Introduction to Risk Financing

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Chinese merchants were among the earliest known business people to utilize risk financing in the conduct of trade and commerce. Merchants who shipped their goods on the Yangtze River could never be sure that their goods would safely arrive at the trading centers down river. It was not unusual for a merchant boat to sink, losing both the boat and its cargo because some sections of the river were treacherous and difficult to navigate. To avoid total loss, merchants would coordinate their shipping activities and distribute their cargo among several ships. If a boat and its cargo were destroyed during its voyage, then an individual merchant suffered only a partial loss instead of a disastrous total loss. By pooling their interests, these merchants had greater assurance that all would not be lost.

In London in the late 1600s, individuals interested in investing or financially participating in shipping and trade ventures would gather at Lloyd’s Coffee House in London. Notices of trade voyages would be posted that identified the type of ship, its cargo, destination, crew, and captain. Individuals would write their names under these notices with the amount of liability they would assume in the event of a loss at sea. Each underwriter pledged his personal assets to cover his percentage of the loss in return for a premium for taking the risk. When the notice or slip was fully subscribed, the contract was complete.

Throughout history, close-knit communities have practiced risk financing in an informal way by pooling their resources. In central Pennsylvania, Amish tradition provided for the entire community to help rebuild a barn or house devastated by fire or storm. In return for each member’s pledge and resources to participate in the rebuilding effort, the risk of disaster was transferred and distributed to everyone in the community.

Within the last ten years, health care institutions have faced aggressive audits and investigations of their billing practices under the Medicare program by the Health Care Financing Administration (HCFA) and the Office of the Inspector General (OIG). As billing practices were found to be in noncompliance with the government’s interpretation of the reimbursement regulations, many providers were (and still are) faced with the repayment
of large amounts to Medicare plus fines and penalties. Providers, for the most part, never anticipated or funded for these business losses, which have had a material negative impact on the financial solvency of their institutions. Traditional insurance for such losses is, for the most part, unavailable. To finance these payments, some providers entered into contracts with insurers that indemnified the provider for the full loss in the year of payment in return for a full repayment of the insurance proceeds, plus the insurer’s expenses, over a designated time period. Although this transaction had all the characteristics of a loan, it was structured as an insurance transaction, allowing for a beneficial accounting treatment by the provider and allowing the provider to stabilize their financials.

In the examples above, the Chinese, English, and Amish entrepreneurs, and health care executives all used some form of risk financing to deal with the potential for financial loss associated with adverse events. The basics of risk financing for a trip down the Yangtze River or to address Medicare fraud and abuse are essentially the same, including some or all of the following:

1. The need to anticipate the risks of the group’s operations.
2. A plan or means to financially deal with a loss if it occurred.
3. Pooling of resources.
4. Transfer of risk.
5. Spread of risk.
7. Verbal or written contracts to substantiate financing in the event of a loss.
8. Identifying the simplest, least expensive, and most creative way to finance loss without jeopardizing the financial integrity of their operations.
9. The ultimate goal to protect the assets of their business or personal lives.

Today, risk financing is viewed as a complicated subject involving legal contracts, sophisticated accounting, and myriad government regulations. All sorts of risk financing structures are available, such as: an indemnification clause in a contract; an insurance policy transferring the risk for a given exposure for a given price; the use of a captive insurance company; or a risk securitization plan utilizing corporate bonds triggered by preestablished loss criteria. The types of exposures and losses faced by health care institutions for which a planned approach of risk financing is needed are also numerous and complex. These exposures range from the traditional slip and fall in the parking lot or medical professional liability and employment risks to the business risks of capitation, Medicare fraud and abuse, and interest rate fluctuations.

This chapter will introduce you to the concepts of risk financing within the overall context of the risk management process. It will establish the principles and foundation for structuring and implementing the various risk financing techniques discussed in detail in the chapters that follow. You will gain an appreciation of the importance of risk financing and a framework for a successful program.

RISK FINANCING IN THE CONTEXT OF THE OVERALL RISK MANAGEMENT PROCESS

You have learned by now that the risk management process involves two major areas that are intricately tied to each other—the identification and analysis of exposures and treating the exposures through some form of risk management technique. Figure 30.1 delineates the structure of this process and its key elements.
If we are unable to treat these exposures in a manner that significantly eliminates the potential for loss through loss control, we must plan for their treatment through some form of risk financing.

The focus of this chapter is on the risk financing techniques and methods for generating funds to finance loss that the risk control process could not avoid. In some cases, the potential for loss was not identified or anticipated for risk treatment. As the figure depicts, risk can be financed through risk retention or transfer to an outside party.

The decision to utilize the most appropriate method for your organization’s risk treatment should be based upon cost efficiency, financial stability and security, and the control over program administration each method affords your organization.

RISK RETENTION

Risk retention techniques can vary from the unplanned payment of a loss from operating funds when the loss occurs to a more planned approach such as the use of a captive insurance company. Basically, there are four methods employed by organizations for the financing of loss through retention.

Use of Available Cash

Losses can be paid out of available cash from operations. Neither loss reserves nor funds have been established or designated for these payments. For example, institutions typically pay the $500 deductible for an automobile loss or the $5,000 deductible for a property loss out of available operating cash. These deductible payments are typically treated as unplanned expenditures from operations.

From a risk financing point of view, this technique is acceptable for losses that are small in nature and infrequent in occurrence. For example, this is not an acceptable technique for financing medical professional liability exposures that typically are significant and frequent for most health care organizations. Unplanned or unfunded payments for this exposure could materially affect the financial stability of the organization at any given time.

Loss Reserves

A loss reserve can be established for the potential liability or payment of losses. The reserve is typically based on expected losses and treated as an accounting entry that reflects the amount of losses that are anticipated but not yet realized.
identifies the potential liability on the organization's financial statements. This liability also can be funded by cash, securities, or other liquid assets that are earmarked for the designated liabilities. This technique recognizes that a liability for loss exists and can go as far as setting aside assets to fund that liability. This is a significant difference from the first technique described above.

An example of the use of this technique is the treatment of the tail liability an organization has when it utilizes a claims-made insurance policy for its professional liability exposures. Accounting standards for health care providers require them to “book” or account for the liability they have for claims that have occurred but have not been reported (IBNR) by the end of their fiscal or accounting year. An accounting entry is made on the financial statements to reflect the liability for this IBNR. This liability may or may not be funded, depending upon the philosophy or resources of the organization.

Use of Borrowed Funds

Borrowed funds can be used to pay for losses when they become payable. For the traditional health care provider, this method is inefficient as it reduces the ability of the organization to borrow funds for more appropriate purchases. Moreover, the cost of unplanned borrowing typically is more expensive when used to fund operating expenses instead of long-term capital improvements. The use of borrowed funds to pay for losses is really a means of borrowing time. Ultimately, the institution must pay for the loss with its own earnings or other resources.

Self-Insurance

Formalized methods of self-insurance can be used when an organization finances its losses through a planned strategy. The most typical forms of self-insurance utilized by health care institutions today are the self-insurance trust and captive insurance company.

Self-Insurance Trust A trust is a funding vehicle that, in simplest terms, is a bank account administered by an independent third party (trustee). The funds are designated for the sole and restricted purpose of paying losses. The trustee administers the trust through a formalized agreement and a statement of coverage that outlines the type and limits of loss to be paid. Funding in the trust is typically established at levels determined by an actuarial study and operated in accordance with Medicare requirements. From an accounting perspective, the trust's assets and liabilities are generally declared in a footnote to the parent's financial statements.

Since a trust is not an insurance vehicle, it is strictly limited to the funding purposes for which it was established. A trust typically cannot be utilized for the for-profit subsidiaries of a not-for-profit parent. Also, a trust lacks flexibility to accommodate regulated lines of insurance and cannot accommodate the risks of third parties (those entities or individuals outside the parent's economic family). Such activities would be considered the conduct of insurance and would be subject to state insurance regulations and/or jeopardize the parent's not-for-profit status.

The trust was once was the most common vehicle for self-insurance of the primary professional and general liability exposures of a health care provider. Now, it is gradually being replaced by captive insurance companies because these vehicles can more flexibly accommodate the various exposures and risk financing needs a health care institution faces in today's environment.
**Captive Insurance Company**  A captive is a closely held insurance company whose insurance business is primarily supplied by and controlled by its owners and in which the original insureds are the principal beneficiaries. Simply stated, a captive is a corporation for which the product is the payment of losses and the revenue is premium payments. Because a captive is an insurance vehicle and can be structured in many ways, it has great flexibility to accommodate the numerous and varied risk financing needs of organizations such as third-party businesses, for-profit entities, and other lines of coverage. It is the most formalized method of self-insurance and its separate financial statements (balance sheet and income statement) legitimize and focus the risk management program within a health care organization. This vehicle elevates the risk management function in an organization as its board members typically are drawn from the senior ranks of management and the parent’s board. Because of a captive’s visibility, there is a greater importance on controlling losses, the primary driver of costs for any program.

A more detailed discussion of these formal methods of self insurance will be presented in later chapters.

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**RISK TRANSFER**

By definition, risk transfer techniques transmit an organization’s risk to an outside party. The most common method of risk transfer is the purchase of commercial insurance. Risk transfer also can be accomplished through noninsurance techniques, such as the use of an indemnification provision in a noninsurance agreement. Indemnification is the process by which one is restored or reimbursed to the extent of the loss (“made whole again”).

Insurance is a contractual relationship that exists when one party (the insurer) for consideration (premium) agrees to reimburse or pay for another party’s (insured) fortuitous loss caused by a predefined event (peril). Risk is shifted to others and spread among many parties. In general terms, covering the risks of unrelated parties by a company owned by multiple owners will constitute insurance.

From a practical view, insurance will nearly always involve some form of risk retention on a planned or unplanned basis. The use of a deductible would be an example of a planned retention. Denial of coverage as a result of an adverse policy coverage interpretation by the commercial insurer would certainly be an unplanned retention. The insurance policy, therefore, should never be viewed as a “complete” transfer of risk.

There are many forms and types of insurance that are generally classified in four areas as defined and illustrated in Table 30.1.

Chapter 31 on insurance will provide you with a more detailed discussion of these coverages. It is important to understand the principles and practices of these coverages as you apply them effectively in a risk financing program.

The other method of risk transfer, the use of indemnification provisions in a contract, can be an effective tool to lower the overall cost of risk. A hold-harmless agreement is an agreement between two or more parties defining an obligation or duty resting on one party to make good the liability, loss, or damage that the other party has incurred or may incur. Hold-harmless indemnification provisions can vary significantly. The most common type may read as follows:

Provider agrees to indemnify and hold harmless the managed care organization (MCO) against any negligent act or claim made with respect to items or services provided by Provider under this Agreement to the extent that the negligent act or claim is attributable to any person or activity for which Provider is solely responsible or
### TABLE 30.1. Types of Insurance

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<th>Type of Insurance</th>
<th>Definition</th>
<th>Examples</th>
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<tr>
<td>First Party</td>
<td>Provides coverage for the insured’s own property or person. Coverage is intended to indemnify the insured to restore him or her to the same financial position that he or she had prior to the loss.</td>
<td>Fire and Property, Business Interruption, Boiler and Machinery, Builders Risk, Flood, Earthquake, Crime, HMO/Capitation Stop Loss</td>
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<tr>
<td>Third-Party or Liability Insurance</td>
<td>Provides coverage to a party other than the insured. Coverage is intended to indemnify the third party for loss or injury caused by the insured. Involves three parties: 1. The insured who caused the harm or damage. 2. The party who is harmed. 3. The insurer.</td>
<td>Professional Liability, GL (Premises Liability), Excess/Umbrella, Employers Liability, Auto Liability, D&amp;O, E&amp;O, Environmental Impairment</td>
</tr>
<tr>
<td>Health and Welfare Insurance (Benefits)</td>
<td>Provides coverage for an insured’s employees. Coverage is intended to indemnify the employee by restoring his or her health and earnings to the level maintained prior to the loss.</td>
<td>Workers’ Compensation, Health Benefits, Long-Term Disability, Short-Term Disability, Dental, Vision, Life</td>
</tr>
<tr>
<td>Financial Guarantees (Surety and Bonds)</td>
<td>Provides a guarantee that specific obligations of a contract or performance will be fulfilled. These differ from traditional insurance in that assets are pledged for the full amount of risk transferred.</td>
<td>Surety and Bonds, Public Official Bonds, Judicial Bonds, Contract or Performance Bonds, License and Permit Bonds</td>
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which arises in connection with the use or maintenance of property, equipment, or facilities under the direction or control of Provider. MCO agrees to indemnify and hold harmless Provider against any negligent act or claim made with respect to items or services provided under this Agreement to the extent that the negligent act or claim is attributable to any person or activity for which MCO is solely responsible or otherwise arises from duties or obligations that are solely the responsibility of MCO under this Agreement.*

This clause states that each of the parties to the agreement will be responsible for indemnifying the other party for loss caused due to their negligence. This method of risk transfer is practical in certain situations such as the execution of construction or supply contracts, but not in others, such as for the professional liability risks of providing care to patients. Patients are unlikely to sign a hold-harmless agreement before agreeing to be admitted to the hospital for care. (Consent-to-treat agreements that patients are asked to sign before surgery or other invasive treatment are not intended to transfer risk but to authorize the particular treatment being proposed.)

As with any risk financing technique, indemnification provisions need to be evaluated for the cost efficiency, financial security, and control they afford in the risk transfer

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*Bureau of National Affairs. Taken from Health Law and Business Library.
process. Therefore, these agreements need to be supported by the financial resources of the contracting party or some form of insurance or surety. They also need to be written or supported in such a way as to clearly define each party's rights and obligations in the event of a loss. In any event, given the legal uncertainties in enforcing hold-harmless agreements, they should never by relied upon exclusively to accomplish risk transfer.

RISK RETENTION VERSUS RISK TRANSFER

The decision whether to transfer rather than retain risk will depend upon many factors, including:

- The size and type of your operation.
- Your financial strength and resources.
- The type of risk to be treated.
- Your risk taking philosophy.
- Your organization's future goals and objectives.
- The overall effectiveness of your risk management and loss control program.

The decision framework and principles discussed here will provide a foundation for choosing between the two.

Risk financing can be viewed as a continuum (see Figure 30.2) between total risk transfer to total retention. The figure provides a framework of the cost efficiency and cost certainty that each technique provides. Total risk transfer through insurance will fix costs with certainty, but cost efficiencies are sacrificed as a result of the insurance carriers' charges for taking on the full risk. The opposite is true for self-insurance of total exposures.

For example, if you purchased insurance for the first dollar of loss for your professional liability exposures, your financing costs for a given period of time would be fixed,

FIGURE 30.2. Risk Financing Continuum
Risk Financing

providing you with the highest level of cost certainty. Theoretically, it would also be the most costly approach since your premium would include:

- The insurance company's profit.
- Overhead.
- Estimate of the losses to be paid under the policy.
- Charges for use of their policy form.
- Reinsurance.
- Miscellaneous services.
- A charge for the "risk" they are assuming for this exposure.

Since they are taking the risk for you, they will want to retain control over most or all major decisions involving the coverage. This might be the best risk financing technique for a small organization with limited assets and resources where maximum cost certainty is important for financial well being. It might also be a better technique for financing miscellaneous exposures for which you cannot reasonably predict the frequency or severity of loss. These exposures can usually be insured at a "reasonable" price.

At the other end of the continuum, you could choose to retain all the risk for your professional liability exposures through some method of self-insurance. The cost of financing the risk would be most uncertain and would vary significantly with the frequency and severity of losses. Your cost efficiency would be at a high level since you would not pay an insurer for profit, overhead, and other charges and because you would retain control over all aspects of the risk financing program. This approach may make sense for very large organizations that have the resources to manage their risk management programs in an effective manner and have sufficient assets to accommodate the volatility of loss payments without impairment to the financial strength of the organization.

Typically, risk managers utilize a combination of risk transfer and retention for professional liability exposures, whereby the predictable layer of loss is retained while the unpredictable, catastrophic loss is transferred. This approach strikes a balance between cost efficiency and certainty. By retaining the predictable loss layer, insurance company profit and overhead and other charges are minimized. Transferring the unpredictable, more volatile catastrophic losses to an insurer at a "reasonable" premium prevents significant swings in overall program costs and promotes financial stability over the long term, a key objective of any well run organization. Program control is also balanced in a more effective and appropriate manner between your organization and the insurer.

As you chose between risk transfer and retention, consider the following guidance:

- The risk taking philosophy of your organization affects the goals of the risk financing program. Define the risk you are willing to take versus what you can afford. Senior management needs to be involved in establishing the philosophy.
- Self-insure the predictable layer of loss where possible. To do otherwise would be trading dollars with an insurer with a loss of control over your program.
- Transfer the unpredictable or catastrophic layers of potential loss at limits sufficient to protect the assets of your organization. Excess coverage at sufficient limits is usually available at reasonable prices. Self-insuring this exposure to loss would be risking a lot to save a little.
- If you retain risk, you should have an effective risk management program in place to control or minimize loss. Sound risk information, loss control, claims handling, and
litigation management systems are prerequisites. You also need to involve senior management and all "your" insureds in the process. An effective program will also make your organization an attractive risk for insurance purposes as you purchase coverage for catastrophic exposures. Keep in mind that risk retention through some form of self-insurance is not a cure for poor loss experience.

• Always take a long-term review of your risk transfer versus retention strategy. In a soft marketplace, you may be able to purchase insurance at a cost that is lower than expected losses. What impact does this have on your long-term costs and control over the program? Will the purchase of insurance take focus away from loss control efforts?

• Be prudent and conservative in funding for your self-insurance program. You can always fund less in the future if your loss experience develops better than expected. You always need a buffer to accommodate adverse loss experience in any program.

• When purchasing insurance, know your carrier better than they know themselves. Make sure they have the financial security, stable management, and policy services to be a good partner. Investigate their track record for paying claims and honoring their commitments. Do you have a relationship with your insured to resolve gray areas of coverage?

• Choose your risk financing consultants, brokers, actuaries, legal advisers, defense counsel, and auditors carefully. They need to be your partners and advocates in safeguarding your organization's assets and reputation. They not only have to be qualified through education and experience, but also need the integrity to have your total interest at heart. Make sure they can work together as a team to make your program as effective as possible.

CONCLUSION

The risk financing of losses that occur despite your best risk control efforts may be from the unstructured payment of loss from operating funds, the application of the indemnification provision of a contract, or financed under the structured terms of a formal captive insurance company. The best and most effective method for your organization will depend upon many factors including the type of risk, its predictability for loss, the financial impact on your organization, your risk taking philosophy, the sophistication of your risk management program, and the degree of control you desire over program services.

As a risk management professional, it is your responsibility to guide your organization in making the best choice in meeting the overall mission and objectives of the organization. A sound risk financing program is important in protecting the assets of your organization and ultimately its reputation and ability to serve its customers and patients.

Suggested Readings


Krauss, G. E. Essentials of Property and Casualty Insurance (10th ed.).