insurance is a method of funding liabilities, typically those of a longer term nature, for which a corporation is either unable or unwilling to purchase traditional guaranteed cost insurance. Finite Risk is a relatively new product from an insurance perspective, but it's based on the standard reinsurance policy that has been purchased by insurance companies for decades.

The underlying principle behind Finite Risk insurance is to allow for the matching of current and potential liabilities against assets over an appropriate length of time. While this is an objective of traditional insurance as well, Finite Risk can improve your accessibility to the time value of money. Finite Risk insurance is flexible and can be structured to meet a corporation's unique cash flow, exposure, tax and financial reporting requirements.

The premise of Finite Risk insurance is a formal recognition that the corporation will pay the majority of its losses over time, but in the event it has a favorable loss experience, it will share not only in the underwriting profit, but also in a portion of the investment income that accrues on its premiums.

Finite Risk insurance will not be as cost effective as an unfunded self-insurance program if there are no losses. However, Finite Risk insurance provides advantages not found in self-insurance, including: greater budgeting stability; an element of risk transfer; and, depending upon how the program is structured, the potential for the current tax deductibility of premiums. Compared to conventional insurance, a Finite Risk approach can provide significant cost savings for more comprehensive coverage. Due to the fact that the corporation is paying for a significant amount of its own losses and can receive a return of a portion of the premiums paid as a result of

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Mr. Leavitt and Mr. Andersen are senior members of William Gallagher Associates' Management Liability Practice. William Gallagher Associates is a leading provider of insurance brokerage, risk management and employee benefits services to firms in selected fast-growth industries including high technology, life sciences, financial services, healthcare services, energy, and environmental services. WGA has offices in Boston, MA; Columbia, MD; Princeton, NJ; and Paris, France.

favorable loss experience, Finite Risk programs often have complex tax and accounting issues that need to be addressed.

Who uses Finite Risk Insurance?

A Finite Risk program can be designed to address a variety of exposures and business problems. A Finite Risk policy can insure almost any type of risk ranging from traditional insurance risks such as excess liability, to more esoteric, business-oriented risks, such as customer warranties. Typically, a strong candidate for Finite Risk has most of the following characteristics:

- Moderate – high severity/low frequency loss profile
- Unique/difficult risk to insure
- High tolerance for risk retention/profit sharing
- Strong financial statements
- Sophisticated risk management systems

Many companies have found Finite Risk insurance to be a cost-effective means of solving several business problems. The following are examples of areas where Finite Risk insurance may be of use to a company:

- Fund or insure an otherwise uninsurable exposure
- Reduce balance sheet liabilities
- Manage cash flows
- Accelerate tax deductions, or obtain tax deductions, for payments that might not otherwise be deductible
- Budget with greater accuracy and less volatility
- Shelter money in a tax-advantaged environment
- Reduce dependence on the commercial insurance market
- Protect against adverse loss development
- Move money out of a country or between operating companies
- Use as basis for funding multiple risks
- Purchase insurance at a lower cost

Finite Risk programs are similar to traditional excess insurance in that they:

- Protect the corporation from the spikes in expenses that self-insured losses can cause, which has a leveling effect on the insured's income statement,
- Involve the payment of premiums that the insured may be able to expense in their financial statements and deduct on their tax returns, and

- Provide full-limit coverage from day one of the policy period.

Finite Risk programs are similar to self-insurance in that:

- An acceptable level of loss is retained by the corporation,
- The greatest cost savings occur when there are no losses in the Finite Risk layer, and
- The insured's funds held for the payment of losses earn interest.

Finite Risk Insurance: A Solution for Companies with Volatile Stock Prices

An example of the newest application of Finite Risk Insurance is insurance for Application Service Providers (ASPs). ASPs provide leased software, hardware, upgrades, or maintain IT services. With the recent volatility of technology stocks, many ASPs with stock problems are having trouble selling their products and services as customers become concerned about survival of these ASPs. There is reluctance to do business with them for fear of spending time, money and effort, only to watch the ASP go bankrupt, leaving customers with a big, costly mess.

WGA recently teamed up with a leading insurer to offer a solution to assist ASPs using a Finite Risk tool. The ASP wires a funded amount to the insurer who holds the money in an interest-bearing account, which allows the sales force to offer insurance policies to its prospective customers for specified amounts. If the ASP goes bankrupt, each policy is intended to defray the costs of moving the data management to another ASP or back in-house. If there are no claims the ASP gets the money plus interest returned. This type of product can work with many types of technology businesses where the company has some cash, but can't get clients to buy into the company's future. The insurance feature of this product is advantageous in lieu of other risk transfer vehicles such as Letters of Credit because it is an insurance policy and will be protected from a bankruptcy court. A Letter of Credit, on the other hand, would be deemed an asset of the company, and the customers would not have a true guarantee because the bankruptcy judge could seize those assets resulting in disadvantaged customers. This is just one of the many examples of the use of Finite Risk Insurance.

Prospective Finite Risk Programs

Prospective Finite Risk examples (programs designed for losses which have yet to occur) generally are best suited to operations that are subject to infrequent, high loss severity exposures. Because the corporation realizes cost savings through the receipt of a return premium (or "no claim" bonus) at the end of the policy term, high loss frequency reduces the potential for a return premium or bonus and, therefore, decreases the desirability of such an arrangement. Providing excess coverage for large individual and large aggregate losses, Prospective Finite Risk programs usually are placed above a self-insured retention (SIR) or a primary or excess layer of insurance.

Most participating insurers are flexible in the structure of Finite Risk programs and are willing to negotiate almost every design element. A typical, simple program structure would provide a single aggregate limit of liability over a period of three to five years (the period is negotiated in advance). The more complex programs, such as pollution risks, may have a term of 10 years or more depending on the life of the exposure. Because of the multi-year nature of Prospective Finite Risk programs, insurers assume substantial timing risks. The timing risk is shifted to the insurers because the entire aggregate program limit may be exhausted before all of the policy premiums are collected.

Conclusion

The decision process for entering into a Finite Risk arrangement is predicated on many factors such as: the organization's credit standing; its ability to make the required premium payments; other cash flow and balance sheet considerations; and the opinions of an organization's attorneys and auditors on tax and accounting issues. Clearly, Finite Risk insurance is not for everyone. However, for companies that have the willingness and the capacity to take on the extra risk, the implementation of a Finite Risk program merits consideration.

In summary, you may benefit from Finite Risk insurance since it:

- Allows you to use risk financing to attract/retain customers
- Protects earnings from unexpected losses
- Allows for profit sharing if loss experience is favorable
- Provides protection against catastrophic loss
- Insulates against cyclical insurance market fluctuation
- Stabilizes expenses over a period of time
- Funds losses with pre-tax dollars
- Transfers the timing risk to an insurance company
- Gives incentive for the promotion of good risk management practices