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# Hanover Stone Partners

## Budget Blasters

# 2014

*How Hanover Stone Partners can help risk managers cope with tight budget constraints and bring more value to the organization.*

John J. Kelly, CPCU
*Managing Partner*
David Adler
Wendy Baker
Andrew Barile
Ken Bauer
Bernie Brown
Bruce Brumbaugh
Ray Bucci
Paul Buckley
Tom Caldwell
Brent Clark
Len Crouse
Mike Davan
Peter Densen
Thomas Falzarano
Roy Fellowes
Marnix Guillaume
Dick Hackenburg
Nancy Kelly
Larry Lund
David McBride
Joseph Milan
Peter Molinaro
Eddie Molloy
Sheila Mulrennan
John Oros
Guy Ragosta
Gus Reyes
John Riley
Ty Sagalow
Greg Serio
Erik Severeid
Kathleen Sheehan
Tom Stokes
Craig Sutherland
Akos Swierkiewicz
Helen Terry
Fred Travis
Jeff Triplette
Ed Troy
Peter Viscardi
David Wehner
Jody Westby
Debbra Zucker

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# Dealing with Tight Budget Constraints

_______ ➢ Understand the nature of your organization's budgetary guidelines. Are the guidelines mandatory or negotiable?

_______ ➢ Are budget constraints posed for the next upcoming financial cycle or beyond? What events create an exception to the guidelines? A new acquisition? A broader risk management mandate and/or new responsibilities?

_______ ➢ Have the prior year's actual expenses been below budget so that, on a cumulative basis, savings requested have already been achieved (but in a past financial cycle)?

_______ ➢ What part of the insurance risk management budget is affected? Think in terms of the components of the Total Cost of Risk:

A. Insurance Premiums
B. Retained Losses
C. Cost of Safety & Loss Prevention
D. Cost of Risk Management Administration

_______ Organizations rarely impose constraints on A or B since these are subject to outside factors and reflect strategic decisions made to protect the enterprise's assets, earnings and cash flows. Moreover, a reduction in insurance premiums at the cost of a reduction in coverage might present questions of corporate stewardship.

_______ If budgetary guidelines focus on C or D, what is the goal? Is it financial performance, cash flow improvement or headcount reduction? Some techniques may generate favorable cash flow but may not significantly shift actual costs (as reflected in the income statement).

_______ Be sure to assess risk management's contribution to earnings or avoidance of cost before cutting essential activities.

> ***Example:*** Eliminating a profitable or highly cost effective captive insurance subsidiary might be counter-productive in the medium to long term, even though some current general and administrative costs might be saved by shutting it down.

# Driving Down Expenses

_______ Let go of the low value administrative stuff. Consider outsourcing to a low cost service provider with experienced staff:

- Certificates of insurance issuance, ID cards, etc.
- Certificates of insurance monitoring
- Insurance compliance- Contract & Policy reviews
- Contract reviews
- Schedules of insurance & Policy summaries
- Renewal specifications
- Premium allocations
- Fleet administration
- Supplier & Vendor background checks
- Other administrative services

_______ Don't forget that total compensation costs are usually 150% of direct salary in most organizations. Think hard about whether the right people are doing the right jobs.

_______ Reduce the amount of time bogged down in the annual renewal cycles. In the eyes of senior management, time spent in the insurance renewal process is "low value" work.

> ***Example:*** Negotiate with property insurers to submit values every other year or possibly every three years unless values increase by +/- X%.
>
> ***Example:*** Pursue multi-year agreements. Offer a 5% or 10% price increase for a three year deal. The market is most likely headed in that direction anyway.

_______ ➢ Has your loss data been scrutinized? Another company's losses can show up on your loss runs. Closed claims can show up as still open with inaccurate reserves, instead of actual settlements. Make sure discontinued operations and sold operations are segregated. In worker's compensation, if the data is wrong, the experience modification will be wrong. Have the experience verified every year.

_______ ➢ Have you conducted a Worker's Compensation Medicare compliance audit? Utilize Worker's Compensation Medicare compliance audits to accelerate claims closures, assure compliance and reduce claims costs. The audit is free for self insureds and paid for by the Medicare service company of your choice.

_______ ➢ Do you know who is actually performing the day-to-day work at your service providers? Inexperienced professionals take twice as long and you are paying for their education. Turnover of staff only exacerbates the problem. Outsourcing processing work to developing countries may appear to be more economical, but most contracts, including insurance policies in the risk management segment are tailored and manuscripted.

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_______ Shift workforce costs from fixed to variable. You will probably continue to be challenged to get headcount approval for the foreseeable future. Retain low cost, experienced providers for peak demands and special projects.

_______ In certain areas such as M&A, new ventures, divestitures and capital projects, variable costs can be fully allocated to the project, as opposed to being charged to the risk management budgets as overhead.

_______ ➢ Surplus Lines Taxes: The Dodd-Frank bill includes provisions to modify how surplus lines taxes are allocated on multi-state programs. Unfortunately, there is enough ambiguity in the bill that there are four conflicting interpretations of the legislation and not each State is embracing the interpretation that results in the greatest tax revenue for their respective State.

_______ ➢ More problematic, the ambiguous wording in the Dodd-Frank bill is leading some tax attorneys to conclude that this bill now has the potential to expand the scope of surplus lines taxes to premiums paid to a captive.

_______ Be very watchful about how your surplus lines taxes are calculated and the timing of your payments to the brokers. Become familiar with the posture of both the State your organization is headquartered and the States where you have proportionate exposure in a given placement.

_______ ➢ In scenarios where captives are being utilized to underwrite corporate risks, can the costs of property engineering, casualty claims reviews, etc. be allocated directly to the captive as underwriting expenses?

_______ Workers Compensation Claims adjustment expenses- Peel back the onion. If portions of the claims adjustment expenses are being outsourced by the insurance company or TPA to third parties, pay close attention and possibly seek alternative quotations in areas prone to mark-ups and referral fees including:

- Medical bill repricing (fee schedule)
- PPO reduction
- IME- Independent Medical Exams
- MRI-Diagnostic Testing
- Surveillance
- Legal Defense

_______ ➢ Is your organization overstating property values, particularly for business interruption and extra expense? Utilizing Hanover Stone Partners expertise in forensic accounting and property engineering, more accurate values can be developed, taking into consideration the analysis and mitigation of supply chain risks, interdependencies and effective disaster planning.

_______ Cat. Modeling and other probability type exercises (weather): Hanover Stone Partners has access to all three cat. models utilized in the industry (EQECAT, RMS and AIR Worldwide) and typically can deliver these analytical tools more economically that the costs being passed along by other service providers. Cat. models were designed to evaluate portfolios of properties. When modeling single risks, considerable effort must be committed to "front end" engineering inspections and data gathering to identify "secondary modifiers" which can have a dramatic impact on the probable loss estimates. There are approximately 25 secondary factors for wind and 25 for earthquake and each can have a (+ or -) impact on the predicted outcome.

_______ ➢ HPR Property Risks: Does your organization need to explore alternatives to the Factory Mutual? FM has historically been an excellent provider of capacity, engineering services and pricing to companies with HPR property exposures, but sometimes alternatives need to be explored, due to disagreements over coverage issues, mandatory engineering requirements, cat. limits. pricing, etc. Markets that can either compliment or replace FM capacity require complete, sophisticated HPR engineering reports that are not always available from the FM. Exploring alternatives takes time and preparation. HSP has the ability to provide high quality, HPR engineering services with all information owned by the client.

_______ ➢ Are you dissatisfied with the performance or service levels being provided by current service providers or perceive that some old fashioned market competition could afford a better economic result? Do you have the time or internal resources to manage a formal RFP process? HSP can take complete ownership of the process based on a client's pre-defined selection criteria and make evaluations and recommendations, completely objectively. The costs associated with this project can be on a fee basis or on a contingency as a percentage of savings.

_______ ➢ Categories of insurance products and risk management services that are viewed internally as "commoditized", either an RFP process or the emerging utilization of online reverse auctions, can be used to confirm the optimal cost/benefit choices.

_______ ➢ Insurance compliance monitoring: Leverage the skills, technology and economies of scale of Hanover Stone Partners to more efficiently monitor insurance compliance of suppliers, vendors, franchisees, tenants, etc. and achieve more thorough compliance.

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- Legacy Risk Management Information Systems (RMIS): Both the investment and on-going operating costs of RMIS has been drastically reduced and there are more qualified system providers than ever before. HSP can work with clients to design, spec. out, evaluate, select and implement RMIS, completely objectively because we do not offer any proprietary products. Because the products available today in the market are more cost effective, savings can be achieved in comparison to legacy products.

- International Broker Networks: Today there are a number of alternative international brokerage networks that have evolved and matured to the point of being a credible alternative to the "big three" brokers. If you perceive the cost of your existing network is too high or have service problems in a particular country, HSP's experienced Risk Consulting Advisers can help in the evaluation of current service providers and the identification and evaluation of potentially more cost effective alternatives.

# Bring More Value to the Enterprise

______ Anticipate and pre-plan for changes in insurance markets that potentially can result in negative budget variances.

- ______ Explore what leverage your organization may have with carriers, brokers and other third party service providers; not solely in the property/casualty arena, but across all institutional relationships including benefit plan providers, administrators, consultants, money managers, debt or capital transactions and very importantly, your investment department. See that your company is looked at as a business partner, not just as one more annual renewal.

- ______ Also understand your enterprise's total counter-party position with major insurance companies. When AIG was in dire financial shape resulting in the Federal government bailout, many companies were shocked to learn the magnitude of their trading relationship with AIG/AIU across corporate risk management, employee benefits, life insurance, reinsurance and the investment department

- ______ Make sure that submissions to underwriters are of the highest quality. They should be approached as marketing presentations of the organization. Write a presentation that tells underwriters what you want them to know about the direction of the company and what they should be focusing on. Include a discussion of all unique aspects of the company including geographical, legal, operational, supply and financial issues affecting the company. Highlight the improvements that you've made to your risk profile, particularly with respect to safety and loss control. Provide broad-based information to make underwriters feel like partners and insiders with your organization.

- ______ Loss profile and analysis: The traditional submission of five or ten years of loss history does nothing to explain or mitigate the loss picture. An analysis of closed locations, discontinued products, implementation of sophisticated safety programs or loss prevention enhancements can explain why a company's historical loss profile is not as significant as the numbers would indicate and the focus should shift to the historical loss experience of on-going operations.

- ______ Retention analysis: Regularly reevaluate retention decisions, particularly in changing market conditions or when your organization's financial performance shows signs of change. Re-validate your criteria for selecting retentions with Financial Executives; as their criteria may also have changed with the economy. Focus on correlated and non-correlated risks that tend to offset the adverse impacts of losses.

- When decisions are made to increase corporate retentions based on risk/reward trade-off analysis, the potential volatility of financial exposure naturally increases. To reduce volatility and the probability of aggregate losses within the retention increasing, emphasis should be placed on simultaneously educating corporate employees, creating an aggressive loss prevention program and implementing strong claims handling procedures, all with the objective of reducing the total cost of risks. The formal program may include many elements including:
    - Stop-loss protection
    - Tighter scrutiny of sub-contractors and vendors compliance with insurance requirements (Have a service organization review their insurance policies; not just certificates of insurance).
    - Confirm that the additional insured endorsement and the contractual indemnity coverage are appropriate for the risk being transferred.
    - In construction risks, consider the utilization of OCIP/MCIP and CCIP (Wrap-up policies) and Sub-Guard products
    - Create an aggressive Loss control program including better communication with managers & employees about benefits of reducing cost of risk; provide employee incentives for suggestions, improved safety, safe driving, etc.
    - Improve claims handling procedures including claims investigations, employee training, proper records management, immediate & proper adjustment of a loss, aggressive claims management and pursuit of subrogation rights. Tailored RMIS system, early claims resolution including utilization of alternative despite resolution techniques and avoidance of becoming a "target defendant".
    - Structured settlements.

- Hanover Stone Partners is a market leader in developing strategic plans for expanding the utilization of captives, particularly in the areas of employee benefits and employee personal lines. Elevate the status of the captive from a cost center to a profit center by expanding to write:
    - Employee Benefits.
    - Employee personal lines
    - Trade credit/ accounts receivable
    - Product warranty
    - Residual value

- Develop a formal Strategic Plan for the utilization and expansion of the captive. This is one area where many risk managers feel the brokers fall short. The captive manager is primarily focused on local compliance and accounting and the profit center where the account is handled is not too motivated to see additional risks underwritten by the captive, at the expense of their transactional positions. HSP is well positioned to develop a sound and objective Captive Strategic Plan without any transactional bias. Elements of the Plan can include:

- Opportunities to increase and formally fund higher retentions.
- Opportunities to expand the utilization of the captive
- Leveraging the organization's capital to maximize terrorism coverage in the U.S. by accessing TRIA's reinsurance capacity.
- Protecting risk management operations by transferring a portion of departmental salaries, risk management services and consulting expenses out of the operating budget.
- Centralize the organization's retained risks to reduce the overall amount of working capital allocable to individual risks.
- Contributing to earnings per share while protecting the company from fluctuations in insurance markets.
- Implementing operating standards for risk management that addresses the ever increasing scrutiny on Enterprise risk mitigation.
- Provide a platform for expanding globally with your risk management operations to match the expansion of your company.

________ Risk Financing strategies- Utilization of Financial Products to strengthen balance sheet and reduce on-going expenses:

- LOC alternatives (ex. Collateral trusts)
- Accelerate claims settlements to reduce collateral requirements
- Structured settlements
- Loss portfolio transfers

________ ➢ Establish uniform vendor privacy and security requirements and incorporate them in all vendor agreements.

________ ➢ Conduct a risk review of the company's cyber security program to identify areas that are weak or could be exploited by insiders and outside bad actors. There isn't enough insurance market capacity to transfer this potential catastrophic risk, therefore risk identification is critical.

________ ➢ Look across the enterprise to evaluate how environmental risks are internally financed through borrowing, LOC's or indemnity agreements. With the broad incorporation of pollution exclusions in CGL policies, environmental risks became the purview of the legal department in many companies. Interestingly, the use of insurance capital can be a more cost effective way to fund environmental loss contingencies or to provide proof of financial responsibility for regulatory compliance under environmental laws.

- Key areas where the risk manager can bring real value are:

  - Environmental indemnities in merger & acquisition agreements of publically traded companies can have up to a tenfold multiplier in negative value of the firm providing the indemnity, particularly in cases where the indemnity can be for 10+ years. For example, a $10,000,000 obligation to back a divestiture of real estate property could be insured by the buyer and seller for the ten year period and typically, the premium for this transaction would be below $100,000.

  - Many times there is a disconnect between the risk management department and the M&A lawyers writing the indemnities and the environmental insurance card is seldom optimized.

  - As plants are being sold or moth balled, there may be ongoing needs for proof of financial responsibility under environmental laws. Companies that used the financial test options in the past for proof of financial responsibility may no longer be able to meet the financial ratios needed to meet the financial tests due to the bad economy. Firms in this situation commonly turn to LOCs or bonds to provide proof of financial responsibility, which are usually a high cost alternative to environmental insurance.

  ***Example:*** For example, to provide proof of financial responsibility on an underground storage tank for a back-up generator at a real estate property, the carrying cost for an LOC may be 1% and the cost of a $1,000,000 pollution policy on the tank is typically $1,000. The cost for the LOC is 10 times the cost of insurance and yet there hasn't been any risk transfer!

- Trade Credit/Accounts Receivable exposures have traditionally been the purview of the Credit Manager in most organizations and consequently, the risk manager had little historical involvement. With the emergence of Enterprise Risk Management, trade credit is just one additional component in the enterprise's basket of risks that needs to be looked at holistically and evaluated from the perspective of correlation with other enterprise's risks. Opportunities to improve the management of trade credit risks include:

  - Save time and resources by outsourcing cross boarder credit decisions.
  - Utilize trade credit insurance to instill discipline in the sales process.
  - Increase the enterprise's sales revenues by enabling extended credit terms.
  - Increase cash flow by adding cross boarder receivables to bank's allowable borrowing formula.
  - Utilization of the corporate captive to participate in underwriting and funding a portion of the organization's trade credit risks, which can be particularly useful in multi-year contracts.

Contact Us:
Hanover Stone Partners, LLC
260 Madison Avenue, 8th Floor
New York, NY 10016
646-216-2181

info@hanoverstonepartners.com

www.HanoverStonePartners.com

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