Casualty Total Cost of Risk: A New Look

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Introduction

Over the past decade, the measurement of total cost of risk (TCOR) has proven a very helpful tool in retrospectively assessing and benchmarking the effectiveness of corporate risk management. The ultimate purpose of TCOR is to aggregate all component costs related to a firm's insurance and other activities involved in the management of fortuitous risk, in order to define and control the overall expense of that risk.

Comprising the sum of expenditures associated with the retention, transfer, other financing, and administration of risk, TCOR is typically examined first on a mono-line basis, then rolls-up to define the full spectrum of programs in a risk management plan. While on the surface TCOR is the simple, straight-forward, retrospective sum of these risk cost components, the definitions of, and the inter-relationships among the various components of the program are very complex. In order for a comprehensive insurance program to perform in an efficient and effective manner, these components need to work in concert to respond to a company's overall risk.

Casualty TCOR – A Priority

Nowhere is TCOR more complex than in the realm of traditional worldwide casualty exposures – workers compensation and general/auto/excess liability – where both the frequency and potential catastrophic severity of the risk are substantial. While Casualty TCOR is nearly always the single greatest expense component in a corporate risk management program, opportunities to achieve efficiencies in Casualty TCOR are commensurately substantial.

Recognizing that many of these opportunities reside in the different ways the cost components influence one another under various program structures, an integrated look at Casualty TCOR is emerging. Expanding the definition of Casualty TCOR to incorporate an integrated philosophy that contemplates not only direct costs, but also the indirect and subjective aspects of a multi-line casualty program, creates the opportunity to identify and remove ambiguities among retained and transferred losses.

Analytics Are Key

Inasmuch as the overwhelming majority of a corporation's Casualty TCOR is nearly always in its predictable frequency losses, the analysis and treatment of these expenses is a fundamental priority in a casualty risk management strategy. Basic loss forecasting methods are routinely used to project anticipated frequency losses and expenses. The data outputs often support the prospective examination of risk transfer attachment points and selection of retention financing methods. The quality of the assumptions that underlie

these loss forecasts influence their results, as is evident in the variances that commonly occur between underwriters' and insureds'/brokers' analyses of identical loss data.

While the differing interpretations of the same information are eventually resolved in negotiations, the sometimes wide discrepancies in results raise questions about the ultimate reliability of the analyses. These inconsistencies are now of heightened concern in light of corporate governance requirements under Sarbanes-Oxley.

The new look at TCOR requires more sophisticated and diverse actuarial rating models. Such models not only more thoroughly examine historical losses, but do so in the integrated context of statistical data compiled by the National Council on Compensation Insurance (NCCI) and the Insurance Services Office (ISO), changes in exposure bases, hazard indices of new or discontinued operations, collateral requirements and their costs, and the like.

Fluidity and Volatility Factors

The relationship between risk retention and risk transfer in Casualty TCOR involves a host of variables. Greater retention of risk invariably raises issues of securitizing retentions via credit instruments and/or collateral, each of which has its own market sensitive cost elements. Premium credits for retained risk are not static either, but are influenced by the relative value of an insurer's capacity in the fluctuating supply and demand economics that operate in the market. Likewise, the growth or contraction of a business changes both its exposure base and its risk bearing capacity. Accordingly, retrospective TCOR calculations are but a snapshot of costs in the context of the state of many fluid conditions at a given time. As a benchmarking tool, the static TCOR results year-over-year typically need to be adjusted for these variables to achieve valid comparisons.

Up or down adjustments made to any risk retention/transfer attachment point also laterally expand or reduce the volatility of the risk one assumes in a program. Difficult to define, but a significant aspect of the reality of risk, volatility can only be factored into the TCOR equation currently by means of sophisticated actuarial analyses.

Service Measures

Any integrated view of TCOR also needs to take into account the cost/benefit factors associated with support services operating in a program. The loss assumptions embedded in primary casualty premium and loss estimates are directly influenced by the efficiency and effectiveness of third party administrators (TPAs), Safety and Loss Control systems, Risk Management

Information Systems (RMIS), and loss modeling and insurance brokerage services. A penny saved in TPA fees could cost dollars in loss severity. The ability of higher priced certified safety professionals (CSP) to reduce frequency losses might save several times the difference in their rates versus lesser qualified engineers.

Integrated Strategic Perspective

In TCOR, as in any interdependent system, the whole is always equal to more than the simple sum of its parts, so in using TCOR as a strategic planning tool it is important to analyze each risk component from the perspective of its influence on the totality. The ability and willingness of a broker to integrate its resources and processes therefore has a direct impact on effectively using TCOR to stress-test potential program designs. For example, due to regulations and/or customs, worker-related casualty risks are handled differently in different countries. The manner in which worldwide umbrella programs are designed to handle worker related casualty risk can create either efficiencies or unnecessary duplications of cover if the brokers of a firm's domestic, international and umbrella programs work separately rather than in concert. Likewise, continuity of coverage between primary plans and the excess cover is a similar integration issue. Recognizing that claims issues are in essence the manifestation of previously latent coverage issues, the integration of brokerage claims resources in coverage design can directly influence TCOR.

TCOR is then today much more than just a benchmark. Driven by a new point of view that reveals the components of TCOR *and* their integrated relationships, it is a tool that is re-defining the range and scope of Casualty Risk Management in a way that can only help reduce expenses to earnings and thereby strengthen a firm's bottom line.

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