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The Risk Retention Series

How should your retention be structured? Helping professional service firms optimize retentions applied to their insurance coverages

*Aon's **Professional Services Practice** share insights to help firms navigate a hardening insurance market in the second article in a series exploring risk retention.*

In the first in our series, ***What's the right level of retention? Helping professional service firms optimize retentions applied to their insurance coverages***, several methods were outlined for considering the level of risk your organization takes on in self-insured retentions.

Retentions, however, can be structured in different ways. Based on a measured understanding of your firm's risk appetite, alternative retention designs should be considered in insurance negotiations.

Retention design can vary by type of coverage and some insurance companies may be willing to offer some types of retention but not others. How your firm selects a retention type is linked to your risk profile and type of risk. The retentions discussed here are the most relevant ones for **professional liability** insurance program design.

- *Self-Insured retention* (SIR) is the simplest form of retention and applies to each reported claim before the insurance policy limits can be accessed. A USD 1 million per claim SIR, for example, applies to each loss that is reported to the insurance policy. An obvious disadvantage is that your firm will pay multiple SIRs in any given policy period if your risk profile is prone to frequent losses.

- Deductibles are different than self-insured retentions, as they are within the policy limits. For example, a USD 10 million policy with a USD 1 million deductible provides USD 9 million of risk transfer, whereas a USD 10 million policy with a USD 1 million SIR protects the insured for the whole USD 10 million amount.

- *Aggregate retention* is triggered when an aggregate amount is reached by any combination of losses in the policy period. For example, a USD 1 million aggregate retention could be breached in a given policy by a single USD 1 million loss or by a series of smaller losses totaling USD 1 million.

- *Coinsurance or quota share retention* is employed when the insured wishes to participate in the risk alongside the insurers. It is most often used in primary policies. For example, a USD 10 million primary professional liability policy that features a USD 1 million SIR could also include 10% coinsurance or quota share retention. Against such a policy, a USD 5 million loss would result in the insured paying USD 1 million in SIR and an additional USD 0.4 million in coinsurance retention (USD 4 million X 10%). The insurance payment would, therefore, be USD 3.6 million. Insureds employ coinsurance to demonstrate confidence in their risk by participating in it alongside underwriters. Coinsurance is also useful when organizations consider the insurance market's assessment of its risk to be punitive and utilize coinsurance to ameliorate excessive premium.

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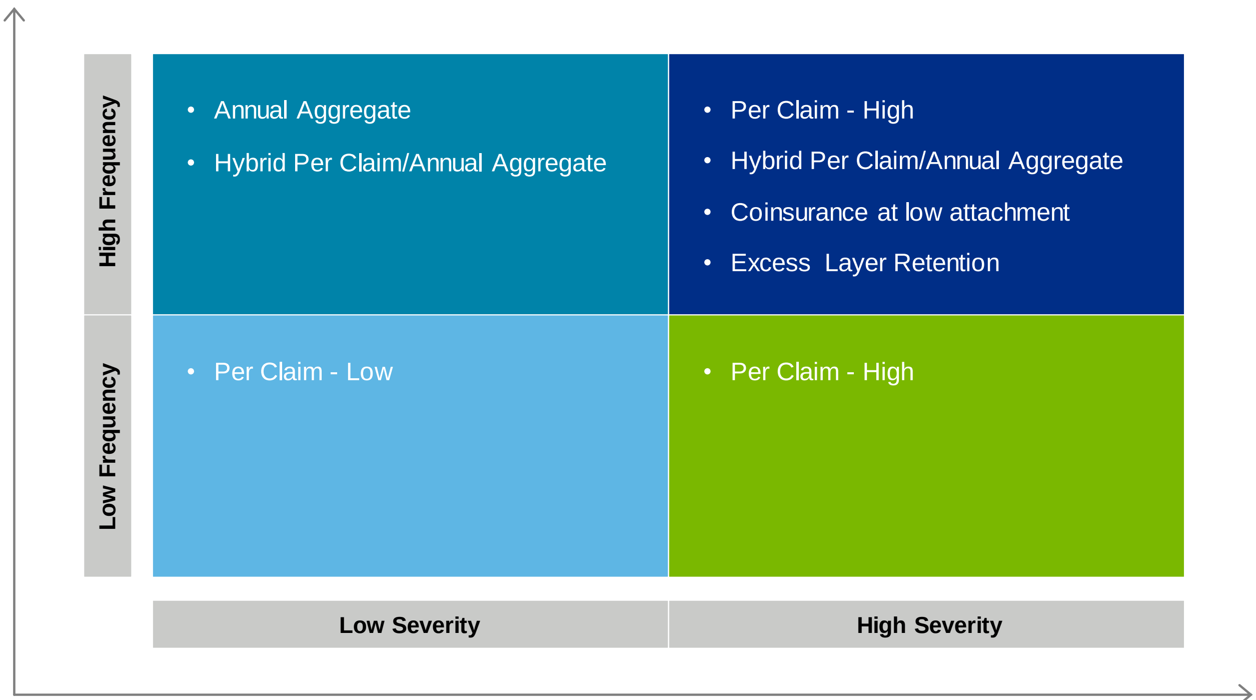
- *Excess layer retention* occurs when a firm has experienced extreme frequency and severity of losses and underwriters are not willing to write certain portions of its excess risk. This results in uninsured layers or holes in the placement. This is a rare form of retention usually caused by market capacity scarcity and has not been much seen in recent years.

The following table details how these different types of retention can be used by various risk profiles:



As noted, most retentions interact with the primary level of insurance programs. Insurance transfers unpredictable risks away from the insured, but underwriters set premiums in a way that discourage the purchase of cover at attachment points which they think are “too low.” These attachment points vary based on the size of the organization and its loss history. At the lowest levels of coverage – for example below USD 1 million for most larger organizations – frequent small claims may be best managed and paid for internally. The level of retention is ultimately set by a combination of factors, including the insured’s loss history and appetite for risk, and the underwriter’s view of the business and the broader risk environment.

Excess layer retention, discussed above, essentially forces the insured to retain a portion of the upper layers of an insurance tower, is not recommended as a proactive retention strategy. The upper layers will have a significantly lower premium cost per million dollars of coverage and are traditionally viewed as best transferred to an insurer. Upper layers of insurance towers are now experiencing pricing pressure, but we still recommend the purchase of risk transfer for excess levels. Excess insurance at high attachment points protect an organization’s balance sheet against severe claims.

Aon’s Professional Services Practice values your feedback. If you have any comments or questions, please contact **Connor Galvin**.