Funding School Risks

In this course, we'll learn the options available to the school district to fund losses that occur and how the risk manager can manage the loss reserving process. Selecting the appropriate funding option requires the risk manager to have knowledge and understanding of, among other things, the district’s Cost of Risk and to understand of Cash Flow Concepts and Loss Development and Training.

The primary focus of this course is to introduce and explain the methods that can be used to finance the district’s losses. Using General Criteria, the risk manager compares and evaluates the various risk financing options and ultimately determines which is best for the school district. Loss reserves impact the district’s Cost of Risk, funding options, financial statements, and audits.

The Certified School Risk Managers Program was created to fill a void in the educational opportunities for school risk managers, and those agents and other service providers who work with them. By taking and passing all five of these courses, you can earn the prestigious CSRM designation.

The Certified School Risk Managers Program (CSRM) is a career-building, five-part designation program for risk management education specialists.

The CSRM faculty is represented by the field's top practitioners and leaders. Five intensive courses guide participants through the risk management process, emphasizing practice over theory.

The five core courses for the CSRM Designation Program correspond to the five steps of the Risk Management Process.

A discussion of the entire Risk Management Process is included for study at the beginning of each CSRM course. We do this because, in the actual practice of risk management, activities in one step influence actions taken in another step, creating interdependent processes.
**Fundamentals of Risk Management (FUN)** – The first step in the risk management process is identifying exposures subject to loss, since an exposure cannot be analyzed, controlled, or financed until it has been identified. This course gives an in-depth look at the overall risk management process, delves into the identification step of the process, and examines the function of the school risk manager.

**Measuring School Risks (MEA)** – This course will delve into the mechanics of forecasting and trending losses to be used in determining insurance program retentions and deductibles.

**Handling School Risks (HAN)** – This course studies the development of a safety and health plan, loss control fundamentals (including the six primary risk control techniques), risk control and mitigation for specific exposures, and managing school claims; a post – accident loss control reduction technique.

**Funding School Risks (FSR)** – The purpose of this course is to examine the various loss funding techniques available to school risk managers. This will include guaranteed cost programs, deductibles and retention programs, pools, and transferring risk through contracts.

**Administering School Risks (ADM)** – This course will cover how a school risk manager implements and monitors the risk management program. Some of the topics will include the school risk management team, information technology for risk management information systems, allocating the cost of risk, ethics in school risk management, and requests for proposals.

**How to Receive Credit for Funding School Risks**

To successfully complete this course, you must pass a final examination in the presence of a disinterested third party proctor/monitor.

Some states have special requirements for the proctor/monitor. To learn more about the proctor/monitor requirements for your state, please click on the Proctor Instructions link below.

Your proctor/monitor will enter his or her email address to sign in to the exam website. He or she must remain in your presence for the entire hour of the exam. Your proctor/monitor will enter his or her email address to sign in to the exam website. He or she must remain in your presence for the entire hour of the exam.
The National Alliance for Insurance Education & Research

The proctor/monitor certifies your identity, and that you have completed the exam without outside assistance of any kind. Make sure to use your 60 day timeframe to carefully prepare for the exam, and select a person to act as your exam proctor/monitor well in advance.

You must pass the exam in order to receive any of the following credit:

- Credit towards achieving the CSRM Designation
- Credit towards achieving the CISR Designation
- 8-hour Annual Update credit for the CSRM Designation
- State Continuing Education Credits/Hours (for state issued license renewal)

Affidavit of Exam and CE Request Form

With every successful exam, you and your proctor must sign and submit an affidavit of exam.

When you pass your exam, fax the affidavit of exam and CE (Continuing Education) request form to the fax number printed on the cover sheet. Please send the original affidavit by mail (address also printed on the affidavit cover sheet.) We strongly recommend that you keep a copy for your records.

Many School Risk Managers will have no need to request Continuing Education credits for an insurance license. Please send the CE Request form even if you are not requesting CE hours/credits for insurance license renewal. Check off the "No CE" box at the bottom of the form.

Note: You will receive an email reminding you to send in the affidavit if you pass your exam with a score of 70 or above. Do not submit an affidavit for an unsuccessful exam.

CSRM Funding School Risks Final Exam

The exam is a challenging 100 point randomized test comprised of 50 multiple choice questions worth 2 points each.

When you submit your exam for grading you will receive your score immediately. The score page is sent to your email address and to The National Alliance for Insurance Education.

The score is recorded in your National Alliance permanent record, but is not certified until you submit the affidavit of exam, signed by you and your proctor. (In New York, the proctor/monitor must mail the affidavit.)
Once we receive and accept your affidavit, we will send your notification of passing.

**Curriculum Support**

Faculty Members from the National Alliance for Insurance Education & Research are assigned to take emails from students in the Online Courses.

Our faculty are experienced practitioners and teachers in the industry. We ask them to respond to each email within 24 hours, or before the end of the next business day.

Each course mentor will be happy to clarify any portion of the curriculum that you seek help with.

Make sure you have carefully reviewed the course curriculum and clearly note the page or self quiz question number when you contact a Course Mentor.

**Help Desk**

The mentors will refer any computer issues you have to the Online Help desk. National Alliance staff are available by phone or email for technical support issues.

cisronline@scic.com.
To phone the Online Help Desk call:
800-633-2165 and select the online option.
Monday through Friday 8:30 am to 5 pm Central Standard Time

**Course Study and Exam Preparation**

Have you ever thought about how you learn? The study aids listed below will help you determine your progress and test your understanding of concepts and examples presented in the course.

- **Learning Objectives** are designed for managing your own learning. The learning objectives for the course are listed at the beginning of each topic. The learning objectives are indicated throughout the course pages as well. At the end of the course, you will have the opportunity to read the learning objectives again, and see how confident you feel about each one.
• **Self Quizzes** are another learning management tool. You are required to pass each self quiz with a score of 70 or above before moving forward in the course, and you can launch a self quiz as many times as needed. To print the score page of your self quiz, click on Assessment Results, then right click on the page. The Assessment Results page makes an excellent study aid.

• **Glossary** terms and definitions are critical to insurance professionals, and a key study aid for your online course. To define a term, click on the Glossary link above. Definitions of newly introduced terms will also be included on the course pages.

• **Knowledge Checks** are application level questions. By attempting to apply the concepts of the course, you will better prepare yourself for the final exam. Make sure you attempt each knowledge check in the course.

• **Course Mentor** And don’t forget to email the Course Mentor with your questions about the curriculum. Our faculty members are distinguished producers and risk managers who currently work in the insurance industry. The mentors are happy to explain and clarify the concepts in the course. They will return your email on the next business day.

A note about the CSRM Online Glossary, our online glossary is extensive and features many terms and concepts used by risk managers. Glossary terms that you see on a course page may be a part of the final exam. However, when taking the final exam, you will *not* be tested on the entire glossary.

As a new risk manager, you have many opportunities to learn from experienced risk managers.

As an experienced risk manager, you will have opportunities to share what you know with others.

**Four Ways to Develop your Career as a Risk Manager:**

1. Network
   • New risk manager
   • School principal
   • Experienced risk manager
   • Board member
2. Join a professional state association that supports school risk management
   • Public Risk Management Association (PRIMA)
   • Your state’s school business officer’s association

3. Become involved in a qualifies risk management training program
   • Obtain risk management certifications and knowledge

4. Develop rapport with external insurance agents, brokers and/or consultants
   • Meet with insurance and risk management vendors

**Florida Residents Only**

An entity that is required to be licensed or registered with the Florida Office of Insurance Regulation but is operating without the proper authorization is identified as an unauthorized insurer. All persons have the responsibility of conducting reasonable research to ensure they are not writing policies or placing business with an unauthorized insurer. Any person who, directly or indirectly, aid or represent an unauthorized insurer can lose their licenses or face other disciplinary sanctions. Please see section 626.901, Florida Statutes, to read the laws. Lack of careful screening can result in significant financial loss to Florida consumers due to unpaid claims and/or theft of premiums. Under Florida law, a person can be charged with a third-degree felony and also held liable for any unpaid claims and refund of premiums when representing an unauthorized insurer. It is the person’s responsibility to give fair and accurate information regarding the companies they represent.
Course Objectives Overview

Section 1 Introduction to Funding School Risks

- The Risk Management Process
- How Funding Applies to the Risk Management Process
- Proactive vs. Reactive Risk Financing

Section 2 Foundations for Funding and Basics of Insurance

- Introduction
- Cost of Risk
- Cash Flow Concepts
- Loss Development & Trending
- Basic Insurance Terms
- Required, Permitted & Prohibited
- Insurance Market Overview

Section 3 Options for Funding School Risks

- Funding School Risks
- Criteria for Comparison
- Guaranteed Cost Plan
- Self-funded Plan
- Pooling
- Purchasing Insurance

Section 4 Reserving for School Risk Managers

- Reserves
- Actuarial Services
- Audit Issues

Section 5 Finance Issues for the School Risk Manager

- Management & Security of District Assets
- Catastrophic Loss or Damage of District Assets
- Internal Controls & the School Risk Manager
- Annual Financial & Compliance Reports

Course Summary
Section 1 Introduction to Funding School Risks

Funding School Risks is one of the courses that comprise the Certified School Risk Manager (CSRM) designation. In Section 1, we discuss the following topics: The Risk Management Process, How Funding Fits into the Risk Management Process, and Proactive vs. Reactive Risk Financing.

Learning Objectives

By the end of this section you will be able to:

1. Identify and describe the five steps of the Risk Management Process.
3. Understand the importance of a proactive approach to Risk Financing.

Risk Management

What is Risk Management? While there are various definitions of Risk Management, they all contain a common theme: to protect the assets of the organization.

School risk managers have a responsibility to protect the assets of their school district.

How does the school risk manager accomplish this? By implementing and following the Risk Management Process.

The Risk Management Process

The Risk Management Process is a powerful five-step guide that can dramatically increase your effectiveness as a risk manager.

**Risk management process:** A system for treating risk: identification and analysis of exposures, selection of appropriate risk management techniques to handle exposures, finance at the most reasonable cost, implementation of chosen techniques, and monitoring the results.

1. **Risk Identification:** The process of identifying and examining the potential courses of losses faced by the school
2. **Risk Analysis:** The assessment of the potential impact (costs) that various exposures can have on the school
3. **Risk Control**: Actions to minimize, at the optimal cost, losses which strike the school district.

4. **Risk Financing**: The acquisition of funds, at the least possible cost, to pay for the losses that strike the school.

5. **Risk Administration**: Planning, implementing, and monitoring the risk management program. Risk Administration also includes the development of the risk management team, utilizing both internal and external sources.

**Step 1: Risk Identification**

The process of identifying and examining the potential sources of losses faced by the school.

________________________

Before you can manage risks, you first need to identify them. Risk managers are, among other things, risk detectives. They find risks and bring them into focus. **Risk Identification makes risk management possible.**

**Risk Identification Tools & Methods**

Risk managers use a variety of tools and methods to help them identify and examine sources of loss to their school. **We've highlighted just a few.**
Physical Inspections
   Conduct a walkthrough of all high schools in the district looking for various exposures and hazards.

Policy & Procedures Review
   Evaluate field trip guidelines to make sure student safety is not at risk.

Compliance Review
   Review fire drill reports to assure compliance with applicable local and state requirements.

Checklists & Surveys
   Review driver pre-route vehicle inspection safety checklists.

Step 2: Risk Analysis

*The assessment of the potential impact (costs) that various exposures can have on the school.*

In Risk Analysis, the risk manager is often looking for trends and patterns.
What tasks are associated with quantitative and qualitative risk analysis?

**Quantitative Risk Analysis**
- Claims development
- Dollar value of claims (severity)
- Number of claims (frequency)
- Indexing for inflation
- Calculating Ultimate Total Loss
- Loss pic calculation

**Qualitative Risk Analysis**
- Review incident reports
- Contract analysis
- Safety audit review
- Policy review

**Step 3: Risk Control**

*Actions to minimize, at the optimal cost, losses that strike the school district.*

Risk control is the “action step” of risk management. You apply the information you identified and analyzed in the first two steps of the Risk Management Process and take actions that minimize risks.

**Risk control**: The technique of minimizing the frequency or severity of losses with training, safety, and security measures. See also Loss control.

**Risk Control is handling risk.**
Risk Control: Two Theories of Risk

Most people would agree that both people and things cause accidents. Good risk management addresses both of these. Two theories of risk have been proposed to explain why accidents occur.

**Human Approach – People Cause Accidents**

**Problem:**
Staff and students who are not trained in safety procedures or do not realize the importance of following them

**Solution:**
Regularly train and motivate them to follow safety procedures

**The Engineering Approach – Things and Energy Cause Accidents**

**Problem:**
Safety guard missing from the table saw in the Woodshop

**Solution:**
Perform regular safety inspections of classrooms
Risk Control: Techniques

Risk managers use a variety of tools and methods to help them identify and examine sources of loss to their school.

- **Avoidance**: Eliminating a risk altogether
  - Example: Not sponsoring a Senior Trip to a foreign country

- **Prevention**: Reducing the frequency (number) of losses
  - Example: Installing outside lights

- **Reduction**: Reducing the severity (cost) of losses
  - Example: Requiring the use of safety equipment

- **Segregation/Separation/Duplication**
  - Example: Maintaining backups of computer data in more than one place

- **Transfer**: Physical transfer and contractual transfer
  - Example: Using a third party to operate Food Services

- **Combination**: Any two (or more) risk control techniques
  - Example: Requiring a hold harmless agreement from the roofing contractor and clocking off walkways close to the roof repair

Complete the exercise on Section 1 Risk Management Process p12 (FSR)
Step 4: Risk Financing

The acquisition of funds, at the least possible cost, to pay for losses that strike the school.

An earthquake hits a California school, damaging buildings and injuring staff members and students.

How will the school pay for this catastrophe? Did it set aside adequate emergency funds? Does it have adequate insurance?

Whatever risks your school faces, addressing funding before the risks occur keeps the school’s expenditures in check. The alternative can be extremely costly – both financially and socially.

Risk Funding: Funding losses

Risk Finance: Two Ways to Finance Risk

There are two ways to finance risk: retention and transfer. There are two types of retention.

Retention: 1) Budgeted losses + tolerance corridor (a tolerance corridor is the marginal retention amount beyond budgeted retention that may also be actively retained); 2) Assumption of risk of loss as through the use of non-insurance, self-insurance, or deductibles. This retention can be intentional (active retention) or, when exposures are not identified, unintentional (passive retention); 3) In reinsurance, the net amount of risk the ceding company or the reinsurer keeps for its own account or that of specified others.

Transfer of risk: A risk management technique whereby a portion of the financial consequences of a loss are transferred to another party through a contract, e.g., a hold harmless agreement, or to a professional risk bearer, i.e., an insurance company.

Active Retention
Retention means using funds from within the school organization to pay for losses. When the school makes a conscious, informed decision to retain all or part of a loss, it is active retention.

Passive Retention
This refers to the times when the school finds out after the loss that it is financially responsible for paying for the damage or injuries. Passive retention is
unplanned and is sometimes referred to as “whoops”. Passive or unplanned retention is something to be avoided.

“What do you mean our insurance doesn’t cover this?” – Passive retention

“What a relief! All we have to pay is our $10,000 deductible.” – Active retention

**Transfer**
You can also finance losses with funds from outside the school organization by using a contractual or other arrangement.

**Insurance Transfer**
A formal social device for reducing risk by transferring a portion of the financial consequences of a loss to an insurer. The insurer agrees, for a consideration, to assume, to a specified extent, the losses suffered by the insured. Insurance involves substituting a relatively small known cost for a potentially larger unknown cost.

Insurance is the most common form of transfer.

If you select insurance as your method to finance the risk of fire to school buildings, the financial consequences of a fire loss have been transferred to the insurance company.

It is important to keep in mind that the financial transfer only applies to losses that are covered by the insurance contract and are within the limits of insurance purchased.

Schools may also use non-insurance transfers to pay for losses. (Non-insurance risk transfer: The transfer of risk from one party to another party other than an insurance company. Transfers financial consequences of an activity to another through an agreement or contract, can be physical transfer or contractual transfer.)

Risk managers may refer to transfers other than insurance as “physical transfers” (such as outsourcing a service) or “contractual transfers” (such as a hold harmless agreement.) (Hold harmless agreement: A portion of a contract that is a promise by one of the parties (first party) not to hold the other party responsible if the other party carries out the contract in a way that causes damage to the party. Many states do not allow schools to hold others harmless; they may, however, be held harmless by another party.)
Physical Transfer

A district outsources its food services. The risks associated with this function have been financially transferred to the company now providing food services.

While there is a contract involved and the food services company will need to provide proof it has insurance, the school district views this as a physical transfer.

Contractual Transfer

The school has hired a contractor to repair the bleachers at the football field.

The contract contains a hold harmless provision that states if a loss occurs, the contractor will assume liability and be financially responsible for all damages.

Step 5: Risk Administration

The process of planning, implementing and monitoring the risk management program.

A risk manager is highly dependent on his or her risk management team, a group of dedicated individuals from within and outside of the school who help the risk manager control losses. Risk management team members include: the risk management department staff, insurance professionals, risk consultants, experienced risk managers, concerned community members, and others.

In the final step of the Risk Management Process, Risk Administration, the risk manager works with his or her team to plan, implement, and monitor the risk management program – in other words, to make adjustments to ongoing operations and to move it forward. Effective Risk Administration requires excellent communication, teamwork, and project management.
The Risk Management Process

If you've taken one of our classroom CSRM courses, you'll recognize the image below.

This diagram of the five-step Risk Management Process illustrates the flow of Risk Identification, Risk Analysis, Risk Control, Risk Financing and Risk Administration.

The feedback gained through implementation and monitoring of the risk management program impacts each of the other steps in the Risk Management Process, as indicated by the arrows on the right-hand side of the diagram.
How Does Risk Financing Fit into the Risk Management Process?

Risk financing (along with controlling risks) is used to address exposures identified and analyzed in steps one and two of the Risk Management Process. This course will cover the following risk financing topics.

Proactive vs. Reactive Risk Analysis

*Proactive* risk financing means actively determining and implementing the most effective transfer and retention practices for the school district. *Reactive* risk financing means funding exposures discovered after the financing program is in place or after they manifest themselves as losses.

The benefits of a proactive approach are:

- More potential exposures are addressed through one or more active transfer or retention programs.
- The organization reduces passive retention problems.


**Reactive Management**

Examples: A fire emergency at the school causes a lengthy school closure and multiple additional costs because the school had not properly planned for a major emergency. Stakeholders in the community react negatively to the management of the emergency.

**Active Management**

Examples: An effective response saves lives and property during a fire at a campus. However, the school discovers later that some of the property was valued at actual cash value when replacement cost valuation would have been appropriate. The district hadn't really looked at what impact the fire would have on the school's budget and must find additional monies to help the school complete the school year after re-opening.

**Proactive Management**

Examples: An effective response saves lives and property during a fire at a campus. The school must close for a week while repairs are made, but plenty of damage was avoided by appropriate fire suppression equipment and alert employees. Except for an item or two, the school is satisfied with how insurance indemnified them for the damages. Business continuation and other types of planning allowed this school to resume operations as quickly as possible.

Please refer to the end of Section 1 to go over the section exercises and self quiz.
Section 2 Foundations for Funding and Basics of Insurance

Understanding how to fund a school’s exposures to loss requires a risk manager to have knowledge of concepts presented in the CSRM courses, Measuring and Analyzing School Risks and Fundamentals of Risk Management. This section will begin with a review of these concepts.

As insurance is a method frequently used by schools to fund losses, a risk manager should have an understanding of basic insurance terms and knowledge of the factors that could affect insurance premiums, services, coverages, and availability.

Learning Objectives

By the end of this section, you will be able to:

1. Understand why quantitative analysis is important to the school district risk manager
2. Identify and discuss the five components for cost of risk
3. Understand future value, present value, and net present value
4. Know examples and purposes of the common tools for loss development and trending
5. Know basic insurance terms
6. Know required, permitted, and prohibited coverages under some states’ laws
7. Understand the market factors that affect coverages, insurability, premiums, and insurance services

Foundations for Funding

Before different funding alternatives can be evaluated, we need to review the results from the Analysis step of the Risk Management process and understand basic terminology used in Risk Financing and insurance.
Importance of Quantitative Analysis to the Risk Manager

Fund Balance

A district’s fund balance reflects an amount of cash that has been accumulated over the years through receiving more revenues, spending less, or a combination of the two. Fund Balance in government is loosely equivalent to equity in the private sector. Fund Balance is not completely comprised of cash - it also includes other amounts necessary to balance assets and liabilities.

Fund Balance amounts fall within one of three categories: Reserved, Designated, or Unreserved/Undesignated.

The category of the Fund Balance determines what a district can do with those funds.

Statistical concepts assist the school risk manager in making effective Risk Control and Risk Financing Decisions.

Most risk management decisions are financial decisions involving the inflow and outflow of dollars. Risk management projects such as increasing or decreasing retention levels, joining a pooling arrangement, or implementing risk control programs, should usually be undertaken only if the benefits outweigh the costs.

The usual way to compare benefits to costs is to use Time Value of Money concepts because benefits (inflows) and costs (outflows) often occur in different time periods.
Fund Balance Amounts – What is available?

The School Risk Manager needs to know if, and how much of a particular fund balance is reserved or designated for risk management purposes.

Reserves are typically found in the district’s General Fund but may exist in most governmental fund types. General Fund balances, if necessary, can be used to pay for unbudgeted expenses and unforeseen losses whether property and casualty, health insurance or workers compensation losses and/or funds for replacement of roofs or major equipment.

Reserves and contingency amounts for employee benefits, such as health insurance and workers compensation, would typically be found in the district’s Internal Service Fund or similar type account.
Cost of Risk

Cost of Risk (COR), also referred to as Total Cost of Risk (TCOR), is a term used to describe the monetary values associated with retaining, transferring, controlling, and administering the school district’s risk management program.

There are five components of Cost of Risk:

1. Risk Management Departmental Charges
2. Insurance Premiums
3. Retained Losses (Active & Passive)
4. Outside Services
5. Other Considerations

Retained Losses (Active & Passive)

ACTIVE retention is when the school makes a conscious decision, PRIOR to a loss occurring, to be financially responsible for some or part of a loss. For example, the decision is made to carry a $25,000 deductible on the school’s property insurance. The $25,000 deductible is an example of active retention. Another example is the school that chooses not to carry collision coverage on its older vehicle. Should a collision loss occur, the school would be financially responsible for the repairs to the vehicle; again, an example of ACTIVE retention.

PASSIVE retention, on the other hand, is when the school doesn’t know, until AFTER a loss, that it is responsible for the financial consequences of the loss. Passive retention can be referred to as “WHOOPS”. Passive retention can occur when the risk manager fails to identify an exposure to loss or when outside funding for the loss isn’t put into place.

Outside Services

This includes the cost for services obtained external to the school district such as the fees to hire a risk management consultant for a project, the cost of a Third Party Administrator for handling the claims from the district’s self-insured workers compensation program, fees to hire a risk control or safety expert, cost of actuarial services to help the risk management department with services such as trending and development, legal services for a specific claim, or the fees paid to an insurance agent or broker.
Other Considerations

These mix direct and indirect costs. For instance, loss of productivity cannot be easily captured and reported in the cost of risk, where cost of overtime and cost of a substitute teacher can be tracked and reported. Below are three examples of other considerations:

Example 1 – Loss of Productivity
Co-workers who witnessed a maintenance worker falling from a ladder may not be as productive as they otherwise would have been, due to their concern for the injured person.

Example 2 – Cost of Overtime
The maintenance department has to work overtime to get a temporary classroom ready when a normal classroom is damaged by a small fire.

Example 3 – Extra Cost for Substitute Teacher
A teacher is injured on the job and will be out on disability; therefore, a substitute teacher will be required.

Now that you know the five components of Cost of Risk, let's look at how this knowledge can be used by the risk manager. Once risk managers know their district's Cost of Risk, they can:

- **Measure progress towards meeting risk management objectives**
  The risk manager compares the cost of risk to the budget for the risk management department. Is it on track to meet budget?

- **Compare on a year-to-year basis to monitor improvement or areas of concern**
  Compare this year's overall COR with last years, comparing it component by component to determine any differences. Compare COR from year to year based on the number of full time employees. Do a more detailed time series analysis on vehicle losses from year to year based on lane miles driven or number of vehicles operated. Are the insurance premiums higher or lower compared to last year? What about retained losses? If retained losses are lower than last year’s, is it because the risk manager implemented risk control techniques which resulted in fewer losses so fewer retention dollars spent? Did reduced losses also positively impact insurance premiums? Did the district rely more heavily on outside service providers this year resulting in an increased COR?
• **Compare to similar districts**
  Adjusting the COR data to a common index allows comparison to other districts. How does the school district’s COR compare to a similar school district in the same geographic vicinity? If the other district’s COR is lower, why? Which measurable component? Is the other district doing something that could be implemented to reduce this district’s COR?

• **Make risk control and risk finance decisions**
  Could the dollars spent on retained losses be reduced by implementing additional risk control techniques? If retention is higher than anticipated, should other finance methods be considered?

• **Focus on and promote safety and loss control**
  A risk manager can show management or other departments tangible results of the risk management department’s efforts when the COR shows improvement in the areas of insurance premiums and retention. Likewise, when the COR is increasing due to losses, it is easy to use the numbers to focus others on the need to lower expenses by reducing the frequency or severity of losses.

### Example of School District Cost of Risk

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Risk Management - Internal (administration)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Insurance costs (net of placement, other fees)</td>
<td>800,000</td>
</tr>
<tr>
<td>Retained Losses and Allocated Loss Adjustment Expense (ALAE) (Based on expected developed loss costs)</td>
<td>850,000</td>
</tr>
<tr>
<td>Outside Services:</td>
<td></td>
</tr>
<tr>
<td>Consulting, coverage placement</td>
<td>50,000</td>
</tr>
<tr>
<td>Claims administration</td>
<td>85,000</td>
</tr>
<tr>
<td>Other risk control</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1,910,000</strong></td>
</tr>
</tbody>
</table>

The majority of a school's funds should be allocated to educational costs such as teachers' salaries and classroom materials.

The higher the Cost of Risk, the less that can be spent on the true mission of a school district: instruction.

**Complete the Knowledge Check: Section 2 Cost of Risk p13 (FSR)**
Cash Flow Concepts

The underlying principle of Time Value of Money (TVOM) is that because of its earning capacity, a dollar today is worth more than a dollar in the future. If dollars can earn interest, they will be worth more the earlier they are received. Likewise, dollars received in the future are worth less because there is not an opportunity to earn interest and there is reduced purchasing power due to inflation.

While most school districts do not normally have large amounts of money in savings accounts, they are subject to opportunity costs for money; that is, the opportunity for their money to earn interest.

A discount rate is the interest rate used to calculate the present or future value of money.

**Discount Rate:** The compliment of the interest rate used to determine the Weighted Average Cost of Capital (WACC). The discount rate is used to compute net present value from amounts to be realized in the future.

The discount rate your school district’s Chief Financial Officer uses for financial calculations should also be used for your district’s Time Value of Money calculations.

Most decisions made by school risk managers are financial decisions involving the inflow and outflow of dollars.

Since inflows and outflows frequently occur at different times, Time Value of Money concepts are applied.
Terms Associated with Time Value of Money (TVOM)

These three terms are associated with Time Value of Money. Let’s look at each one by applying it to a relevant example: the purchase of an alarm system for a vocational school.

Here is the problem we want to look at:

Due to numerous theft losses at the vocational school, the risk manager has recommended the purchase of a $90,000 video alarm system. The district will finance this purchase over a two-year period of time.

The risk manager projects the new alarm system will reduce their theft losses by $25,000 annually over the 5-year life of the system. These losses are currently retained. In addition, the property insurance company will grant a $1,200 annual credit for the next three years.

How would the risk manager rationalize, or defend, the decision to make the purchase?

When the risk manager looks at inflows and outflow without applying TVOM, it appears the district would realize a $38,600 savings by purchasing the alarm system.

Without considering TVOM, the value of "inflows," (savings, loss reduction and insurance credits) from purchasing the alarm system add up to $128,600. When you deduct the cost (outflow) of $90,000, the district realizes $38,600.

However, we know this isn’t correct, because some of these dollars are paid in the future, and some are paid now. Future dollars are worth less than receiving or paying those same dollars today.
Instead, the Risk Manager will apply Time Value of Money concepts to determine the financial impact of purchasing the alarm by bringing all inflows and outflows to the same point in time.

**Facts:** The school district will pay $30,000 now, $30,000 a year from now and $30,000 in two years. The calculation below determines the present value of these three "outflows" or payments. The calculation is based on a discount rate of 8% (given by the district's chief financial officer.)

**Important Note:**
We have determined the multipliers (.926 and .857) for the equations below by referring to a present value table. The use of this table is not within the scope of this course, and you will not be asked to calculate present or future value on the final exam.

You need only to understand that a risk manager needs to determine the value of the three outflows in today's dollars, before completing his analysis of the cost and benefits of the project.

**Calculation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Formula</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial payment</td>
<td>$30,000 x 1.00</td>
<td>$30,000.00</td>
</tr>
<tr>
<td>2nd Payment</td>
<td>$30,000 x .926</td>
<td>$27,780.00</td>
</tr>
<tr>
<td>3rd Payment</td>
<td>$30,000 x .857</td>
<td>$26,200.00</td>
</tr>
<tr>
<td>Total Outflows</td>
<td></td>
<td>$83,980.00</td>
</tr>
</tbody>
</table>

This means that the present value of the three payments is estimated to be $83,980.00.

The amount that today's dollars can grow in the future when compounded at a given interest rate, or the value of a future payment or payments made in today's dollars at a given interest rate.
Facts

The school district expects to save $25,000 a year for five years beginning now due to an anticipated reduction in retained losses. The district will also receive a $1,200 credit on its property insurance for each of the next three years.

Again, we referred to a present value table to get the multipliers that you see in our calculations on the right. (You do not need to perform the calculations for this course.) We adjust all of the values of the inflows into today's dollars and total them.

Total value of "inflows" $111,139.00

(Notice that the multiplier gets smaller every year as the 8% discount rate is applied further into the future (the value of the dollar declines.)

Calculations

Savings this year: $25,000 x 1.00 = $25,000.00
                      $1,200 x 1.00 = $1,200.00
Savings at the beginning of year 2: $25,000 x .926 = $23,150.00
                          $1,200 x .926 = $1,111.00
Savings at the beginning of year 3: $25,000 x .857 = $21,425.00
                          $1,200 x .857 = $1,028.00
Savings at the beginning of year 4: $25,000 x .794 = $19,850.00
Savings at the beginning of year 5: $25,000 x .735 = $18,375.00
Total Inflows                        $111,139.00

The amount of today's dollars, or the value today of a future payment or payments discounted at the appropriate discount (interest) rate
The National Alliance for Insurance Education & Research

The Net Present Value (NPV) is the difference between the present value of the benefits of a project and the present value of the costs of a project. A positive NPV indicates the project will make (or save) more money than it will cost and will probably be a “go” from a financial standpoint.

Here is the NPV for the vocational school’s alarm system:

$111,139 (Inflows)  
- 83,980 (Outflows)  
__________________  
$ 27,159 (Positive NPV)

When TVOM was not applied, the NPV was calculated to be $38,600 – an $11,000+ overstatement of benefits!

Complete the Knowledge Check: Section 2 Present & Future Value p23 (FSR)

Loss Development & Trending

A risk manager analyzes current loss runs to determine trends and to accurately estimate the district’s future losses.

The first step is to gather information from loss runs. However, the risk manager cannot rely on this “raw data” to accurately estimate future losses.

**Raw Loss Data** – Loss runs are only the starting point when trying to predict losses for the future.
To illustrate this point, let's look at an example:

A school district's loss run shows several losses turned in towards the end of the loss run cycle. One of those losses is for a grade school student hurt while on a field trip. The loss reserve is $25,000.

The claims investigation is not complete and the full extent of the child's injuries is not known. It could take years to close this claim.

Do you think this claim will only cost $25,000? Probably not, and neither does the risk manager, based on the district's past loss history. This is when Loss Development and Trending come in. The risk manager will use a Loss Development Factor and an Inflation Index Factor to turn today's loss values into tomorrow's estimated final payout.
Development Factors

As we just saw, loss runs may not include all losses for that specified period of time as not all losses are reported as soon as they occur. In addition, the amount shown for a specific claim may not be the amount for which it eventually settles. Liability and workers compensation settlements typically increase with age – the longer the claims process, the larger the payout. Claims do not get better with age!

The Development Factor is a ratio that is applied to current valuation of losses to determine an estimate of ultimate payout (accumulation of all payments on a claim up to and including the final payment). This is an example of severity development. It is assumed that current losses will be paid according to the same patterns as prior losses at similar stages of development.

Development Factors are frequently calculated separately for incurred losses, paid losses, and claim counts.

Developed Losses – Development Factors are applied to losses to account for potential ongoing costs as losses develop over time.

Inflation Index Factors

The next step is to apply an Inflation Index Factor to previous losses in order to value them in today’s costs. The inflation index factor allows for more accurate comparisons from year to year.

Because of inflation, a loss that settled in 2002 for $5,000 would settle for much more now. It could appear that the district is having larger losses compared to years past, when in fact the increase may be solely due to inflation.

By applying the Inflation Index Factor, the risk manager is able to convert the value of old losses into today’s dollar. This allows for more accurate comparisons of loss data from one year to another.

The index used should be determined by the type of loss being adjusted. For example, workers compensation losses could use a medical inflation index, and building damages could use a construction index.

Losses Indexed to Inflation – Losses are indexed to inflation to account for changes in prices over time.
Indexing to an Exposure Base

An Exposure Base is a unit used to measure loss costs, e.g. payroll, revenue, student count, number of buses, etc.

Along with Development and Inflation Index Factors, an Exposure Base is used to estimate ultimate total losses and allows for more accurate comparisons from year to year.

**Losses Indexed to an Exposure Base** - An exposure base is applies to losses to account for changes in risk exposures

Let’s look at an example of how indexing losses to an Exposure Base can be beneficial to a risk manager when comparing one year to another.

The district’s Workers Compensation losses were developed and indexed to inflation as shown. Clearly the district’s losses have increased substantially over the past five years; increasing from $160,758 to $941,324.

It is obvious the district has experienced an increase in its frequency &/or severity of losses – but why? Have the district’s exposures to loss (student count, payroll, number of teachers, etc.) remained the same? If so, the staggering increase in losses would be a major concern to the risk manager. But, what if the increase in losses is due to an increase in exposures?

Indexing losses to an Exposure Base might give the risk manager better insight as to what has taken place and what may take place in the future.

<table>
<thead>
<tr>
<th>Year</th>
<th>Indexed Ultimate Total Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>'X1</td>
<td>$160,758</td>
</tr>
<tr>
<td>'X2</td>
<td>$633,160</td>
</tr>
<tr>
<td>'X3</td>
<td>$581,912</td>
</tr>
<tr>
<td>'X4</td>
<td>$504,889</td>
</tr>
<tr>
<td>'X5</td>
<td>$941,324</td>
</tr>
</tbody>
</table>
In this example, the risk manager used payroll as the Exposure Base (or the unit) for measuring losses.

Look at the range of payroll among the five years. One reason for the increase in losses between the first and last year may have something to do with the difference in payroll. If the district has more employees (more exposures to loss), the district would expect to have more Workers Compensation losses.

Even though Year ‘X2 and Year ‘X5 had different loss experience and different levels of payroll, they are similar, in that both years had losses that ran close to 4.8% of payroll.

<table>
<thead>
<tr>
<th>Year</th>
<th>Indexed Ultimate Total Losses</th>
<th>Payroll (Adjusted for Inflation)</th>
<th>Indexed Ultimate Total Loss Rate (Losses/Payroll)</th>
</tr>
</thead>
<tbody>
<tr>
<td>'X1</td>
<td>$160,758</td>
<td>$8,119,098</td>
<td>.020</td>
</tr>
<tr>
<td>'X2</td>
<td>$633,160</td>
<td>$13,315,321</td>
<td>.048</td>
</tr>
<tr>
<td>'X3</td>
<td>$581,912</td>
<td>$15,179,446</td>
<td>.038</td>
</tr>
<tr>
<td>'X4</td>
<td>$504,889</td>
<td>$17,152,796</td>
<td>.029</td>
</tr>
<tr>
<td>'X5</td>
<td>$941,324</td>
<td>$19,725,716</td>
<td>.048</td>
</tr>
</tbody>
</table>

Improved loss trending information is achieved when losses are first developed and then indexed for inflation.

The information gained provides the school district risk manager with an indication of whether losses are proportionately increasing, decreasing, or remaining the same. Once that is known, appropriate loss control and risk financing measures can be taken to address problems.
The topics we've covered so far are reviews of material presented in other CSRM courses.

**Time Value of Money** and **Loss Development/Trending** are tools useful for determining the most effective funding solutions.

Cost of Risk is the framework within which all risk funding activity occurs. Any risk funding solution should be understood in terms of its impact on Cost of Risk.

**Time Value of Money**: Recognizes the change in the value of a dollar due to time. TVOM calculations involve both Present Value and Future Value.

**Loss development**: The difference between the original loss as originally reported to an insurer and its subsequent evaluation at a later date or at the time of its final disposal.

Complete the Knowledge Check: Section 2 Development & Trending Tools p33 (FSR)

**Basic Insurance Terms**

Insurance, as with most industries, uses a language of its own.

Since insurance is a frequently used method to finance losses, risk managers should be familiar with commonly used insurance terms and concepts, which will be helpful when communicating with their agent, broker, claims adjuster or insurance company.

- **Agent**
  
  Person or organization who solicits, negotiates, or instigates insurance contracts on behalf of an insurer (insurance company).

  Agents can be independent businessmen/businesswomen or employees of the company. The agent represents the insurer.

  Some states may not have agents/brokers licenses, replacing them with producer licenses.
The broker negotiates insurance for the insured.

When licensed and acting as a broker, the individual does not represent an insurance company – the broker represents the insured. This is a major difference between an agent and a broker.

Some states may not have agents/brokers licenses, replacing them with producer licenses.

- **Insured**
  
The person(s) protected under an insurance contract.

- **Insurer**
  
The insurance company covering the risk or providing the insurance protection; the insurer agrees to indemnify for insured losses and perform other insurance-related operations as defined in the insurance contract (policy).

- **Underwriting/Underwriter**
  
The process an insurance company uses to decide whether to accept an application and issue the insurance policy as requested, issue the policy with either pricing or coverage modifications or reject the application for coverage.

  The person at the insurance company performing this function is called an underwriter.
**Peril**

A “cause” of loss; an event which may be the cause of a loss. Some insurance policies use the term “cause of loss” instead of “peril”.

The perils of fire, wind, theft, vandalism, earthquake, flood, etc., can all cause damage to a building. Disability is a peril that can result in loss of income to a person.

Property insurance policies will identify the perils that are covered and the perils that are excluded from coverage.

**Exclusion**

An exclusion is language in an insurance policy that either restricts or takes away coverage completely. Exclusions may impact coverage by limiting or excluding specified types of property, certain perils, or specific activities.

Exclusions are also used when the insurance company is unwilling to provide a particular coverage otherwise covered by the policy. The insurance company would add an exclusion to remove the undesired coverage. For example, the insurance company covering the school buildings may not be willing to provide hail coverage in a hail-prone area. An exclusion taking away hail coverage would be added to the insurance policy.
It is extremely important to understand the coverage provided by an insurance policy, including the exclusions, since the insurance company will only pay for losses that are covered by the policy. Most insurance policies contain exclusions. For example, most property insurance policies automatically exclude loss resulting from war, and most liability policies automatically exclude bodily injury intentionally caused by an insured.

- **Deductible**
  
The amount of the loss covered by an insurance policy that the insured is financially responsible for prior to the insurance company paying its portion of the loss. The deductible is stated on the policy’s declarations and can be either a flat amount or a percentage of either the loss or the amount of insurance.

  Property insurance policies typically contain a deductible. Most liability policies do not have deductibles.

  A deductible is a form of retention.

  Example: Effingham County School District has a $10,000 deductible on its property insurance. A fire damages a school building causing $100,000 damage. The school district will retain (be responsible for) the first $10,000 of the covered loss (the deductible) and the insurance company will pay the rest.

- **Binder**
  
  A temporary insurance contract issued when insurance coverage is placed in force (bound) and the agent or broker either has binding authority with the insurance company or has received permission from the insurance company to bind coverage.

  The binder is proof of insurance coverage pending the insurance company’s issuance of the policy or an endorsement.

- **Certificate of Insurance**
  
  Issued for informational purposes only and states the coverage that was in effect on the date the certificate was issued.

  Information contained on a Certificate of Insurance includes the named insured, insurance company, effective and expiration dates of the policy, deductible amount, coverages and limits of insurance.

  A certificate of insurance is not a contract or legal document, it does not give any rights to the certificate holder and it does not amend, extend, or change the policy.

*Complete Knowledge Check: Section 2 Insurance Terms p37 (FSR)*
Admitted and Non-Admitted Carriers

Admitted Carriers are those insurance companies licensed by a state’s Department of Insurance to do business in that state. They provide the majority of insurance coverage in the United States. Admitted Carriers are covered by the state’s Guaranty Fund if they fail financially.

Non-admitted Carriers, also referred to as surplus lines carriers, write property and casualty coverages that Admitted Carriers will not write. Non-admitted Carriers are not covered by a Guaranty Fund so claims could go unpaid if the company becomes insolvent.

Premium Terms

Premium is the amount paid by an individual or organization for insurance coverage.

Written Premium refers to the total premiums of all policies written by an insurer during a specified period of time, which is usually one year. An insurer with $10,000,000 Written Premium means that the premiums for all policies in force at that time total $10,000,000.

Written Premium is comprised of Earned Premium and Unearned Premium. The risk manager should have an understanding of these terms as they are used by insurers when calculating profitability/loss ratios.

Written Premium consists of:

- **Earned premium**, or that portion of a policy's premium that has been "used" by the insurer to provide insurance coverage, and
• **Unearned premium**, or that portion of the policy's premium that has not been "used" to provide insurance coverage. This is typically the portion of the premium that will be returned to the insured if the policy is cancelled.

**Example:**
Clover Park School District has a policy with a $365,000 annual premium. Each day the insurer provides coverage, i.e. each day that goes by, the insurer “earns” $1,000 ($365,000 divided by 365 days in a year = $1,000 per day.)

The policy has been in force for 90 days.

$365,000 (Written Premium) - $90,000 (Earned Premium) = $275,000 (Unearned Premium)

Audited Premium is an adjusted premium resulting from a review of the exposure base that is usually performed by the insurance company at the end of a policy period.

Some policy premiums are based on an estimated exposure. If an audit reveals the exposure base was underestimated, additional premium will be owed for the previous policy period. If the exposure base was overestimated, a return premium may result.

For example, Workers Compensation premiums are audited against classification codes because employees move in and out of classifications based on changes in jobs. Exposure bases for other types of insurance policies include payroll, number of students, number of buses, number of teachers, etc.

Business auto policies and general liability policies are also typically subject to an audit.

**Complete Knowledge Check: Section 2 Insurance Terms p42 (FSR)**
Loss Terms

Loss Pic is the school district’s projected losses; forecasted losses. The Loss Pic is determined after an analysis of historical losses including trending and development.

Stop Loss

Limits, or places a cap on the school district’s out-of-pocket expenses due to a loss.

A school district may choose to self-insure its buildings. Not wanting to have an unlimited property retention, the district may choose to purchase excess insurance over its self-insured plan to cover that part of a property loss that exceeds a specified threshold.

Aggregate Stop Loss

Applies to an insured plan with a deductible (deductible plan). When the total amount paid for deductibles reaches a predetermined amount as specified in the policy, the insurer will pay 100% of subsequent claims.

The school district has a $100,000 deductible, it may wish to limit the total out-of-pocket losses to $300,000. Once the school district has paid a total of $300,000 the insurer pays 100% of future losses up to the insurance policy’s limit of coverage.
Attachment Point

Attachment Point is a term used when an excess liability policy is part of an insurance program. Since excess insurance is not designed to provide first dollar coverage, it “attaches” or pays for losses only after the dollar amount of the loss reaches a specified threshold.

The school district needs to arrange financing for losses falling below the Attachment Point of its excess policy. If insurance is used, it is commonly referred to as underlying insurance.

In this example, the excess policy will only cover that part of a loss that exceeds $1,000,000, up to a maximum of $4,000,000 (Limit of Coverage).

Paid Losses

Paid Losses refers to the amount actually paid in losses during a specified period of time, usually a policy year. Paid Losses do not include estimates of amounts that will be paid in the future (reserves).

Incurred Losses

Incurred Losses refers to the total of Paid Losses plus reserves and Allocated Loss Adjusting Expenses (ALAE).

Probable Maximum Loss (PML)
Maximum amount of loss that can reasonably be expected under ordinary circumstances. Also known as PML.

Example #1: The school district has a fleet of buses.
An analysis of past years’ loss run suggest the probable maximum loss next year will be equivalent to a portion of the overall value of the fleet. The maximum possible loss, however, could be equivalent to the value of the entire fleet.
Maximum Possible Loss
The worst case scenario; the greatest amount of loss that could occur.

Example #2: The school district has two bus transportation barns, each on opposite ends of town, with half of the buses parked at each location.

The probable maximum loss would be equivalent to the total value of all buses parked at one location since the buses at one location could all be damaged at the same time; i.e. all vandalized, all destroyed by fire, etc. The maximum possible loss would be the total value of all buses at both locations as all of the buses could be damaged or destroyed should a natural disaster occur.

Case or Claim Reserve
The amount the claims adjuster assigns to an individual claim for future payment. There is no provision for development or Incurred But Not Reported (IBNR).

Loss Reserve
An estimation of the liability for unpaid claims that have occurred as of a given date. Loss Reserves include Incurred But Not Reported (IBNR) claims, losses due but not yet paid, and amounts not yet due.

Incurred But Not Reported (IBNR)
Incurred But Not Reported (IBNR) represents the liability for unpaid claims that is not reflected in the case reserve estimates for individual losses.

IBNR includes:

Additional cost development on known (severity development) cases based on historical data. For example: a back injury that will require additional surgery or physical therapy in subsequent years.

Reporting of claims that occurred during the policy period, but were not recorded as of the evaluation date (the date the losses were reviewed or evaluated). For example asbestosis may not manifest itself for many years after the exposure to asbestos has occurred.
IBNR also includes accounting for claims that are assumed to have occurred but have not yet been reported (frequency development).

**Loss Expense Terms**

Allocated and Unallocated Loss Adjustment Expenses are incurred by an insurance company during the claims process. (If the school district is self-insured, these claims expenses would be absorbed by the school district.)

The risk manager should be familiar with these terms and the information each represents, as they are used in Cost of Risk and other calculations.

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**Complete Knowledge Check: Section 2 Insurance Terms p51 (FSR)**

**Ratios**

Loss Ratios are one important method of financial analysis for an insurer. A loss ratio is simply a comparison of the insurer’s losses compared to its earned premium.

A Loss Ratio can be used not only to compare how the insurance company is doing as a whole or by type of coverage, but also to see how the school district’s individual insurance program is performing.

Let’s look at each of the following ratios.
Pure Loss Ratio: Incurred Loss ÷ Earned Premium

The underwriter is reviewing the school districts general liability insurance. During the last policy period the district had $250,000 in incurred losses (known claims reserves and IBNR reserves). The earned premium was $450,000.

$225,000 ÷ $450,000 = 50%

This means that 50 cents of every $1 in premium paid by the school district was used by the insurance company to pay for losses. This leaves 50 cents for expenses, ALAE, agent/broker compensation and profit.

Total Loss Ratio: (Incurred Losses + ALAE) ÷ Earned Premium

In addition to the $225,000, the insurance company also incurred $50,000 in ALAE. The earned premium was $450,000.

$275,000 ÷ $450,000 = 61%

This means that 61 cents of every $1 in premium paid by the school district was used by the insurance company to pay for losses and direct expenses associated with those losses. This leaves 39 cents for other expenses, agent/broker compensation and profit.

What if the total losses had been $500,000 instead of $275,000? The Total Loss Ratio would have been 1.11% meaning that for every $1 in premium received, the company paid $1.11 in losses.

This could have a negative impact on school district’s renewal and/or the renewal pricing.

Expense Ratio: Underwriting Expenses ÷ Earned Premium

In this example, the underwriting expense for the insurance company is $300,000 and the earned premium is $9,000,000.

$300,000 ÷ $9,000,000 = 33%

This means that 33 cents of every $1 in premium paid by the school district was used by the insurance company to put the "business on the books".
Combines Ratio: Total Loss Ratio + Expense Ratio

Using the Total Loss Ratio calculated earlier, let’s look at the insurer’s Combined Ratio for the school district’s general liability insurance:

61 % (Total Loss Ratio) + 33 % (Expense Ratio) = 94 % (Combined Ratio)

This means that 94 cents of every $1 in premium paid by the school district was used to pay claims and cover expenses.

While the school district has no control over insurer expenses, it does have some control over its losses.

Required, Permitted, and Prohibited Coverages

State laws may regulate the insurance coverage that a school district is required to purchase and may prohibit purchase of other types of coverage. The required and prohibited coverages vary from state to state. When not addressed by state law, other coverages may be at the discretion of the school district.

Typically required coverages:

- Health Care Coverage for full-time school district employees
- Workers Compensation Insurance for workers who suffer work related injuries or illnesses.
- Medical Liability Insurance for medical professionals (physicians and nurses) who administer treatment or medication to students
- Motor Vehicle Insurance for other people’s bodily injury and property damage caused by drivers covered under the school district’s insurance. (The amount of liability coverage required for motor vehicle insurance varies state by state.)
Permitted Coverages that the District May Choose to Purchase

<table>
<thead>
<tr>
<th>Bodily Injury</th>
<th>Commercial Property Insurance</th>
<th>General Liability Insurance</th>
<th>Educators Legal Liability (ELL)</th>
<th>Collision and Comprehensive Auto Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Covers injuries sustained by students during athletic competition. The law may limit the amount of coverage a district may purchase and may stipulate that failure to carry it does not create any increased legal liability.</td>
<td>Protects against damage to school district property caused by a covered peril such as fire, lightning, wind, hail, etc. Other property-related coverages that typically require the issuance of a separate policy include crime, flood and earthquake.</td>
<td>Protects against wrongful acts or omissions or the negligence of the school district and its employees resulting in bodily injury or property damage.</td>
<td>A specialized professional liability policy that provides liability coverage (including defense) for teachers, school leaders, district officers, and board members for acts, errors, and omissions arising from their services as professional educators. It usually covers such allegations as discrimination, harassment and failure to educate. Volunteers may be included.</td>
<td>Provides coverage for damage to vehicles owned, leased or hired by the school district caused by a collision or other perils including fire, hail, theft, vandalism and glass breakage.</td>
</tr>
</tbody>
</table>

School Districts May be Prohibited from Purchasing Some Auto Coverages:

- Medical Payments Coverage which pays for medical and funeral expenses for people occupying an insured vehicle regardless of who is at fault.

- Personal Injury Protection (PIP) pays for medical and funeral expenses for an insured. Depending on the state’s PIP law, it may also provide coverage for loss of income, childcare, and loss of services. PIP is not available in all states and may be referred to as No-Fault Coverage.

- Uninsured or Underinsured Motorists (UM/UIM) coverage pays for bodily injury incurred by a vehicle owner, occupant, or pedestrian as a result of an
accident that is the fault of another driver with either (1) no insurance or (2) insufficient insurance.

- UM/UIM allows insureds to collect from their own insurance company the monies they should have been able to collect for their injuries from the at-fault uninsured or underinsured driver.

Insurance Market Overview

With insurance a frequently used risk finance tool for some or all of a school district’s exposure to loss, the risk manager should be aware of market factors that may affect coverages, insurability, premiums, and insurance services:

Hard vs. Soft Markets

Market’s Willingness to Accept the School District’s Risks

“Unbundling” Opportunities

Alternative Markets

Hard vs. Soft Markets

Insurance availability and pricing in both the primary and reinsurance market is often dictated by the condition of the insurance marketplace and whether it is a “Hard Market” or a “Soft Market”.

How the market changes from “hard” to “soft” or from “soft” to “hard” will not be covered in this course. This course will provide the risk manager with the characteristics of these markets and the impact on coverage availability and pricing.

Characteristics of Soft & Hard Markets include:

<table>
<thead>
<tr>
<th>Soft Market</th>
<th>Hard Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Coverage more readily available</td>
<td>• Coverage may not be available at all</td>
</tr>
<tr>
<td>• Premiums may be lower</td>
<td>• Premiums may be higher</td>
</tr>
<tr>
<td>• Deductibles may be lower</td>
<td>• Deductibles may be higher</td>
</tr>
<tr>
<td>• Higher limits of coverage may be available</td>
<td>• Coverage may be more restricted</td>
</tr>
</tbody>
</table>
Market’s Willingness to Accept School Risk

Some insurance companies are not interested in providing insurance protection for school district risks. Other insurance companies are known to specialize in school risks.

Market conditions, hard vs. soft market, may also affect the willingness of an insurance company to cover the school district’s risks.

“Unbundling” Opportunities

When a school district purchases insurance coverage, the insurer typically includes some services at no additional cost.

For example, the insurance company would provide claims adjusting and loss control services at no charge to the school district. These services are said to be “bundled” with the insurance coverage.

There are situations when a school district chooses self-insurance as a financing method instead of purchasing insurance. Yet, the district may still need services typically provided by insurance companies when insurance is purchased from them.

Some insurance companies allow some of their services to be purchased separately from insurance coverage.

This “unbundling” of services allows the school district to purchase needed services from the insurance company without purchasing insurance protection.

Alternative Markets

Alternative market options, such as insurance pools, may be limited for schools.

Pools will be discussed in Section 3 - Options for Funding School Risks

Tailoring the Insurance Policy

Insurance policies are rarely issued without an endorsement. Endorsements are used to restrict coverage, provide coverage, or to comply with state requirements by changing policy language.

Endorsements can enable a school district to tailor an insurance policy to meet its unique needs.
Restrict Coverage

The insurance company may be unwilling, due to underwriting or pricing considerations, provide a coverage that is included in the policy. An endorsement would be used to exclude coverage.

Provide Coverage

The school district may need coverage that is not automatically provided by the insurance policy. An endorsement or endorsements may be used to tailor the coverage to meet the specific needs of the district.

Comply with State Requirements

The state’s Department of Insurance may require insurance companies to change policy language to comply with the state’s insurance statutes or regulations such as cancellation or non-renewal requirements. An endorsement would be used to change policy language to comply with the state’s insurance laws or regulations.

Solvency of Insurance Company or Insurance Company Ratings

There are several organizations that assign a rating to insurance companies. These ratings are an indicator of the insurance company’s financial stability.

The financial condition of an insurance company is very important to the risk manager. Should the insurance company become financially insolvent, it may not be able to pay claims. This could require the school district to use internal funds to pay claims. Sound like passive retention?

The risk manager should be aware of and use the insurance company’s financial rating as one consideration when making a buying decision. The school district’s insurance agent or broker should be able to provide that information. Other resources include rating organizations that monitor the financial stability of insurance companies as well as the National Association of Insurance Commissioners and the individual states’ Department of Insurance.

Passive retention Unplanned acceptance of losses because of failure to identify risk, failure to act, or forgetting to act.

Please refer to the end of Section 2 to go over the section exercises and self quiz.
Section 3 Options for Funding School District Risks

Financing of Risk (Funding of Risk) is the fourth step in the Risk Management Process. There are several options from which risk managers can choose when deciding how to finance their district’s losses. As each option has unique characteristics, risk managers need to have a working knowledge of each, including its benefits and potential disadvantages. It is only with this understanding that risk managers can make the best financing decision for their district.

Learning Objectives
By the end of this section you will be able to:

1. Know the methods of transferring the financial obligation of a loss
2. Know the difference between active and passive retention
3. Understand the general criteria used for comparing various risk financing options
4. Know the characteristics, advantages, and disadvantages of a guaranteed cost plan
5. Know the characteristics, advantages, and disadvantages of a deductible plan
6. Know the characteristics, advantages, and disadvantages of a self-funding plan
7. Know the characteristics, advantages, and disadvantages of a pooling arrangement
8. Understand the factors that determine the amount of insurance to purchase

Funding School District’s Risks

Selection of the most appropriate funding options is dependent upon the quality and relevance of the work performed during the identification and analysis steps. After all, it is unlikely that financing will be arranged for an unknown exposure to loss or for a loss that isn't considered to be high in frequency and/or severity.

Financing risk involves numerous options risk managers need to understand before they can make financing decisions that are best for their district.
A non-insurance transfer is usually a contractual arrangement that requires others, outside of the school district, to pay for certain losses.

Risk Financing Transfer

- Non-Insurance Transfer
  - Indemnity Agreement
  - District Named as Additional Insured
  - Hold Harmless Agreement
  - Waiver of Subrogation

- Insurance Transfer
  - Guaranteed Cost Plan
  - Deductible Plan
  - Self Insured Retention
  - Pooling
Indemnity Agreement

An indemnity agreement requires the other person or organization to indemnify the school district for the financial consequences should a loss occur that is the subject of the agreement.

Indemnify: To make compensation to an entity for incurred hurt, loss, or damage; restore to original position

An indemnity agreement is frequently used in conjunction with a hold harmless agreement.

Example:
ABC Construction is awarded a contract by Alpena Public Schools to repair the roof of the high school. The contract contains an agreement that requires ABC to compensate Alpena Public Schools for any loss that occurs during the roof repair.

Named as Additional Insured

Being named as an additional insured on another person’s or organization’s insurance policy provides the school district with protection for losses covered by that insurance policy. It may also provide defense coverage if certain requirements are met.

Example:
The same contract for the roof repair requires ABC Construction to add Alpena Public Schools as an additional insured on its liability insurance policy.

As an additional insured, Alpena Public Schools has coverage for losses covered by ABC’s insurance policy.

Hold-Harmless Agreement

A hold harmless agreement is a provision in a contract that requires one person or organization to respond to certain legal liabilities of the other person or organization; in other words, to hold them “harmless” should there be damages or injuries to a third party.
Example:
The contract for the roof repair includes a hold harmless agreement. ABC Construction is required to hold Alpena Public Schools harmless should a third party suffer damages or injuries during the construction.

During the roof repair, a tile falls and injures a student. Should the student make a claim against Alpena Public Schools, ABC Construction would be responsible for the damages because of the hold harmless agreement.

Waiver of Subrogation

A Waiver of Subrogation is a provision in a contract; however, it only applies to losses that are covered by the other person’s or organization’s insurance policy.

It protects the school district in situations when the school district is responsible for a loss that is covered by the other party’s insurance policy. It stops the insurance company from seeking financial recovery from (subrogating against) the school district after the insurance company pays the loss.

Subrogation: 1) The right of a person to assume a legal claim of another; the right of a person who has paid a liability or obligation of another to be indemnified by that person; an insurer’s substitution in place of the insured in regard to a claim against a third party for indemnification of a loss paid by the insurer; 2) The substitution of one person in place of another with reference to a lawful claim, demand, or right held or owned by the original party.

Example:
Alpena Public Schools leases a warehouse from BEK Industries. The lease agreement includes a Waiver of Subrogation.

Due to the negligence of a district employee, the warehouse burns to the ground. BEK’s property insurance company paid $500,000 to rebuild the warehouse. The Waiver of Subrogation stops the insurance company from being able to seek reimbursement of the $500,000 from the school district.
Complete Knowledge Check: Section 3 Transfer p12 (FSR)

Methods of Transfer: Insurance

Insurance is a relatively small cost substituted for the potential or unknown of a large loss. It is based on the theory of indemnity.

Insurance coverage can be written on a Guaranteed Cost or a Loss Sensitive basis.

The premium for a Guaranteed Cost plan is charged on a prospective basis, but never on the basis of the school district’s actual loss experience during the policy period.

On the other hand, the cost of a Loss Sensitive plan is impacted by the actual losses the school district has during the policy period.

Indemnification: Policies written on an indemnification basis reimburse the insured only after the insured has paid their own loss first.

Prospective: Meaning from the present going forward

Insurance Transfer

- Guarantee Cost basis
- Loss Sensitive basis

Note: Guaranteed Cost and Loss Sensitive plans will be covered shortly.

Retention

Retention is using funds from inside the school district to pay for losses. Active Retention occurs when the school district makes a conscious decision to retain a loss. Funding for retained losses comes from one of three sources: Current Expenses, Funded Reserves or Unfunded Reserves.
Passive Retention occurs when the school district is unaware it retained a loss until AFTER the loss occurs.

Since financing arrangements were not made for a loss the district didn’t know it was retaining, internal funds will have to be found to pay for a passively retained loss. As you can imagine, Passive Retention should be avoided.

There are typically three causes of passive retention.

**Failure to Identify**

A newly acquired piece of expensive equipment in the Science Lab was not added to the Asset List.

**Failure to Act**

The equipment was listed on the Asset List; however; replacement cost was not updated when the list was reviewed.

**Forgetting to Act**

The equipment was listed on the Asset List and the school district recognized the need to purchase special insurance coverage. However, the insurance coverage was not obtained.

**Complete Knowledge Check: Section 3 Retention p16 (FSR)**
Criteria for Comparing Options

Risk managers have various risk financing options from which to choose. To determine which option is the best for their district, risk managers should review the program characteristics and key issues.

One method useful for evaluating risk financing options is to compare each of the seven criteria shown below.

Each provides a different way of looking at the complexities of insurance programs and is useful for making reasonable comparisons among different programs.

Seven Criteria for Comparison

1. Degree of Retention
2. Cash Flow
3. Loss Sensitivity
4. Program Flexibility
5. Mechanics of Program
6. Program Services
7. Implementation Issues
Degree of Retention

Financing options under consideration should be compared with regard to each option’s Degree of Retention. How much can the school district afford to retain, and how much will be transferred to the insurance company?

Full transfer of risk is possible under a Guaranteed Cost Plan. (Remember: Transfer is only up to the limits of insurance purchased and for the losses covered by the insurance policy. The school district always retains risk in excess of the policy limits or outside the policy’s coverage.)

Full retention is possible through a fully Self-funded Plan.

<table>
<thead>
<tr>
<th>Degree of Retention</th>
<th>Cash Flow</th>
<th>Loss Sensitivity</th>
<th>Program Flexibility</th>
<th>Mechanics of the Program</th>
<th>Insurance Program Services</th>
<th>Implementation Issues</th>
</tr>
</thead>
</table>

↑

How much to retain?
How much to transfer?
Ranges from Guaranteed Plan to fully Self Funded Program

Cash Flow

The next criteria to compare is the program’s Cash Flow possibilities.

How much will the funding option cost? When will it have to be paid? Keeping in mind the previous discussion on Time Value of Money, the district’s objective is most likely to reduce the amount it has to pay and to pay later rather than earlier.

Premium – Must it be paid in a lump sum or are installments available? If installments are available, it may create the opportunity for the school district to earn interest income or use the funds for other risk management purposes.

Losses – From a cash flow perspective, better paid later rather than sooner. The level of retention in the funding option would have an impact on this. (Note: Paying predictable losses is more economical than paying more or higher premiums to insure them.)

<table>
<thead>
<tr>
<th>Degree of Retention</th>
<th>Cash Flow</th>
<th>Loss Sensitivity</th>
<th>Program Flexibility</th>
<th>Mechanics of the Program</th>
<th>Insurance Program Services</th>
<th>Implementation Issues</th>
</tr>
</thead>
</table>

↑

How Timing of premium and loss payments; opportunity for interest income
Degree of Loss Sensitivity

Is the cost of a funding option impacted by losses the school district will have? In other words, what is its’ Loss Sensitivity?

Different funding options have different degrees of Loss Sensitivity. For example, an insurance plan with a deductible is more loss sensitive than a Guaranteed Cost Plan.

Under a deductible plan, the school district pays a deductible for each loss. Under a Guaranteed Cost plan, the entire loss (up to the limit of insurance) is paid by the insurance company.

Funding options can be sensitive to loss frequency and/or loss severity.

Frequency Sensitivity
The school district is actively retaining the first $10,000 for each liability loss and has purchased insurance to cover losses in excess of $10,000 up to the policy’s $2,000,000 limit. The district, however, does not want to retain more than $100,000 during the next 12 months. The district has arranged insurance coverage to pick up losses from the first dollar once the district’s total retention reaches $100,000.

Severity Sensitivity
The school district is fully self-funding its auto liability. It anticipates the $1,000,000 active retention will be adequate based on the loss pic determined during risk analysis. The district, however, does not want to retain the amount of any loss in excess of $1,000,000 so it arranged for an excess insurance policy to cover losses in excess of $1,000,000 up to the limits of the excess policy.
Program Flexibility

How flexible is the funding option?

When insurance is one of the options being considered, the school district needs to determine if the insurance company can tailor the coverage to meet the needs of the school district.

Not all districts are the same and if the district is one with a unique exposure to loss, can the insurance company provide the needed protection? Are endorsements readily available?

Is the insurance company willing to unbundle claims administration?

Mechanics of the Program

Looking at the Mechanics of the Program is the fifth criteria for comparison.

When will the insurance policy be issued? Some insurance companies take longer than others for policy issuance. Is time of issuance important to the school district?

Does the premium have to be paid annually or can it be paid in installments such as monthly or quarterly?

Who is responsible for paying claims? The insurance carrier, Third Party Administrator (TPA) or the school district?

How frequently will the insurance company provide loss runs? What information is included in loss runs? Do they include reserves or only paid losses?
Insurance Program Services

Three major service areas are:
- Claims administration
- Loss control
- Information & customer service

Which of these services are important to the school district? How do they compare carrier to carrier? Will services be provided by the insurance carrier, an outside party, or performed internally? If the services are to be performed internally, does the school district have people capable of performing those services or will specialists need to be hired? How will the risk manager measure the quality of service?

Implementation Issues

For every risk funding alternative being considered, the risk manager needs to understand the associated implementation Issues.

For example, does the school district administration have the resources necessary to interface with the claims services that are being provided?

Will loss run data be accessible in a format compatible with the school district’s information system format?

Will the district need to hire additional staff to meet the needs of the funding option selected?
Options for Funding School District Risks

Let’s look at four different approaches to funding school district risks. These are not the only options available; however, they are the most commonly used options.

This table summarizes the first three Criteria for Comparison for each of these four options

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Degree of Retention</th>
<th>Cash Flow Advantages</th>
<th>Loss Sensitive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guaranteed Cost; Full Insurance</td>
<td>None</td>
<td>Generally, No</td>
<td>No</td>
</tr>
<tr>
<td>Deductible Plan</td>
<td>Low to High</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Self Funding</td>
<td>High</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Pool</td>
<td>Varies</td>
<td>Varies</td>
<td>Varies</td>
</tr>
</tbody>
</table>

Approaches to Funding School District Risks

Next we will study the characteristics, advantages, and disadvantages of each of the four plans commonly used by school districts to fund losses.
Guaranteed Cost Plan

Characteristics of a Guaranteed Cost Plan

100% transfer of risk to insurer up to policy limits and subject to the policy terms and conditions. Guaranteed Cost Plans are not loss sensitive to the current policy year.

Loss Sensitivity
The school district has three large losses during the policy period. The premium for that policy period is NOT impacted by these losses as it is a Guaranteed Cost Plan. The policy premium is the same for that policy year whether the district had no losses or had numerous losses.

The premium is fixed; the policy can be endorsed; and the premium is often subject to audit.

Fixed premium
The premium is not impacted by losses the district has or doesn’t have. However, endorsements to the policy can change the premium.

The premium is not impacted by losses the district has or doesn’t have. However, endorsements to the policy can change the premium.

Policies may be subject to audit. For example, the premium was based on the school district having 2000 students. At the end of the policy year, the audit revealed the school district actually had 2300 students. The premium that was based on number of students will be re-calculated and the school district will receive an audit bill for the additional premium due for last year’s policy.

Installments may be possible.

Payment Options
The insurance company may have payment options available so that the district can make monthly or quarterly payments rather than paying the entire premium at the beginning of the policy - cash flow advantage!
Insurance company usually provides services; unbundling is uncommon.

Unbundling of Services
The insurance company will not typically let the school district or others provide claims administration or loss control services for the insurance purchased in a Guaranteed Cost Plan.

Premium discounts, credits or debits are often possible; may be customized to some extent.

Discounts
Premium discounts, credits, or debits are based on the characteristics of the school district’s exposures to loss, loss experience, safety programs, etc. For example, a school district with few losses may have a lower premium than a school district that had many losses.

Guaranteed Cost Plan

Advantages

There is budget certainty, subject to audits. The school district knows what the insurance premiums are and can budget accordingly.

Easy, one-stop shopping. All services are provided by the insurance carrier. The school district is not responsible for claims administration.

Certificates of Insurance are provided by the insurance company or the agent/broker.

Coverage can sometimes be flexible; additional coverages may be available.

Poor experience may go unpunished at renewal.

Loss Experience and Policy Renewal
An insurer trying to establish itself in an area may be open to a second year renewal with a school district even if the loss experience was not consistent with expectations. Likewise, when a carrier is trying to establish a long term relationship with the school district, it may be more open to renewing despite poor experience over a single year.

This is more true in a Soft Market as opposed to a Hard Market. (A brief explanation of Hard Markets and Soft Markets was covered in Section 2.)
Guaranteed Cost Plan

Disadvantages

Insurer profit and expenses are passed along to the school district. Both of these items are embedded in the insurance premium paid to the insurance company.

Cash flow is poor or non-existent. The school district pays the full premium upfront and loses the opportunity to use those funds elsewhere.

Good experience may go unrewarded or inadequately rewarded at renewal. A school district with no losses may pay the same premium as a district with numerous losses.

Services from the insurer may be inappropriate or inadequate; the school district may need loss control services beyond the insurance company’s capabilities.

Coverage is often inflexible with few or no options.

Lack of short-term incentives to reduce losses may affect long-term Cost of Risk.

Incentives
If the insurance premium is not reduced when the school district has losses less than anticipated, there may be reluctance on the part of the school district to spend time and/or money to reduce losses. However, if losses continue the insurance premiums could increase or worse yet, the insurance company could cancel or non-renew the insurance coverage.
Guaranteed Cost Plan

Payment Summary

- Insured: Pays Premium to Insurance Carrier
- Insurance Carrier: Makes Claim Payment to Claimant
- Claimant

Guaranteed Cost Plan

Criteria for Comparison

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Degree of Retention</th>
<th>Cash Flow Advantages</th>
<th>Loss Sensitive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guaranteed Cost; Full Insurance</td>
<td>None The school district does not retain any part of the loss; the insurance company pays all losses covered by the insurance policy, up to the limits of insurance.</td>
<td>Generally, No The school district typically pays the insurance premium at the beginning of the policy period so there is no Cash Flow Advantage.</td>
<td>No The premium is the same for the policy period regardless of the school district’s frequency or severity of losses.</td>
</tr>
</tbody>
</table>

Complete Knowledge Check: Section 3 Guaranteed Cost Plan p34 (FSR)
Deductible Plan

There are many types of Deductible Plans. You may remember from Section 2 that the deductible is the amount of the loss covered by an insurance policy for which the insured is financially responsible.

Characteristics of a Deductible Plan

**Deductible levels can range from very small to very large.**

**Deductible Levels**
A small deductible can be as low as $1,000. A large deductible is typically considered $100,000 or higher.

The size of the deductible is often dictated by the size of the school district. A smaller district may be willing to retain the first $10,000 of a loss, while a larger district may be financially able to retain the first $100,000.

**The premium is fixed (subject to audit).**

**Fixed Premium**
Deductibles, coverages, limits and rates can be negotiated.

**Deductible level flexibility is common (including use of aggregates); forms and coverages tend to be standardized.**

**Flexible Deductibles**
The availability of choices with regard to the size of the deductible is dependent upon the insurance company’s willingness and ability to provide various levels of deductibles.

An aggregate in a deductible plan limits the amount the school district pays for deductibles during the policy period.

For example, a policy with a $10,000 deductible may include a $100,000 aggregate, which limits (or places a cap on) the district’s deductible payments during the policy period. The school district has ten losses and has paid $100,000 in deductibles. Once the $100,000 aggregate threshold is met, the school district will not be responsible for any more deductibles through the end of the policy period.
Defense costs are negotiable; they may or may not be outside of the deductible.

**Deductible Costs**
Does the deductible apply to actual loss payments or does it also apply to defense costs?

If the deductible applies to defense costs, there is an increased likelihood that the school district will find itself responsible for a deductible payment even when there isn't a payment to a claimant.

When defense costs are paid within the limit of insurance, the deductible typically applies. A Deductible Plan with the defense costs inside (or within) the limits of insurance usually has a lower premium than one with defense costs outside of the limits of insurance.

**Insurance Company usually provides services.**

**Services Provided by Insurance Company**
Outside claim consultants are sometimes involved.

**Cash Flow Advantages**

**Payout Lags**
These can be achieved through installment payments, deductible credits and deductible reimbursement to the insurance company, or "payout lags." Payout lag refers to the time between the loss occurring and the actual payment of the deductible.

The deductible is not paid by the school district at the time of the loss; it is paid after the claims investigation has been completed and the insurer has made payment to the claimant. During this time, the school district has use of the funds including the ability to earn interest income.

**Can be quite sensitive to losses depending upon claim frequency and the size of the deductible.**

**Sensitivity**
A Deductible Plan can be loss sensitive with respects to loss frequency. Each time a claim occurs the school district is subject to the policy's deductible, which increases the cost of this risk funding option.
Deductible Plan

Considerations

You may recall from Section 2 that a loss pic is the projected losses or forecasted losses that is determined after an analysis of historical losses including trending and development.

There are two loss pics that should be considered when determining the level of deductible: the per occurrence (or deductible) amount and the aggregate.

For example:

The school district may select as an appropriate loss pic per occurrence to pay no more than $100,000 per claim. Likewise, the school district may select $1,000,000 as an appropriate loss pic for the most it wants to pay for deductibles during the policy period. This is known as a deductible aggregate.

Large Deductibles

Let’s look at three situations when a large deductible plan makes sense.

1. The school district may not have a choice; it may be forced to use a large deductible because the insurance company may not offer another choice due to the school district’s exposures or loss history. For example, student activities that create a high exposure to loss, large losses (severity), too many losses (frequency), etc.

2. The school district has predictable losses and can receive an appropriate premium discount (also referred to as deductible credit) with a large deductible plan. The discount is worth the increased retention.

3. A large deductible plan is very loss sensitive in both frequency and severity. As a result, a risk management focused school district can take advantage of lower premiums in exchange for its risk management efforts demonstrated by reduced losses.
Example:

Tacoma Public Schools has been on a Guaranteed Cost Plan for the past five years. During that time the risk management department, with the strong support of the district’s administration, implemented aggressive, yet realistic, loss control programs. As a result, the district has reduced both its loss frequency and severity.

A Large Deductible Plan may be more beneficial to the district now rather than remaining with a Guaranteed Cost Plan so that it can take advantage of its loss control efforts.

Note: As the deductible gets larger, a deductible plan can be a good first step towards self-insurance.

---

**Deductible Plan**

<table>
<thead>
<tr>
<th>Advantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Insurance policy and certificates of insurance are standardized. Deductibles do not need to be shown on the certificate.</td>
</tr>
<tr>
<td>2. Smaller deductibles can be structured with reasonable budget certainty. (As deductibles get larger, less budget certainty is the result.)</td>
</tr>
<tr>
<td>3. Deductible plans are easy to implement and relatively easy to administer (depending on the insurance carrier).</td>
</tr>
<tr>
<td>4. Direct savings and cash flow savings can be substantial, particularly if the loss frequency is low and adequate credits are received for the deductible level.</td>
</tr>
<tr>
<td>5. There is a real incentive to reduce loss frequency, as there is the possibility of payback for loss control programs. Fewer losses mean fewer deductibles paid.</td>
</tr>
<tr>
<td>6. There is coverage flexibility. Unbundling or customized loss control and claims adjusting services are common. The school district may be able to negotiate lower than normal expense components. For example, fees are often negotiated.</td>
</tr>
<tr>
<td>7. The school district can potentially provide greater control over claims compared to a Guaranteed Cost Plan. With a Guaranteed Cost Plan, the school district typically has no involvement in the claims process.</td>
</tr>
<tr>
<td>8. The school district needs less staff to handle claims and other administrative activities as compared to a Self-Funded Plan.</td>
</tr>
</tbody>
</table>
9. The insurance company pays the first dollar on claims, and then collects the deductible from the district.

**Deductible Plan**

<table>
<thead>
<tr>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coverage and pricing is often inflexible. The insurance company may not be able or willing to provide the coverage desired at the price desired.</td>
</tr>
<tr>
<td>The school district’s failure to develop adequate forecasts or maintain relevant claim data may have a negative impact on the school district.</td>
</tr>
<tr>
<td><strong>Impact of Inaccurate Loss Pics:</strong></td>
</tr>
<tr>
<td>For example, if the loss pics are inaccurate the school district may find itself paying deductibles in excess of what it projected.</td>
</tr>
<tr>
<td>Deductible credits may be inadequate to justify the increased risk.</td>
</tr>
<tr>
<td><strong>Look at the value of the deductible credit:</strong></td>
</tr>
<tr>
<td>The school district needs to evaluate the amount of the deductible credit compared to the increase in retention – does it make financial sense? The school district shouldn’t risk a lot for a little.</td>
</tr>
<tr>
<td>Insurer’s services may fail to meet the school district’s needs.</td>
</tr>
<tr>
<td>School district has little or no control over claim settlements.</td>
</tr>
<tr>
<td>The school district may be required to offer some form of security, often in the form of an escrow.</td>
</tr>
<tr>
<td>As the insurance company is responsible for loss payments, it needs to be sure it can be reimbursed by the school district for the deductible. To make sure the school district has the funds, the insurer may require the school district to establish an escrow account. This is more common in large deductible plans.</td>
</tr>
<tr>
<td>Aggregate deductible protection may not be available.</td>
</tr>
</tbody>
</table>
The inability to obtain aggregate protection means the school district is financially responsible for the deductible on every loss during the policy period. This could create financial difficulty if the district experiences an unusually higher number of claims than was projected.

**Poor loss experience can offset all previously identified advantages.**

This will most likely occur when the frequency and/or severity of the school district’s actual losses are higher than that which was projected.

**The school district’s failure to determine an appropriate attachment point can have repercussions on cash flow.**

The level of deductible chosen by the school district must be appropriate based on the school district’s loss experience, funds available for retention, creditability of data used in loss pics, etc.

### Deductible Plan

<table>
<thead>
<tr>
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<th>Degree of Retention</th>
<th>Cash Flow Advantages</th>
<th>Loss Sensitive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deductible Plan, Full Insurance</td>
<td>Low to High</td>
<td>Cash flow advantages through installment payments, deductible credits, and deductible reimbursement to the insurance company (payout lags).</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Can be quite sensitive to losses depending on the size of the deductible as well as the frequency and severity of claims.</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Complete Knowledge Check: Section 3 Deductible Plan p45 (FSR)
Compare the Two Plans Discussed So Far

<table>
<thead>
<tr>
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<td>No</td>
</tr>
<tr>
<td>Deductible Plan</td>
<td>Low to High</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Complete Knowledge Check: Section 3 Deductible Plan p47 (FSR)

Self Funding Plan

**CHARACTERISTICS**

- Self-funding refers to the decision to retain a primary coverage layer allowing the school district some degree of control over the claims process. Claims services may be provided by internal staff or outside providers.
- Coverage above the retention (excess coverage) is usually purchased. Excess coverage may be required by regulation.
- The school district is responsible for the losses that fall within the retention. In a deductible plan, the insurance company is responsible to pay losses even if the school district cannot pay its deductible.
- Self-Funding of Workers Compensation is subject to state regulation.
- In the long run, Self-Funding could be the most efficient and least expensive way to handle losses, provided the school district has the capacity to administer the program and the school district’s budgeting process enables adequate funding levels for reserves.
Self Funding Plan

Considerations

When should a school district consider using a Self-Funding Plan rather than a Guaranteed Cost or Deductible Plan?

Indicators that a Self-Funding Plan may be a viable option for the school district include:

1. The school district has a robust loss control program and a history of statistically valid, highly predictable losses.
2. The school district has a staff capable of efficiently handling the administration of the program.
3. The school district desires to have greater control over the payment of claims than is available with a deductible plan.
4. The school district is looking for cash flow and cost containment advantages.

Self Funding Plan

Advantages

1. The handling of claims is vested solely with the school district or designated third party administrator (TPA) selected by the school district.
2. The school district has greater control over claims administration since the claims are being handled either internally or by a TPA selected by the district.
3. The school district has greater incentive to lower claims cost by focusing on loss control. Fewer losses means fewer claims dollars paid.
4. As effective self-funded program can potentially lower the Cost of Risk and enable the risk management program to contribute to the school district’s strategic goals.

Self Funding Plan

Disadvantages

The excess insurance company is not obligated to pay any claims within the retention or to pre-fund the claim settlements. The excess insurance policy does not respond until the loss exceeds the school district’s retention.

Few services, if any, are provided by excess insurers. Claims administration and loss
prevention become the responsibility of the school district. If the district is not adequately staffed for these services, a TPA will need to be used.

Claim reporting and claim coordination issues could be a problem.

**Coordination Issues**
This may require some degree of sophisticated claims handling capability within the school district.

Does the school district have an IT system (such as a Risk Management Information System/RMIS) that can be used for claims administration and other risk management functions?

Certificates of insurance may be an issue.

**Certificates of Insurance**
An insurance company cannot be shown on a certificate of insurance since a Self-Funding Plan does not use an insurance company (other than excess insurance) to provide risk funding.

If the school district has to provide a certificate of insurance, other arrangements or other funding options may need to be considered.

---

### Self Funding Plan

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Degree of Retention</th>
<th>Cash Flow Advantages</th>
<th>Loss Sensitive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self Funding Plan Full Insurance</td>
<td>High</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>The school district retains all losses up to the attachment point of any excess insurance.</td>
<td>With the exception of the excess insurance, the school district does not pay premiums. In addition, the funds to make claim payments may be able to earn interest income until actually paid to claimants.</td>
<td>Loss sensitive as all losses, up to the attachment point of any excess insurance coverage, is the responsibility of the school district. Can be quite sensitive depending on the frequency and severity of claims.</td>
</tr>
</tbody>
</table>

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**Complete Knowledge Check: Section 3 Self Funding Plan p53 (FSR)**
Pooling Arrangement

A Pooling Arrangement is the fourth and final funding option most commonly used by school districts.

A pool is a group of school districts, generally not large enough to self-insure individually that achieve efficiencies by combining aspects of their risk management programs.

Pool: 1) An organization of insurers or reinsurers through which particular types of risk are underwritten with premiums, losses, and expenses shared in agreed ratios. 2) A group of organizations (generally not large enough to self-insure individually) that form a shared risk pool.
Pooling Arrangement  

Characteristics

Joint & Several Liability is one characteristic of a Pooling Arrangement that all members of the pool need to fully understand.

Joint & Several Liability means that all members of a “group” (or in this case a pool) are jointly liable for group responsibilities and that each member (if circumstances arise such that other members are financially unable to meet group liabilities) is severally or individually responsible for total liabilities of the group.

Joint and several liability: A legal doctrine applying in some states that allows an injured person to sue and recover the full amount from any one or more of several wrongdoers at his option, regardless of that wrongdoer’s degree of negligence.
Example:

ABC School District is a member of a pool. Another school district in the pool had a large loss.

Joint Liability Illustrated

Once the loss exceeds the Maximum Claim Fund, all of the members of the pool would equally share in the remaining amount due (to meet the underlying requirement) before the Aggregate Excess Coverage responds. If there were 20 members of the pool and the amount needed was $1,500,000, each member would be responsible for $75,000 ($1,500,000 divided by 20) even though the loss was caused by one member.

Several Liability Illustrated

Of the 20 members of the pool, one of the school districts was financially unable to pay its $75,000. The $1,500,000 would now be shared among the 19 members – increasing the payment from $75,000 to $78,947 ($1,500,000 divided by 19).
Pooling Arrangement

Advantages

Create stability or reduction in Cost of Risk.

**More Stable Cost of Risk**
The focus on loss control may result in the reduction of the school district’s frequency and/or severity.

Cause heightened attention to loss control and claims management.

**Heightened attention to loss control:**
Because of the financial benefit to the pool when losses are reduced, there are financial benefits for implementing both pre and post loss risk control techniques.

Ability to design a rating plan that reflects the group’s combined loss experience.

**Tailored Rating Plan**
A school district with a high loss ratio may be able to benefit from the better loss ratios of others in the pool, as rates may be based on the combined experience.

Ability to design coverage forms to meet members’ needs.

**Coverage Forms**
A district by itself may not have negotiating power when it comes to getting an insurance company to agree to provide coverages unique to school districts. A pool is in a better position to provide or arrange the coverage needed for its members.

As the pool matures, the members will gain experience with managing costs and providing services.

**Benefits as Pool Matures**
Extensive historical data can improve the pool’s ability to forecast losses. Aggregate coverage may be reduced or removed altogether. The pool may, eventually, become an insurance company.
Pooling Arrangement

Disadvantages

Risk sharing

Risk Sharing
Some members may not be as good a risk as others. They may have larger
exposures or mismanaged risk programs. A school district with fewer exposures and
an effective risk management program could find itself subsidizing the Cost of Risk
for other members. The experience of the pool as a whole will affect the premiums
and the required attachment point for any excess insurance coverage.

The pool may fail to maintain adequate records.

Inadequate Record Keeping
Credible loss pics are impossible to calculate if data is unavailable

Underwriting risk

Underwriting Risk
The pool may charge inadequate premiums because of inexperience in rating the
exposures.

Financial Problems

Financial Problems
There may only be minimal dollars in the pool to pay claims and expenses.

Remember Joint & Several Liability!

Management Inexperience

Management Problems
Members may lack expertise in managing a pool.

The pool may fail to maintain control of losses and exposures.

Maintenance of Loss Control Programs
This could cause the pool to lose its advantages with regards to lower costs and
specialized coverages.
The pool may lose its reinsurance or excess coverage.

Reinsurance and Excess Coverage
This is certainly a concern if the pool is experiencing poor loss experience with regard to frequency and/or severity.

The pool may lose members thereby creating less buying power and change of exposure base which may result in adverse selection

Loss of Membership
A school district may leave the pool to avoid being “lumped” with districts that are not as good of a risk. The district may decide to use another risk funding plan that would be more beneficial for the district. The pool may find the members left to be those that are not good risks and have no other risk funding options.

Joint and Several Liability

<table>
<thead>
<tr>
<th>Pooling Arrangement</th>
<th>Criteria for Comparison</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of Plan</td>
<td>Degree of Retention</td>
</tr>
<tr>
<td>Pooling Arrangement</td>
<td>Varies</td>
</tr>
</tbody>
</table>

Participation in Public Entity Risk Pools

**GASB 10** defines a Public Entity Risk Pool as a cooperative of governmental entities joining together to finance an exposure, liability or risk, which may include property and liability, workers compensation or employee health care.

**GASB 10:** Governmental Accounting Standards Board (GASB) 10 establishes accounting and financial reporting standards for risk financing and insurance-related activities of state and local governmental entities, including public entity risk pools.
School districts may participate in risk pools with or without transfer of risk. Whether or not there is actual transfer of risk determines how outflows are treated from an accounting standpoint.

**No Transfer of Risk**

The district should recognize losses as if it was self-funded, such that payments made to the risk pool represent a reduction of the liability account set up in the Internal Service Fund for recording inflows and outflows.

**Transfer of Risk**

Premiums paid including any supplemental premium assessments made by the risk pool to its members, represent total payments expected and should be accounted for as direct expenditures of the fund from which payments are made.

As with each of the other scenarios presented in this section, the Risk Manager needs to understand the particular nature and arrangement involving the district’s risk financing activities and be able to appropriately and effectively communicate with and assist key financial personnel who oversee these activities.

**Complete Knowledge Check: Section 3 Pools p63 (FSR)**
Mechanics of Purchasing Insurance

The amount of insurance to purchase is normally based on the factors displayed below.

**Value of the Exposure**: The higher the value of the exposure, the more likely insurance should be considered as a risk funding method. While the district may be able to retain a $5,000 loss, it will probably not want to retain a $1,000,000 loss from a bus accident.

**Ability to Absorb the Maximum Possible Loss**: What do the school district’s financials indicate? Are there funds available to pay for the Possible Maximum Loss?

**Willingness to Absorb the Maximum Possible Loss**: The financial may indicate the funds are available but is the district willing to use those funds for losses? If administration is risk adverse, there is unlikely to be a willingness to use the funds to pay for losses.

**Value and Cost of Insurance**: Is insurance available and are the coverages those that are needed by the district? What is the premium for the coverage? In a Soft Market the district may find insurance premiums lower and may be an incentive to purchase insurance for exposures previously retained. Likewise, in a Hard Market the district may decide to retain some exposures to loss because the insurance coverage is either not available or excessive.
Recall from Section 2 the distinction between Maximum Possible Loss and Probable Maximum Loss:

**Maximum Possible Loss**
The worst case scenario; the greatest amount of loss that could occur.

**Probable Maximum Loss**
Maximum amount of loss that can reasonably be expected under ordinary circumstances.

**Tips for Purchasing Insurance**

There are resources such as associations and state Department of Insurance websites that may provide tips for school districts using insurance as their risk financing option. One example of state tips for school districts can be viewed by clicking on the link below.

See the Tips example on the next page.
"Insurance Decisions for Texas School"
http://tdi.statetx.us/consumer/sdguide/

Obtain quotes from several companies

Consider higher deductibles for each coverage type. Generally, the higher the deductible, the lower the premium.

Inquire about endorsements that change or add coverage. A district may need these for exposures not covered in standard policies.

Remember the cheapest policy is not always the best. Inquire about an insurer’s track record for reliability, value and customer service. Make sure the carrier is financially stable.

Consult the agent and company for ways to reduce risk. Many companies offer customers risk reduction programs that can help reduce risks and lower rates.

Understand the district’s responsibilities in case of a claim and report all claims promptly and accurately.

Inform the agent promptly of any changes relating to insured vehicles, district property, employee health coverage, etc.

Confirm that contracts provide for ample notification of cancellation/non-renewal. Never cancel an old policy until appropriate replacement coverage is in force.

Confirm all representations from an agent or insurance company in writing.


Insurance Pricing (Not including Workers Compensation)

The cost of insuring predictable losses will usually be more than the cost of retaining them. In addition to paying for losses, the insurance premium also takes into consideration the insurance company’s expenses and anticipated profit.

Insurance is not typically the first choice as a method of financing a school district’s exposures to loss as other funding options are typically less costly.
The insurance premium will normally equal the expected losses divided by the complement of the insurance company’s expense ratio.

**Facts:**

School District Exposure: 10 schools with 10 losses of $10,000 each

Insurance Company **Expense Ratio**: 35%

**Formula**

\[
\text{Average Frequency} \times \text{Average Severity (Expected Losses)} \times \frac{1}{1 - \text{Expense Ratio}}
\]

**Calculation**

\[
\frac{10 \times \$10,000}{1 - .35} = \frac{\$100,000}{.65} = \$153,846 \quad \text{Expected Premium = $153,846}\]

\[
\text{Expected Losses = $100,000}
\]

On the average, it will cost approximately $1.54 to transfer each $1.00 of loss to the insurance company ($153,846 divided by $100,000)

**Operating Costs Per Student/Per Other Benchmark**

Districts are routinely benchmarked and compared according to a variety of cost-based benchmarks.

The most common benchmark is cost per student, which is routinely used to make comparisons across all major expenditure Functions. An example would be the Cost per Student for expenditures pertaining to instruction.

Other benchmarks could include cost per square foot, cost per full-time equivalent employee (FTE), or one as specific as cost per meal (a food service benchmark, usually broken down into labor, food and direct costs.)

The level of detail can be very precise in that costs could be compared year-to-year or across districts according to a specific expenditure.

The selection and use of an appropriate benchmark depends mostly on the function or purpose of what is being compared.
If using cost per student, it is important to know, when comparing districts, whether the student benchmark is enrolled students, students in Average Daily Attendance (ADA), students in Weighted Average Daily Attendance, or other method of measurement.

A final word about benchmarking:

- Districts are notorious about making comparisons. These comparisons can be year-to-year comparisons within the district or district-to-district comparison using an understandable and commonplace benchmark.
- If a risk manager is making cost or other comparisons on the basis of the number of students, it is important to know exactly what the basis for comparison is.
- There are usually significant differences in the number of enrolled students, students in Average Daily Attendance (ADA), and students in Weighted Average Daily Attendance (WADA).
- The distinctions among these are too complex to discuss within the context of this course, but School District Risk Managers need to be familiar with each measurement standard and make sure they fully understand the comparison that is being made.

**Summary of Risk Transfer Techniques**

We began the discussion of criteria when comparing risk financing options by an understanding of the Degree of Loss Transfer or Retention.

The possibilities ranged from a Full Transfer using insurance as the mechanism to Full Retention using a Fully Self-Funded option.
The discussion of transfer options and criteria for comparison continued with a review of the seven criteria that are useful to a risk manager when evaluating risk financing options:

**Criteria for Comparison**

1. Degree of Retention
2. Cash Flow
3. Loss Sensitivity
4. Program Flexibility
5. Mechanics of Program
6. Program Services
7. Implementation Issues

The four funding options most commonly used by school districts were introduced including their characteristics, advantages and disadvantages.

<table>
<thead>
<tr>
<th>Type of Plan</th>
<th>Degree of Retention</th>
<th>Cash Flow Advantages</th>
<th>Loss Sensitive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guaranteed Cost; Full Insurance</td>
<td>None</td>
<td>Generally, No</td>
<td>No</td>
</tr>
<tr>
<td>Deductible Plan</td>
<td>Low to High</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Self Funding</td>
<td>High</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Pool</td>
<td>Varies</td>
<td>Varies</td>
<td>Varies</td>
</tr>
</tbody>
</table>
Section 4 Reserving for School District Risks

Business decisions can be easily impacted by a school district’s loss reserves and loss reserving practices. Understanding reserves, not only how they are determined, but also how they are accounted for on financial statements is part of Funding or Financing of Risk in the risk management process. Outside actuarial services may be used to develop the numbers necessary for the district’s financial reporting including the identification of audit issues.

Learning Objectives

By the end of this section you will be able to:

1. Know the types of reserves and understand the basics of the reserving process.
2. Understand the objectives and two basic criteria of the major accounting standards for school district risk managers.
3. Understand what reserve amount should be carried on the financial statement and when reserves should be reviewed.
4. Identify factors that contribute to reserve instability or stability; identify business decisions affected by reserves.
5. Identify reasons a school district would employ actuarial services.
6. Know what information an actuary needs to perform an actuarial analysis.
7. Understand criteria for selecting a projected loss amount from a range of reasonable estimates for financial reporting.
8. Identify accounting audit findings that trigger concerns for school district risk managers.

Reserves

A loss reserve is defined as “An estimation of the liability for unpaid claims that have occurred as of a given date, including those losses incurred but not yet reported, losses due but not yet paid, and amounts not yet due.”

A loss that occurs today may not be a closed claim until years down the road. This is especially true for liability and worker compensation claims and even more true for losses involving children.
As a result of the “lag time” between the loss and the final settlement, reserves should be set that accurately depict what is projected to be the ultimate payout.

If not, the school district’s financials will not paint an accurate picture of its current and future loss exposures.
Overview of the Reserve Process

Types of Reserves

When setting reserves, all four categories (or types of reserves) should be considered and included.
**Case:** A Case Reserve is an estimate of what a specific claim will eventually settle for. For example, a teacher falls in the school hallway and injures his back. The claims adjuster will establish a reserve for that specific claim.

**IBNR:** Incurred But Not Reported (IBNR) represents the liability for unpaid claims not reflected in the case reserve estimates for individual losses. The two components of IBNR are (1) additional development on known cases (claims) and (2) the claims that have occurred but had not been reported as of the evaluation date.

**More About Incurred But Not Reported (IBNR):**

For example, a reserve is established for a claim involving an injured student. It is possible that over time the claim may increase in value due to an unforeseen medical condition or because it is taking longer to settle than anticipated. This is an example of the component of IBNR due to additional development.

Another example of IBNR occurs when losses take place that the school district is unaware of at the time the district’s loss report is created. A staff member had a slip and fall a week ago but didn’t report it because there didn’t appear to be anything wrong.

Two weeks later her elbow is still tender, and she realizes the slip and fall wasn’t as minor as she thought; she will now need medical treatment so she reports the loss to the district. Since the school district evaluated its total losses after the fall it didn’t know about, the loss report/reserves do not show an accurate picture of the school district’s losses.

IBNR reserves take both of these situations into account with the goal of having the school district’s losses accurately accounted for.
Allocated: Allocated Loss Expenses (also known as Allocated Loss Adjustment Expenses – ALAE) are those that are directly assigned to or arising out of a particular claim; any expense assigned and recorded directly to a particular claim. Examples of Allocated Loss Expenses include court fees, the expense of outside legal counsel or the fees expert witnesses for a specific claim.

Unallocated: Unallocated Loss Expenses (also known as Unallocated Loss Adjustment Expenses – ULAE) are salaries, overhead, and other related adjustment costs not specifically allocated or charged to particular claim.

Complete Knowledge Check: Section 4 Basics of Reserving p10 (FSR)
Salvage: Salvage is the value of damages property or recovered stolen property. Salvage value applies to property (real and personal) and vehicles.) When setting reserves, the claims adjuster will estimate if there will be any salvage value after the claim is paid. For example, when the insurance company pays for a total loss to damaged property, the damaged property is now owned by the insurance company. If stolen property is recovered, the owner of the property has the option of returning the previously received claim payment in return for the recovered property. If the recovered property is not wanted, it becomes the property of the insurance company.

Subrogation: Subrogation is the right of the insurance company to seek reimbursement for damages from the person or organization actually responsible for the loss. Subrogation takes place only after the insurance company has paid the loss. When setting reserves, the claims adjuster will determine if any of the anticipated claim payment can be subrogated. For example, the district’s bus is hit by a vehicle whose driver was 100 percent at fault. The school district may choose to have the bus repaired by the insurance company that provides its Collision Coverage rather than dealing with the other vehicle’s insurance company. After the district’s insurance company has paid for the collision damage, it will subrogate against the other driver for reimbursement.
Discounted: Discounted loss reserves are liability estimates that have been reduced to reflect the potential to earn investments on funds set aside to pay losses which have occurred but not yet been paid. This accounts for the lag time between the date of the occurrence and the payment of the claim. For example, the claims adjuster estimates the value of the claim to be $100,000; it is anticipated it will be two years before the claim is paid and closed. Rather than set the reserve at $100,000, the adjuster applies Time Value of Money Concepts. The reserve is set at $92,500, which is the amount needed at a 4 percent discount rate to equal the $100,000 needed at the end of two years.

Undiscounted: Undiscounted loss reserves have not been adjusted using TVOM concepts.
Review of Types of Reserves

Complete Knowledge Check: Section 4 Basics of Reserving p14 (FSR)

Reserve Process

Now that you understand the four types of reserves, let’s continue the Reserve Process by examining who sets case reserves and case reserving philosophy.
Who Sets Case Reserves?

Depending on the risk financing option selected by the school district, third party administrators (TPAs), insurance carriers or inhouse staff of school districts may be responsible for setting case reserves.

If the school district has a Guaranteed Cost Plan or a Deductible Plan, the insurance company’s claims adjuster will typically set reserves.

A school district on a Self-Funding Plan may use in-house staff to set the case reserves. The school district may also outsource its claims administration to a Third Party Administrator (TPA), in which case the TPA would set case reserves.

Case Reserving Philosophy

Two philosophies to case reserving are Stair Stepping and Reserve to Ultimate.

Stair stepping describes the reserving practice of increasing or decreasing the case reserve as new information is received on the claim.

- **3/25/2009** Case reserve increased to $80,000 when employee is still unable to return to work as additional medical treatment is needed.
- **9/18/2008** Case reserve increased to $25,000 after review of medical reports.
- **7/15/2008** 5,000 Case Reserve set for workers compensation loss.

Reserve to Ultimate is the reserving practice of setting the case reserve to the maximum ultimate payout, that is, what is projected to be the actual total loss payout.

**Example:**

After determining there is coverage, reviewing the facts of the investigation and evaluating damages, the adjuster projects the ultimate payout to be $50,000 and sets the case reserve accordingly.
Reporting Losses and Reserves

Losses and reserves are reported to ensure an accurate picture of the school districts current and future loss exposures.

You may wish to review the development of losses in Section 2.

- Add case reserves and paid losses to obtain total reported losses.
- Use historical losses to determine development factors.
- Apply development factors to estimate losses incurred but not reported (IBNR); and to determine developed cost of reported losses.
- Record results on income statement and balance sheet
- Project future losses

Complete Knowledge Check: Section 4 Basics of Reserving p21 (FSR)

Accounting Standards

Section 3 introduced Governmental Accounting Standards Board (GASB) 10 as establishing accounting and financial reporting standards for risk financing and insurance-related activities of governmental entities, including schools districts.

According to GASB 10, when should the school district record losses on its financial statement? After all, it is important that financial statement accurately portray the school district’s current and future loss exposures.

There are two basic criteria for recording losses on a financial statement. Both of these criteria must be met.

1. Information available before the financial statements are issued indicates that it is probable that an asset has been impaired or a liability had been incurred as of the date of the financial statements.
   
   AND
   
2. The amount of loss can be reasonably estimated. The school district can estimate how much the event or loss will cost.
Risk Financing and Related Insurance Issues Covered by GASB 10

GASB Statement No. 10 defines risk management and financing as the process of managing an organization’s activities to minimize the adverse effects of certain types of losses. The main elements of such management are Risk Control and Risk Financing.

- **Risk Identification**: The process of identifying and examining the potential sources of losses faced by the school district.
- **Analysis and Measurement**: The assessment of the potential impact that various exposures can have on the school district.
- **Risk Control**: An action to minimize, at the optimal cost, losses that strike the school district.
- **Risk Financing**: The acquisition of funds at the least possible cost to pay for the losses that strike the school district.
- **Implementation**: Implementing the desired actions and risk management plans.
- **Monitoring**: Examining and evaluating the results of risk management actions and plans.
Types of Risk Addressed in GASB 10

Losses from these types of risk are included within the scope of GASB Statement 1; therefore loss reporting needs to meet GASB requirements.

Tort: A civil or private wrong giving rise to legal liability

Theft of, Damage to or Destruction of Assets: Example; if a building (real property) or laptop computer (personal property) is damaged or destroyed, the school should report the value of the impaired asset on its financial statement.

Business Interruption: Including loss of rents for rental of facilities to others, additional increased cost of working for extra staff time required for the smooth running of school (such as recreating records), claims preparation costs, etc.

Errors and Omissions: Including Directors & Officers and Educators Errors & Omissions

Job-Related Injuries or Illnesses: Workers Compensation
Acts of God: Also know as Act of Nature. An event produced by a physical cause of nature and not within human control or intervention. Examples include flood, earthquake, hurricane, tornado, hail, etc.

Employee Benefit Related Losses: Accident and health, dental and other medical benefits to its employees.

Account for Self-Insurance Claims

Under a Self-Insurance (or Self-Funding Plan), a school district must account for the claim on its financials based on the same criteria previously discussed.

Both of the following requirements must be met in order to be recognized on financial statements.

1. Information available before the financial statements are issued indicates that it is probable that an asset has been impaired or a liability had been incurred as of the date of the financial statements.
2. The amount of loss can be reasonably estimated.

If both conditions are met, an accrual for the claim should be recognized on the district’s financial statements. If an accrual for a loss meeting the conditions is not recognized, the district’s financial statements are not reflecting an accurate picture of the district’s current and future loss exposures.
Example:
While cutting a piece of sheet metal, a maintenance worker is injured when a small piece of flying metal hits him in his face. The school district's risk manager estimates the loss will ultimately cost approximately $45,000.

This loss should be recorded on the district's financial statements. If not included, the district's liabilities will be understated.

**Accrual:**
Charges that have not been paid by the end of an accounting period but must be included in the accounting results for the period.

As you can see, it is critical that the Risk Manager communicate closely with key financial personnel in the district to ensure that the district's audited and published financial statements properly present information about known and projected claims or losses.

**Accounting for Self Insurance in Different Types of Funds**

In most instances, school districts that self-insure use an Internal Service Fund to account for risk financing activities, the most common of which pertain to workers compensation and employee medical.

Internal Service Funds are used to account for services furnished by a designated department to another department within the school district.

Most transactions between Internal Service Funds and other funds take the form of quasi-external transactions.

Monies flow into the Internal Service Fund from other funds of the district, including the General Fund and Special Revenue Funds.
In the case of workers compensation and employee medical contributions, the flow of funds into the Internal Service Fund is usually linked directly to the district’s payroll system.

A key requirement for funds to be able to flow into the Internal Service Fund is that the charges made to the other funds must be based on an actuarial method or historical cost information and adjusted over a reasonable period of time so that Internal Service Fund revenues and expenditures are approximately equal.

In other words, the inflows and the outflows of the Internal Service Fund should “offset” over a period of time.

The School Risk Manager is one of the best sources of information to enable key financial personnel to provide the proper structure for its risk financing activities.

Complete Knowledge Check: Section 4 Accounting Standards p33 (FSR)
Criteria for Reserves Review

What reserves should be carried on the school district’s financial statements?

Let’s agree that using only case reserves is normally inadequate for setting estimates of ultimate liability. If the estimate for the school district’s ultimate liability is based solely on case reserves, the liabilities on the financials will be understated.

Why? Because, as was previously discussed, case reserves do not provide for either (1) the development of known losses or (2) the late reporting of losses that had already occurred but were unknown by the school district at the time the financials were developed.

To more accurately record reserve levels carried on financials, a combination of case reserves and IBNR is most commonly used.

When should reserves be reviewed? Reserves should be reviewed for appropriate levels:

- When an estimate of losses for budgeting purposes is necessary
- When understated or overstated retained losses could significantly affect the financial statement
- When retention levels do not adequately reflect the expected losses

Reserve Stability

There are factors that can contribute to the instability of reserves and factors that can contribute to the stability of reserves.

Instability

The following have the potential to destabilize reserves:

- Tort reform
- Changes to Workers Compensation statutory benefits
- Lack of uniform procedures for adjusters
- Changing TPAs or changing management within TPA
- Rate of inflation
- Capabilities of individual attorneys
- Claimant attitudes
Stability
The following have a positive influence on the stability of reserves:
- Large volume of similar claims
- Dedicated claims unit
- Consistency of management
- Explicit reserving procedures
- Stable economic and legal environment

Factors that Contribute to Instability of Reserves
- Tort Reform
- Changes to Workers Compensation Statutory Benefits
- Lack of Uniform Procedures for Adjusters
- Changing TPAs or Changing Management Within TPA
- Rate of Inflation
- Capabilities of Individual Attorneys
- Claimant Attitudes

Tort Reform: Refers to laws designed to limit the situations under which an injured person may sue and/or limit the amount of compensation a jury or judge may award for non-economic losses (losses for pain, suffering, loss of companionship, etc.

Changes to Workers Compensation Statutory Benefits: What happens to the accuracy of workers compensation reserves when a state’s statutory benefits are increased? A loss with a $25,000 reserve for an injury that now has a statutory benefit of $50,000 is quickly under-reserved.

Lack of Uniform Procedures for Adjusters: Lack of uniform procedures lends itself to different adjusters making different decisions as to the level of reserve necessary for the same or similar type of loss.

Changing TPAs or Changing Management Within TPA: When the TPA or management within a TPA changes, does the reserving philosophy also change? Did the prior TPA (or management) establish a $50,000 reserve for an injury that the new TPA now reserves at $100,000?

Rate of Inflation: Increasing or decreasing inflation rates can obviously impact the stability of reserves.

Capabilities of Individual Attorneys: Attorneys differ with regard to experience and expertise their application of such may result in differing opinions as to the appropriate reserve necessary for a loss.
Claimant Attitudes: Some claimants may seek the benefits owned to them as the result of legitimate injuries or damages while other exhibit a sense of entitlement – looking for the “big bucks” – and use the judicial system to do so. This may cause reserves to differ for the same type of loss simply because of the differences in the claimant’s attitude.

Factors that Contribute to Stability of Reserves

- Large Volume of Similar Claims
- Dedicated Claims Units
- Consistency of Management
- Explicit Reserving Procedures
- Stable Economic and Legal Environment

Large Volume of Similar Claims: When adjusters have experience with a large number or similar claims, they use their knowledge (reserved, ultimate payouts, etc.) of the pay claims to set consistent and appropriate reserves on new claims.

Dedicated Claims Units: Individuals with the sole responsibility of claims administration and management may have a better understanding of reserving and the appropriateness of reserve levels - both of which contribute to reserve stability.

Consistency of Management: Just as changes in the TPA of the management of the TPA contribute to the instability of reserves, consistency in management contributes to stability.

Explicit Reserving Procedures: Just as lack of uniform procedures for adjusters contributes to the instability of reserves, the opposite contributes to stability.

Stable Economic and Legal Environment: Just as Tort Reform and Inflation contribute to the instability or reserves, the lack to tort reform and inflation contribute to stability.

Business Decisions Affected By Reserves

Why is it important reserves be accurately reflected? Not withstanding GASB requirements, business decisions are affected by reserves.

The school district relies on the accuracy of the information contained in its financials when making business decisions; therefore, financials MUST accurately depict the reserves on present and future loss exposures.
### Retention Levels
- The risk manager relies on loss data when determining the appropriate retention level for the district. If the financials have inaccurate reserve levels, the loss projections might also be inaccurate.

### Excess Insurance Pricing
- Overstated reserves can not only cause the premium on excess insurance protection to be higher than it should be, but also potentially cause the district difficulty in finding an insurance carrier willing to provide the protection.

### Safety & Loss Control Programs
- Loss control programs are typically prioritized based on the frequency and/or severity of loss exposures. Inaccurate reserve levels could result in an inaccurate prioritization when deciding where to spend the district’s time and money on a safety or loss control program.

### Budget Forecasting
- Inaccurate reserves can cause the school district to be under or over budget before the budget period even begins.

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**Complete Knowledge Check: Section 4 Stability of Reserves p40-42 (FSR)**

### Actuarial Services

An actuary computes statistics relating to insurance, typically estimating loss reserves and developing premiums. This type of consultant often holds a professional designation such as ACAS (Associate of the Casualty Actuarial Society) or FCAS (Fellow of the Casualty Actuarial Society).

In looking at how districts use actuaries, we will consider the following questions:
- Why would school districts employ actuarial services?
- What information is needed by the actuary to perform an actuarial analysis?
- What are the questions that the actuary might ask?
- What are the ranges of reasonable estimates provided by the actuary?
Why Would School Districts Employ Actuarial Services?

- Actuaries are expert in evaluating IBNR (incurred but not reported) losses for the district.
- Actuaries can evaluate the appropriateness of the retention in large deductible or self-funded plans.
- Actuaries can consult on the reasonableness of premium and retention for insured programs.
- Actuaries can calculate a range of reasonable estimates for the reserves created by the district.
- Actuaries can calculate cost allocations for assigning loss costs to appropriate operating units within the district.
- An actuarial review may be required by auditors if reserves appear to be out of line.

What Information is Needed to Perform an Actuarial Analysis?

Once the school district decides to obtain actuarial services, it needs to gather the information that is needed by the actuary.

1. Five years of historical losses by line of coverage showing paid and incurred losses valued as of the end of the year.
2. Exposure information (payroll for workers compensation, number of vehicles for business auto liability, number of students for general liability, etc.)
3. Type of risk financing plans (Guaranteed Cost, Deductible, Self-Funding, or Pool) and copies of any policies, including:
   - Retention and deductible levels for the last five years
   - Aggregate limit of liability
   - Whether losses are on a limited or unlimited basis (Losses may be limited by Tort Reform, Statute of Limitations, or Sovereign Immunity)

The actuary will also have questions about the school district’s risk management program. What questions might the actuary ask?

Has there been a change with the TPA? A change with the TPA could indicate a change in reserving philosophy, potentially impacting an actuarial analysis.

Have significant Loss Control programs been recently implemented? If so, the analysis may need to take into account an expectation of reduction in loss frequency & or severity which could impact IBNR, retention levels, reasonableness of premium, etc.
Have exposures changed? Section 2 discussed indexing losses to an Exposure Base. When an exposure base changes, the loss experience attributed to that Exposure Base may change accordingly. A new campus equates to an increased exposure when is important to recognize and include in an actuarial analysis.

Have changes occurred in payroll? Just as lack of uniform procedures for adjusters contributes to the instability of reserves, the opposite contributes to stability.

The Loss Pic

CSRM Measuring School Risks goes into further detail about how expected losses for the upcoming fiscal year are calculated. For purposes of this course, we start with questions about how the actuary will present this data.

What will the actuary provide with respect to an estimate of expected losses?

Range of Reasonable Estimates
The actuary will often provide estimates as ranges rather than as specific amounts. For example, expected losses may be stated as between $100,000 and $130,000.

Confidence Level
The actuary will also provide the "confidence" level. Confidence intervals (expressed as a percentage) are concepts that actuaries use to show how "good" their predictions are.

What should the risk manager select for reporting purposes?

For financial statement purposes; always remember that actual outcomes may be outside this range of estimates.

- When an amount within the range appears at the time to be a better estimate than any other amount within the range, that amount should be accrued.
- When no amount within the range is a better estimate than any other amount, the minimum amount in the range should be accrued.

For example, if the actuary states the best estimate of Expected Losses is $90,000 then that is the amount ($90,000) that should be accrued.
More about confidence intervals:

Even the largest schools will not be able to say with certainty whether their reserves or loss projections are accurate. For example, the actuary may say that "within a 75% confidence level, Workers Compensation losses for 20XX are expected to be between $100,000 and $130,000." What is unsaid in this statement is that there is a 25% level of confidence that the losses will fall above this range.

Here’s a related example: If an insurance pool has expected losses of $500,000 for the next year, it may require its members to fund at the $750,000 level so additional assessments may not be necessary.

Complete Knowledge Check: Section 4: Loss Pics p49-50 (FSR)

Audit Issues
Self-Funding Plan: Does the district have the funds to pay for losses that occur? Was excess insurance secured? Is there an Aggregate Stop Loss?

Decision Not to Purchase Insurance; Uninsured Exposures: With insurance no longer the funding tool, has internal financing been arranged? Is insurance unaffordable? Is the district risking a lot for a little?

Decision to Purchase Insurance for Previously Uninsured Exposure: Why was insurance purchased? Did the exposure to loss increase? If so, can it be risk controlled? Has insurance become affordable?

Increase in Deductible or Retention: Was the increase required by the insurance carrier? Are loss pics credible? Has internal funding been arranged?

Reduction in Liability Limits: Has the exposure been limited by Tort Reform or Immunity? Has internal funding been arranged should a loss exceed the limits?

Membership in a Pool: Is the school district familiar with the advantages and disadvantages of a pooling arrangement including Joint & Several Liability?

Property Values Unchanged From Prior Years: Why did property values remain static? Were they over insured previously? For insured property, do the values provide for replacement of the property should it be damaged or destroyed?

Solvency of Insurance Carriers: What is the financial condition of all insurance companies used by the school district? Is the school district protected by the state’s Insurance Guaranty Fund should an insurance company become insolvent?

Complete Knowledge Check: Section 4: Audits p52 (FSR)
Section 5 Finance Issues for the School Risk Manager

Up to this point, this course has primarily focused on methods risk managers can use to fund losses school districts may incur. In addition to arranging financing, school risk managers also have an important role in other finance activities within the district. After all, the district’s Cost of Risk can be positively impacted if the risk manager can

1. assist in maintaining and controlling inventories;
2. act as the liaison to the insurance company after a loss has occurred; and/or
3. provide risk management information needed for the district’s annual report.

Learning Objectives

By the end of this section you will be able to:

1. Identify and explain the Risk Manager’s role in the management and security of the district’s inventories and capital assets.
2. Identify and explain how district assets are recorded after a catastrophic loss or damage.
3. Understand the role of the Risk Manager and the district’s Internal Control Practices.
4. Know what is included in the Annual Financial and Compliance Report and how it relates to the Risk Manager.
Capital Assets and Consumable Goods Inventories

It is standard practice for school districts to have very large sums of money tied up in various types of assets, including consumable goods (inventories) and capital assets.

Consumable goods inventories
Are those items that are depleted or used up over a relatively short period of time.

Capital assets
Yield their use and are depleted over a longer period of time – usually more than one year. They normally meet a pre-defined higher monetary value and have estimated useful lives of more than one year.

Examples of Consumable Goods Inventories

Districts have many types of consumable goods including: supplies for campuses and departments, food inventories, medical supplies, fuel inventories, instructional supplies, and other supplies and materials for the maintenance and operation of the district’s facilities.

Capital assets are not typically carried in an ongoing inventory though it is not out of the question that some very large districts could maintain a ready inventory of classroom furniture and the like.

Capital assets are normally tracked on a fixed asset ledger, which rolls up and reports to the financial statements. The district usually has control procedures that tend to assure continued existence and possession of the asset.
Examples of Capital Assets

Land, buildings, furniture, fixtures and equipment, equipment under lease, vehicles, works of art and historical treasures, expensive computer equipment, construction-in-progress, and infrastructure are all examples of capital assets.

One school district’s definition of Capital Assets states: “Capital assets are tangible assets used in operations and have initial useful lives extending beyond a single reporting period. Equipment will not change its original shape, appearance or character with use and it can be expected to last more than one year with reasonable care and maintenance.”

Many districts inventory low dollar items (library books, chairs, tables, etc.) on a group basis and periodically test the accuracy of the group through random sampling or periodic inventories.

The School Risk Manager should understand that individual goods or assets might be considered insignificant when taken individually, but they become significant when taken as a whole.

While one lunchroom table is valued at $900, 30 have a value of $27,000. One case of paper may be $18; however, with 1000 cases of paper on hand at any one time, paper inventory is now $18,000. And, one chair valued at $40 is inconsequential; however, 2000 chairs with an $80,000 value are not.

It is important for risk managers to know the combined values of assets that as a single item may have low value and might otherwise be overlooked as inconsequential to a loss of any value.

$40 vs. $80,000
Manager should work with the property manager and business office to evaluate the means by which inventories of consumable goods are maintained and controlled, making recommendations with respect to the tracking, security, and safeguarding (i.e., warehousing) of these items.

For example, when a delivery is received at the warehouse is it compared to the purchase order to make sure the correct product and quantity was received?

Whether the physical inventory of consumables is maintained at a warehouse or at each campus, the risk manager can help with suggestions for improving control of the district’s Consumable Goods Inventory.

The School Risk Manager should know and understand the district’s policy and procedures with regard to Capital Assets.

This will help the risk manager identify existing capital assets as well as those that are acquired.

These policies and procedures also explain permitted usage, inventory control, and the distribution or disposing of Capital Assets.
Capital Assets Policies and Procedures

- Capitalization Threshold
- Non-Capitalized Assets Inventory Control
- Custody and Proper Use of Individual Capital Assets
- How Capital Assets are Controlled
- Procedures for Receiving, Tagging and Distributing Capital Assets
- Available Data Regarding Capital Assets
- Procedures for Disposing of or Retiring Capital Assets

Capitalization Threshold

Each district will determine the value at which property is considered a Capital Asset. The threshold may apply to a single item or to a group purchase of items that collectively meet the threshold.

A small district may have a $1,000 threshold, while others have a $5,000 or $10,000 threshold.

Non-Capitalized Assets Inventory Control

This is property that falls below the district’s threshold for capitalization. Even though property is not considered a Capital Asset, it should be carried on an inventory.

For example, the district purchases a new computer for the finance department. The value of the computer does not meet the threshold for a Capital Asset. However, the district’s policy will typically have the computer subject to an inventory control.

Custody and Proper Use of Individual Capital Assets

Who has custody of (and responsibility for) the property?

Can the property be used for personal use? Can the property be used by others using the school facilities for non-school activities?

For example, other community organizations may use the facilities during non-school hours.

Does the district permit these organizations to have access to and use AV equipment, technology, tables and chairs, etc.?
How Capital Assets are controlled.

Are capital assets controlled as a unit or as a group? This determines how they are tracked in an asset management system.

For example, are computers individually listed or are they recorded as a group?

How Procedures for receiving, tagging and distributing capital assets

Is all acquired property processed through Receiving?

What items require an inventory or asset tag?

How is property delivered to its intended recipient?

Available Data regarding Capital Assets

What information is available?

Does the district maintain an Asset Management System that includes information such as purchase dates, purchase prices, life expectancy, location of assets, and other information that will be useful to the risk management department not only for insurance purposes, but also for managing the risk of theft?

Procedures for disposing or retiring capital assets

What is the district's policy for property to be sold, surplused or transferred? Who has authorization to do so? When is the property removed from the asset management program?

Complete Knowledge Check: Section 5 Inventory & Assets p17 (FSR)
Catastrophic Loss or Damage to District Assets

Losses do happen and when they do the school risk manager is typically involved in the claims process.

The risk manager should coordinate activity between the district’s insurer and other responsible parties in the district. These responsible parties could include administration, finance and/or maintenance.

It makes good business sense for risk managers to be and stay involved in the claims process. After all, they are typically the individual at the district who is most knowledgeable about the district's insurance coverage and the claims process as a whole.

School risk managers should be very thorough in terms of the information they provide to key financial personnel after a loss.

This includes specific information about assets that have been totally destroyed or lost and need to be removed from the district's financial records.

When a loss occurs to Capital Assets it may be referred to as an Impairment of Assets. Any impairment should be measured, recorded and disclosed.

If there is insurance coverage for the loss and the insurance recovery will be received in the same year as the impairment (loss), the damages are recorded to reflect the difference between the cost of replacement or restoration of the asset(s) and the amount of the insurance recovery. This difference is recorded as an Operating Expense.
For example, a fire destroyed a portable classroom. It will cost $375,000 to replace the portable. The insurance company paid the district $325,000 for the loss.

Complete Knowledge Check: Section 5 Recording District Assets p23 (FSR)

Internal Controls and the School Risk Manager

Internal Controls are designed to provide reasonable assurance regarding:
- The safeguarding of assets against loss from unauthorized use or disposition
- The reliability of financial records for preparing financial statements and maintaining accountability for assets

What is the role of the risk manager in the district’s Internal Control system?

In some districts, business office personnel are hesitant to involve the risk manager in their Internal Control system.

Other districts recognize that the presence or absence of a proper Internal Control structure impacts the security and safeguarding of critical district assets and therefore involve the risk manager in their Internal Control systems.

In these districts, risk managers provide valuable input including identifying the areas subject to loss and recommending effective risk control techniques to reduce both the frequency and severity of losses.
Some areas within a district's internal control structure are subject to a greater risk of theft or gross mismanagement.

The risk manager can recommend and/or implement Risk Control techniques to reduce the frequency or severity of losses in these target areas.
This is an example of a district's recommended Internal Control Practice for Cash Receipts. Note the risk control techniques incorporated: segregation, prevention, and reduction.

**Authorization** – Develop procedures to specify how the department is to comply with district’s requirements and department expectations. Supervisors should verify cash deposits, voided transactions, and cash overages and shortages.

**Segregation of Duties** – Establish a chain of accountability immediately upon initial receipt of cash. Individual accountability should be maintained at all times. Transfers between two people should be jointly verified and documented. Different employees should be responsible for (1) receiving and recording cash collections, (2) balancing daily cash receipts to related cash recordings, and (3) verifying that the deposit amounts reflected in the general ledger are in agreement with departmental records. In departments where staffing levels do not permit this amount of segregation, senior management must be aware of this limitation and perform additional reviews of the records to ensure that funds are adequately protected.

**Safeguarding** – Separate, lockable containers or compartments should be available to each person collecting money. The money should be locked when the cashier is not available. Keys to the cash box should be limited only to the cashier and the supervisor. Checks should be restrictively endorsed upon receipt. Cash counting area should be reasonably secure and free of interruptions. Cash should be kept in a safe or locked drawer overnight. Cash should be deposited weekly or immediately when the amount on hand exceeds $50.00. Safe combination should be changed regularly and shared on a need to know basis. The safe should be physically suitable for its purposes.
Recording & Depositing – Deposits should be presented intact. All cash receipts should be recorded on a cash receipt form, cash register, or a properly controlled computer database at the time of receipt. Checks should be made payable to the district.

Reconciliation & Review – All receipt numbers should be accounted for.

The School Risk Manager’s role in helping assess and maintain the Internal Control structure of the district needs to be discussed and clearly understood by all parties involved in the process.

The district’s auditors annually test and evaluate aspects of the Internal Control structure as part of their financial audit of the district. Any deficiencies identified may be noted on the district’s annual report.

The Annual Financial and Compliance Report and the Risk Manager

Districts are required by law to undertake an annual financial and compliance audit and disclose their audited financial statements and the results of the compliance audit to the education regulatory authority in their state and the general public.
Several important considerations relating to risk management are included in these Notes.

The Notes to Financial Statements are an integral part of the financial statements.

Key information is disclosed pertaining to such items as capital assets of the district, the Internal Service Fund(s) of the district, compliance with internal control systems, and insurance activities of the district relating to various exposures and risks of loss.

The following are examples of one district's "topics" included in the Notes Section of its financial report:

- Summary of Significant Accounting Policies
- Deposits & Investments
- Interfund Transactions
- Changes in Capital Assets
- Construction in Progress
- Pensions
- Long Term Debt
- Operating Leases Non-Capitalized
- Risk Management
- Reconciliation between Government Fund Financial Statements and Government Wide Financial Statements
- Fund Equity
- Special Items
- Contingent Liabilities
- Litigation
- Subsequent Events

Detailed information is also provided relating to the district’s pension plan(s), healthcare coverage, maintenance of effort, Section 125 Cafeteria Plan, litigation and contingencies as well as other risk management related issues.
Here is an example of an entry in the Notes regarding the district’s pending litigation.

### Litigation

The district is defending against several suits and claims, which are routine in nature and common to school districts. Possible losses from these suits and claims are provided for by coverage through the State’s Risk Management Pool. For actions not covered by the Pool, possible losses are provided for in the General Fund reserve for self-insurance and payables.

Based on the recommendations of counsel, the district has provided an adequate amount for possible liabilities which management considers adequate for any uninsured losses which arise from such claims. However, the district is currently being sued for approximately $25M in the 2008 student shooting at ABC High School and this exceeds coverage amounts by $5M. While the district does not have this available in its reserves, it is very early in the legal proceedings and this information is preliminary and subject to change.

The School Risk Manager is a key person in providing much of the information pertaining to these specific areas of the Notes and should have a good understanding of what is reported and the impact it has on the overall perception of the district from the financial management perspective.
As can be seen from this section, a variety of areas pertaining to school district operations come into play for the School Risk Manager. An effective (and successful) School Risk Manager serves as a resource, not an impediment, to the sound management of the district’s human and other assets.

The Risk Manager doesn’t necessarily make the rules and establish the procedures, but provides valuable insight and input to the overall process of managing and controlling valuable district resources.
Review the learning objection for each section.

Section 1 Introduction to Funding School Risks
Make sure you feel confident that you have understood the objectives of Section 1.

Learning Objectives
1. Identify and describe the five steps of the Risk Management Process.
3. Understand the importance of a proactive approach to Risk Financing.

Section 2 Foundations for Funding and Basics of Insurance
Make sure you feel confident that you have understood the objectives of Section 1.

Learning Objectives
1. Understand why quantitative analysis is important to the school district risk manager.
2. Identify and discuss the five components for cost of risk.
3. Understand future value, present value, and net present value.
4. Know examples and purposes of the common tools for loss development and trending.
5. Know basic insurance terms.
6. Know required, permitted, and prohibited coverages under some states’ laws.
7. Understand the market factors that affect coverages, insurability, premiums, and insurance services.

Section 3 Options for Funding School District Risks
Make sure you feel confident that you have understood the objectives of Section 1.

Learning Objectives
1. Know the methods of transferring the financial obligation of a loss.
2. Know the difference between active and passive retention.
3. Understand the general criteria used for comparing various risk financing options.
4. Know the characteristics, advantages, and disadvantages of a guaranteed cost plan.
5. Know the characteristics, advantages, and disadvantages of a deductible plan.
6. Know the characteristics, advantages, and disadvantages of a self-funding plan.
7. Know the characteristics, advantages, and disadvantages of a pooling arrangement.
8. Understand the factors that determine the amount of insurance to purchase.

Section 4 Reserving for School District Risks
Make sure you feel confident that you have understood the objectives of Section 1.

Learning Objectives
1. Know the types of reserves and understand the basics of the reserving process.
2. Understand the objectives and two basic criteria of the major accounting standards for school district risk managers.
3. Understand what reserve amount should be carried on the financial statement and when reserves should be reviewed.
4. Identify factors that contribute to reserve instability or stability; identify business decisions affected by reserves.
5. Identify reasons a school district would employ actuarial services.
6. Know what information an actuary needs to perform an actuarial analysis.
7. Understand criteria for selecting a projected loss amount from a range of reasonable estimates for financial reporting.
8. Identify accounting audit findings that trigger concerns for school district risk managers.

Section 5 Finance Issues for the School Risk Manager
Make sure you feel confident that you have understood the objectives of Section 1.

Learning Objectives
1. Identify and explain the Risk Manager’s role in the management and security of the district’s inventories and capital assets.
2. Identify and explain how district assets are recorded after a catastrophic loss or damage.
3. Understand the role of the Risk Manager and the district’s Internal Control Practices.
4. Know what is included in the Annual Financial and Compliance Report and how it relates to the Risk Manager.