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Managing Your Risk: Self-Insured Retentions vs. High Deductibles

February, 2014
Property Casualty 360

In the current economic climate, first-dollar coverage has become a luxury that many commercial insureds can no longer afford. Although policies with large self-insured retentions (SIRs) and deductibles have always been available, they were frequently overlooked in the past when bottom lines were healthier and insurance-premium costs were subject to less scrutiny. As more insureds assume greater responsibility for managing the risk of smaller claims while relying on traditional insurance products for catastrophic protection, more policies are being issued with significant SIRs and deductibles.

While insurance limits attach above the primary layer of risk imposed on the insured in both self-insured retentions and deductibles, these types of coverages are otherwise very different. That's why it's important that clients understand the differences between SIRs and deductibles and the various issues that can arise both for the insured and the insurer.

What's the difference?

SIRs and deductibles are similar in that both require the insured to bear financial responsibility for a portion of a loss and, in this regard, represent an exposure that is not covered by insurance. However, there are important differences in the way they operate.

Insurance policies written with deductibles provide that the insurer will pay the defense and indemnity costs in connection with a covered claim, and then charge or bill back the deductible amount to the insured. In other words, the "deductible" is a sum that is subtracted from the insurer's indemnity and/or defense obligation under the policy. Importantly, the responsibility for the defense and settlement of each claim rests solely with the insurer, and the insurer maintains control over the entire claim process.

Policies written with large self-insured retentions, in contrast, may place responsibility for claims handling, including the investigation, settlement and payment of claims, in the hands of the insured. Under a policy with an SIR, the insured is typically required to pay the defense and other allocated expense costs as well as indemnity payments until the amount of the retention has been exhausted. Once the SIR has been exhausted, the insurer responds to the loss and assumes control of the claim.

Self-insured retentions are distinct from deductibles in at least one important respect: The insured whose coverage is subject to a self-insured retention generally is obligated to retain its own defense counsel. Indeed, in a self-insurance arrangement the claims-handling generally is controlled by the insured, an independent adjusting company, or a primary insurer's claim department retained by the insured to assist it in claim management. In essence, a self-insured is the primary insurer. Not surprisingly, many insureds that employ self-insurance are major companies or commercial entities, sophisticated in matters of insurance, risk management, and loss control.

Another difference between a deductible and an SIR is that the SIR does not reduce available policy limits, whereas a deductible may reduce policy limits. Thus, an excess insurance contract with limits of $750,000 sitting above a $250,000 SIR will provide the insured with $750,000 in coverage once the SIR is satisfied. A $250,000 deductible, in contrast, may reduce the $750,000 insurance policy limits, leaving $500,000 in limits after the deductible is satisfied.

An SIR is generally a specific amount of loss that is not covered by the policy but instead must be borne by the insured. An SIR endorsement may provide that the insurer shall have the right, but not the duty, to assume charge of the defense and settlement of any claim, including those below the level of the SIR.

One of the key characteristics of an SIR is that the insurer has no obligation to indemnify or defend a loss until the insured has paid the amount of the SIR. For purposes of analyzing the affect of “other insurance” clauses, this characteristic is the most significant characteristic of an SIR because it is this characteristic that transforms what would otherwise be a primary policy into an “excess” policy.

The magnitude of the difference between SIRs and deductibles depends upon the precise policy terms. Most significantly, the insured with an SIR generally assumes responsibility for claims handling and will report to the insurer only those claims that it considers likely to exceed the amount of its retained limit. By contrast, in the case of liability policies with a deductible, claims are tendered to the insurer for handling.

Exhausting SIRs and the Impact of Bankruptcy

When an insured who files for bankruptcy maintains an SIR, many issues arise with regard to the payment and defense of claims that fall within the SIR and what constitutes its satisfaction. Even when the insured has filed for bankruptcy, an excess insurer will only be liable for any amount that exceeds the SIR. An SIR is not an amount that the debtor owes the excess insurer, but rather is the “threshold” of the excess insurer’s liability to the debtor.

What constitutes satisfaction of the SIR is altered when the insured files bankruptcy. A typical policy provision provides that it shall be a condition precedent to the insurer’s liability that the insured make “actual payment, by way of settlement or judgment of damages,” of the SIR. Not surprisingly, insurers maintain that an obligation to fund the initial losses is an absolute precondition to coverage.

One question about insolvent self-insureds concerns what constitutes satisfaction of the SIR/deductible. In some instances, bankruptcy courts have granted claimants against the self-insured an unsecured claim for the portion of any eventual recovery that falls under the SIR/deductible. This has been found to be sufficient “satisfaction” of the SIR.

As the pressure to contain insurance costs by increasing the portion of the risk retained by the insured grows, larger SIRs and deductibles offer the commercial insured a series of advantages and disadvantages. On the positive side, SIRs allow the policyholder to control the defense and settlement of smaller claims and, depending on the reporting requirement in the specific policy at issue, may allow the insured to keep smaller claims out of its experience rating. On the negative side, administering claims within the SIR may involve more staff and resources than planned or may require the insured to hire a third-party administrator at its own expense to handle claims within the retention amount.

Under deductible policies, not only does the insured avoid the indemnity obligations it would have under an SIR, it also avoids the loss-adjustment expenses. In addition to lower premium costs, one of the major benefits identified by many commercial insureds whose policies have larger SIRs and deductibles is that they provide the company with an entirely new awareness of loss control which, in turn, can translate into improved loss experience in the long run.

Check Your Policy

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