The Risk Retention Series

What's the right level of retention? 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 first article in a series exploring risk retention.*

Underwriters are putting pressure on insureds to increase retentions. This trend is occurring across **professional liability**, **cyber risk**, **EPLI** and other lines of coverage.

Insurers view this from one side of the equation. As they evaluate their incoming premium versus their portfolio risk profile in the current shifting environment, they conclude that they need to preserve their risk capital for where it is needed most, i.e., severity claims. As a result, they are seeking higher retentions, to reduce frequency claims and their impact on insurer capital.

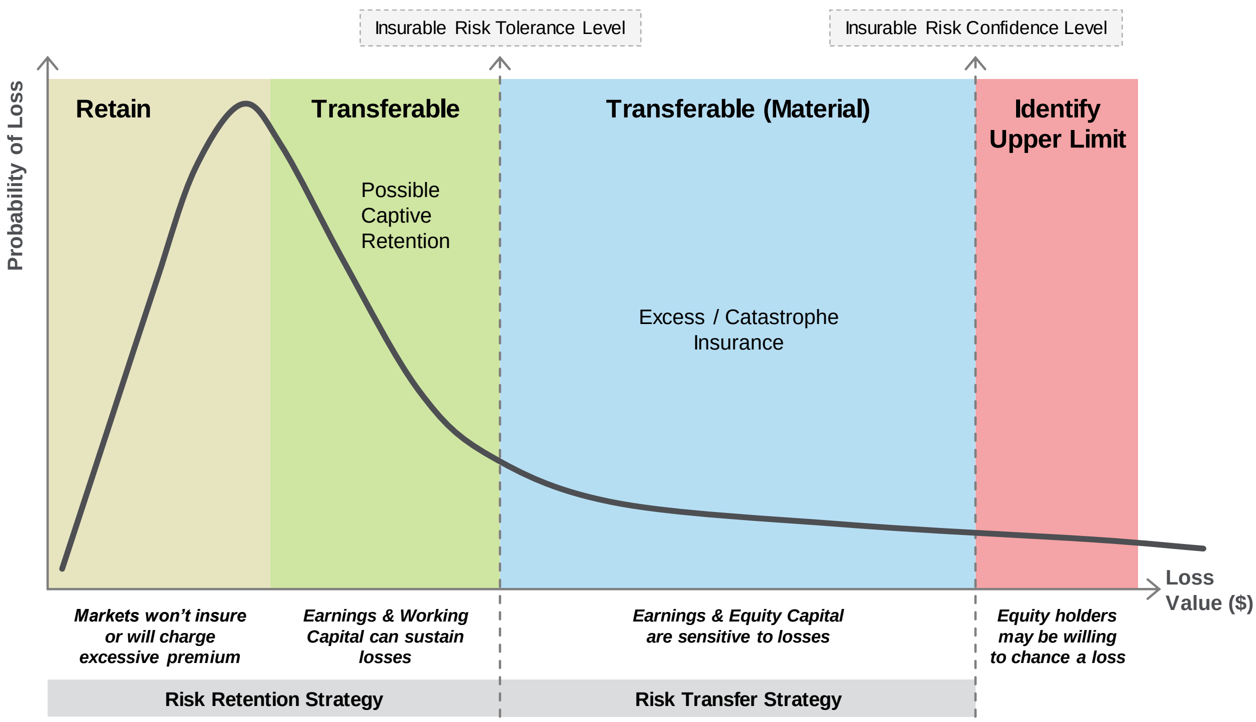
Insurers have repeatedly advanced the argument that during the last 10 years, professional liability retentions have not kept up with economic or litigation inflation, especially with regard to defense costs. In fact, in some cases retentions have been reduced over this period. In other situations, increasing retentions can also be in the insured's best interest. Higher retentions can help in avoiding the erosion of insurance programs with frequent small claims, that may be best self-managed and self-insured.

It is important for firms to harness their data and establish their baseline levels of risk retention. Specifically, professional service firms should weigh several variables to determine the retention appropriate for their organization. Some thoughts on this include:

- There are several perspectives on risk retention. Recognizing the difference between risk tolerance and risk appetite is a good starting point.
    - Risk tolerance might be loosely defined as that amount of risk that an organization can financially withstand.
    - Risk appetite, as the term implies, suggests a level of comfort with the amount of retained risk.
    - The numerical amount assigned by a firm to each of these is often quite different, with risk appetite usually being the lower number.
- Large retentions can introduce unacceptable volatility into a firm's income statement. The amount of variability a higher retention has on net profits and expected distribution to shareholders should be closely considered, from both a pre-tax and post-tax basis, since the difference may be material. Thinking about the tolerance level of partners/stakeholders to variability in their annual distributions may help to create internal consensus on the decision between higher retention or higher premium.
- The balance sheet provides another good benchmark for most firms – working capital is the difference between current assets and current liabilities and can be considered a snapshot of an organization's discretionary spending power. Ten percent of working capital has been used as a benchmark for loss retentions, but other demands on a firm's balance sheet should be considered.

- Some insurers in the professional liability market (for law firms and other professional service firms) believe that between 0.5% to 2.0% of a firm's revenue be used as a guidepost for retentions. This clearly leads to a wide range of retention alternatives and for larger organizations that have a low frequency of claims, this can result in unrealistically high retention levels. It is very important for professional service firms to come into this negotiation with its own perspective on retention levels, to avoid agreeing to a too large (or too small) retention that doesn't align with risk appetite.
- Aon's Professional Services Practice maintains an extensive proprietary placement database used to support client decision-making. By leveraging this database across the professional services sector, we found that most organizations' retentions fall between 0.25% and 1.0% of revenue- the median being 0.44% with some significant outliers that may have other factors (e.g., claims experience) impacting retention levels.

The below chart can be a helpful visual when discussing an appropriate level of risk:



Retention level decisions are not made in a vacuum – they are usually part of a larger negotiation during an insurance renewal. Many factors come into play, including loss history, insurance market environment and the level of premium. These factors impact the larger negotiation in many ways. For example, if a difficult loss history is causing the retentions to be increased, there may not be any corresponding premium consideration. However, there are always options and if your firm can accept more risk, we suggest considering a higher retention as a useful negotiating tool to manage market conditions. In some cases, a higher retention can be a simple and effective means to alleviate premium increases and achieve some independence from the insurance market cycle.

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