Determining the optimal balance between risk transfer and risk retention measures keeps the risk financing program aligned with the individual's or organization's overall risk management goals. For the portion of those loss exposures that an individual or organization decides to transfer, a variety of risk financing measures are available.

RISK FINANCING MEASURES

To assist an individual or organization in selecting appropriate risk financing measures, an insurance or risk management professional must understand how each measure operates and whether it will enable the person or organization to meet its risk financing goals.

Each risk financing measure is unique not only in its operation but also in its ability to meet an individual's or organization's risk financing goals. The decision to use a specific risk financing measure depends on the specific characteristics of the targeted loss exposure, as well as the characteristics of that risk financing measure.

The risk financing measures discussed here are these:

- Guaranteed cost insurance
- Self-insurance
- Large deductible plans
- Captive insurers
- Finite risk insurance plans
- Pools
- Retrospective rating plans
- Hold-harmless agreements
- Capital market solutions

Guaranteed Cost Insurance

This section uses the term guaranteed cost insurance to refer to insurance policies in which the premium and limits are specified in advance. The premium is guaranteed in that it does not depend on the losses incurred during the period of coverage.

Guaranteed cost insurance policies are designed to cover property, liability, personnel, and net income loss exposures from various causes of loss and have been widely offered by the insurance industry for many years. Insurance is a funded risk transfer measure. The insurance buyer (insured) transfers the potential financial consequences of certain loss exposures to an insurer.

The insured pays the insurer a relatively small, certain financial cost in the form of an insurance premium. In exchange, the insurer agrees to pay for all the organization's losses that are covered by the insurance policy, typically subject to a deductible and policy limit. The insurer also agrees to provide necessary services, such as claim handling and liability-claim defense.

Organizations that have large loss exposures often have difficulty finding a single insurer that is willing or able to supply adequate guaranteed cost insurance coverage. To solve this problem, many organizations purchase multiple guaranteed cost insurance policies as part of an overall insurance program. An insurance program is typically divided into two or more layers—a primary layer and one or more excess layers.

Primary layer
The first level of insurance coverage above any deductible.

Excess layer
A level of insurance coverage above the primary layer.

The **primary layer** is the first level of insurance coverage above any deductible. It is also referred to as the working layer because it is the layer used most often to pay losses.

An **excess layer** is a level of insurance coverage above the primary layer. Insureds who want more insurance coverage than that offered by the primary layer usually purchase one or more excess layers. The insurance policies issued to provide coverage in excess layers are often referred to as excess coverage.

Excess coverage
Insurance that covers losses above an attachment point, below which there is usually another insurance policy or a self-insured retention.

Excess coverage is insurance that covers losses above an attachment point, below which there is usually another insurance policy or a self-insured retention. Some insurers do not provide primary layers of coverages; they specialize in supplying excess layers.

Umbrella policy
A liability policy that provides excess coverage above underlying policies and may also provide coverage not available in the underlying policies, subject to a self-insured retention.

Buffer layer
A level of excess insurance coverage between a primary layer and an umbrella policy.

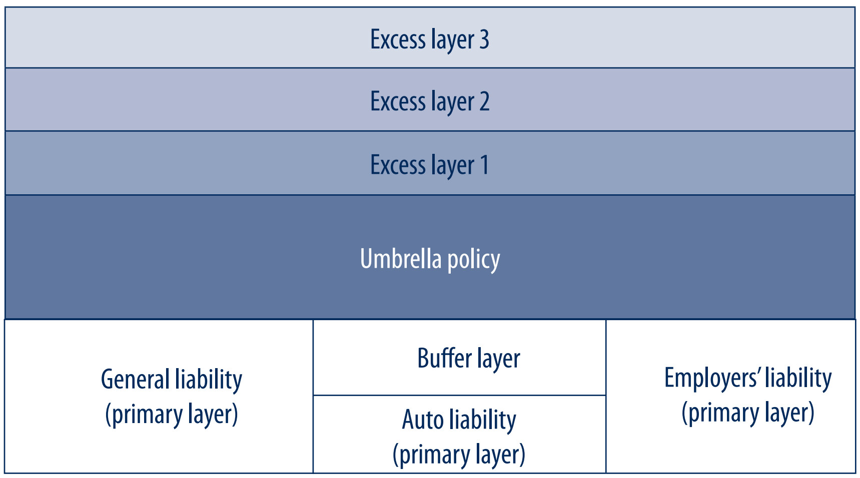
In between primary and excess layers in an insurance program, an organization may use an **umbrella policy**. A **buffer layer** is used when the umbrella policy requires underlying coverage limits that are higher than those provided by the primary layer.

As an example of using layers of coverage, consider a large hotel chain that uses a layered liability insurance program to insure its large liability loss exposures:

- The primary layer of the insurance program consists of three primary (underlying) policies covering general liability, commercial auto liability, and employers liability.
- Coverage above the primary layer is provided by an umbrella policy, which provides coverage for all three areas of liability.
- For the auto liability coverage, the umbrella policy requires a buffer layer above the primary layer because the primary auto liability policy limits are below the umbrella policy's minimum requirements.
- Finally, the hotel chain has three layers of excess insurance above the umbrella policy, providing layers of coverage for loss exposures not covered by the umbrella policy.

The exhibit illustrates the hotel chain's multilayered liability insurance program. See the exhibit "Multilayered Liability Insurance Program Including a Buffer Layer."

Multilayered Liability Insurance Program Including a Buffer Layer



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The number of layers the insured purchases depends on both the limits the insured desires and the limits that are available from insurers. The premium per $100 of coverage (the rate) usually decreases for each layer of coverage (for example, in the preceding exhibit, excess layer 3 would probably be cheaper than excess layer 2) because there is a corresponding decrease in the probability that losses will be large enough to use higher layers. See the exhibit "Ability of Guaranteed Cost Insurance to Meet Risk Financing Goals."

Before using guaranteed cost insurance for risk financing, an organization should assess the extent to which such insurance meets the organization's risk financing goals. An additional benefit offered by guaranteed cost insurance is that generally the individual or organization can deduct the insurance premium for tax purposes. See the exhibit "Alternative Risk Transfer (ART)."

Self-Insurance

Self-insurance can be contrasted with an informal retention plan, under which an organization simply pays for its losses with its cash flow or current (liquid) assets but has no formal payment procedures or method of recording losses.

Self-insurance
A form of retention under which an organization records its losses and maintains a formal system to pay for them.

Self-insurance is particularly well-suited for financing losses that are paid out over a period of time, thereby providing a cash flow benefit (compared with guaranteed cost insurance) to the organization retaining its losses. Consequently, workers compensation, general liability, and automobile liabil-