Municipal Risk

WINTER 2023

LAS AMO Business Services

Strategic Budgeting for Risk

This quarterly publication provides helpful information on insurance and risk management.

Contact us if there are topics you want us to cover.

Setting the budget is one of the most important decisions made by municipal governments.

The budget serves as the foundation of municipal operations, programs and priorities. The budget also needs to cover the costs of protecting people and property. From insurance premiums to below-deductible costs, municipalities must budget for future costs of premiums and claims in a landscape that is becoming more complex and is filled with uncertainty.

Whether you are building an annual or a multi-year budget, there are a number of unique factors to consider when budgeting for risk.

1 Insurance Policies Renew Annually

While RFPs for insurance services are generally issued every few years, insurance providers are not offering multi-year renewals in current market conditions. That means municipalities have to manage annual premium increases by budgeting for risk. A full analysis and understanding of your municipal risk profile is the best way to build resilience into the budgeting process.

First, municipalities need to know that changes to annual premiums depend on two factors:

Growth – For example, how many vehicles were added to the fleet, the value of new buildings or pieces of equipment added to the asset list.

Rates – Insurers determine how much they will charge per vehicle, per $100 of insured property value and what the liability rate will be based on their rating standards. Most will consider previous claim experience, population, full-time employee count and municipal operations in this rate. To gather this information, insurers are requiring significantly more information, with more applications that contain more questions.

Traditionally, municipalities have used a projection (also referred to as an indication) provided by their insurance provider and applied it to the previous years premium. The challenge with indications is that they are only a best estimate and the timing is off for most budget cycles. Insurers typically won't provide a projection more than 60 or 90 days out from renewal. For municipalities looking to budget in June with a January 1 renewal, the timelines simply don't line up. As well, these indications don't address unknowns, such as growth or inflation.

2 Claims Have a Long Tail

The cost of risk is largely influenced by claims. Claims can take up to two years to be reported and can take up to 15 years to settle. Claims vary widely and don't incur expenses at the same or even at a predictable rate. This makes them a large unknown when attempting to budget for future years.

3 Historical vs. Future Perspective

Given that claims have a long a tail, your claim data and analysis is paramount. To effectively budget and manage risk, you need to know not only what your claims cost, but what they will cost in the future.

In addition to claims and premiums, there are additional budget pressures related to risk, such as expenses that fall below the deductible or uninsured losses.

Total Cost of Risk (COR) is the sum of all aspects of an organization's operations that relate to risk, including retained (uninsured) losses and related loss adjustment expenses (LAEs), risk control costs, insurance and other risk transfer costs, and administrative costs.

Source: www.irmi.com

If a municipality is increasing deductibles or reducing coverage, the budget needs to recognize that those costs may deliver short-term relief on premiums but will begin to build year over year on all other below-deductible line items. Looking historically at below deductible expenses will not provide the full picture and will leave the affected line items short. Reserve funds should be considered for future costs of increased deductible expenses.

What can help?

Municipalities can engage an actuarial firm to prepare for both annual renewals and budgeting. It can be helpful for the firm to conduct a review of the expected and ultimate claim amounts attributable to the municipality based on current coverage and deductibles. There are several reports you can request – Deductible Study, Technical Premium Study and Reserve Study. These reports are especially helpful in the current hard market. This work gives municipalities access to data that insurers also use in their calculation. Let's take a look at each one:

Deductible Study

A deductible study will help you with budgeting and to select deductible/self insured retentions. An actuary will use your current deductible on each policy, as well as ten (10) years of past losses and premiums to forecast future losses. This study is critical when considering whether increasing deductibles to offset premium for one year is feasible based on how it will impact future years. This study is particularly useful in the event a deductible increase was imposed by the markets. A deductible study will financially demonstrate the increased risk you are assuming using predicted future losses. This is based on both historical losses and predictive analysis, rather than only considering historical losses.

Technical Premium Study

A technical premium study will look at deductibles, ten (10) years of losses, the value of your assets and other key underwriting data to determine what your technical premium should be. A technical premium study builds in insurers administration costs and accounts for profit. You can compare this number against what the markets are charging to make strategic decisions about this risk that you wish to transfer and that that you wish to keep.

The key is to determine the true cost of your risk today and what it will cost tomorrow. It is critical to build in a forward-looking strategy rather than historical, especially in the event of a deductible increase.

The insurance premium line item is your risk transfer cost. Using one or more of the studies discussed above will help you budget for your future total cost of risk. This in turn will build in resilience and allow municipalities to weather market changes.

Reserve Study

Whether you have a reserve in place for insurance premiums or for all related risk costs, it is important to know what your reserve level should be at both the current and future deductible levels you may be considering. By calculating the outstanding liabilities for all open claims., the analysis helps inform the level of regular contributions to the reserve. If you do not have a reserve in place, this study would help to set one up.