Self-Insured Retentions versus Deductibles

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While many of you know the difference between self-insured retentions (SIRs) and deductibles, many more of you *think* you know the difference. And some of you didn't know there *was* a difference between SIRs and deductibles. This brief article is for the latter two categories.

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SIRs and deductibles, while quite different, are designed to accomplish the same goals. Each imposes a specific layer of risk onto the insured, almost always the primary layer, above which insurance limits attach. In each case, the premium for the insurance directly excess of the SIR or deductible is credited to reflect the fact that the insured is assuming some amount of primary risk. This, however, is where the similarities end.

The major differences between SIRs and deductibles concern

(1) insurer responsibilities in the event of a loss,

(2) collateral requirements,

(3) defense costs,

(4) certificates of insurance, and

(5) limits erosion.

Insurer Responsibilities in the Event of a Loss

Under an SIR, the excess insurer generally has nothing to do with losses that do not penetrate its attachment point. The insurer may, however, require notification when a claim is reserved for an amount that pierces the attachment point. Under a deductible, however, the insurer pays every loss (up to the maximum limit of liability), and is then reimbursed by the insured up to the amount of the deductible. In practice, small losses are simply paid by the insured to avoid the "dollar-trading" problem.

Collateral Requirements

Insurers require collateral in situations wherein they assume credit risk. That is to say, in situations where the insured cannot pay a loss, the insurer is obligated to step in and pay the loss. In SIRs, because the insurer has no responsibility for paying losses until the SIR is exhausted, there is generally no collateral requirement. Conversely, large deductibles very often require that the insured provide a letter of credit (LOC) or some other acceptable form of collateral to cover expected losses that occur within the deductible.

For example, let's say that you have a $250,000 per-occurrence deductible on your workers compensation coverage. Your expected losses from $0 to $250,000 amount to $1 million. Your collateral requirement might be $1 million, but more likely it will be some multiple of this figure, perhaps 150 percent of $1 million. If your program has an annual aggregate limit, you may be required to provide collateral up to and perhaps exceeding this limit. So why wouldn't everyone simply opt for an SIR and avoid the collateral issues?

Workers compensation and in some cases, automobile liability, are only available on a deductible basis because state law requires insurers to pay claims on a first-dollar basis unless the insured is a qualified self-insurer, in which case it must post a self-insurer's bond with the state. For most other coverage lines, an SIR is used most frequently.

Defense Costs

Under the standard, garden variety insurance policy, the costs to defend claims are included as supplementary payments and do not erode the policy limit. This is generally the case with small deductibles, but in the large deductible world (over $100,000), whether defense costs erode the deductible is subject to negotiation; they usually do. Under an SIR, the question of who pays for defense costs and whether the SIR is eroded is moot—the insured pays all expenses associated with defending claims until the loss exceeds the SIR and its amount is not eroded.

Certificates of Insurance

Here is one of the reasons why insureds might choose a deductible over an SIR. Remember that under a deductible, regardless of how claims are paid, the insurer is ultimately responsible for paying losses. This means that a certificate of insurance need not divulge the fact that a deductible applies. Conversely, SIRs must be divulged on insurance certificates as the insurer has no responsibility to pay claims until the SIR is exhausted. Some certificate holders, banks, for instance, often demand to know the amount of any deductible or SIR regardless of whether it must be divulged.

Limits Erosion

Under an SIR, the policy's annual aggregate limit is usually not affected by the SIR amount. Let's assume that your aggregate SIR under your general liability policy is $1 million, and your total policy limits amount to $10 million. You would have $10 million of coverage excess of $1 million SIR. Under a deductible, the annual aggregate limit is usually eroded by the amount of the deductible. In the same scenario, in a deductible plan, your total limit of liability would also be $10 million, but $9 million of it would be available from the insurer, and you would be responsible for the initial $1 million.

Here is a handy checklist of the above five features.

	Deductible	**SIR**
Insurer Responsibilities in the Event of a Loss	Yes	No
Collateral Requirements	Yes	No
Defense Included in Limit	Yes (usually)	No
Ability to Certificate	Yes	
Limits Erosion	Yes	No

Unless restricted by law, most insureds opt for SIRs over deductibles. However, not every insurer allows SIRs. Many of the admitted multiline insurers require deductibles because it means that they're involved in every significant claim. Insurers know that without effective loss adjusting and claims management, small claims can quickly become large claims. These insurers generally don't unbundle their services, meaning that they retain the right to adjust each and every loss, as well as manage the claims portfolio and provide legal services. Non-admitted specialty insurers, however, are far more likely to permit SIRs. In fact, most non-admitted insurance companies are not equipped to handle each and every claim, so an SIR suits their purposes quite nicely.

Conclusion

In these days of ultra-tight credit, collateral can be a major headache. Some insureds would rather use a non-admitted insurer and go with an SIR to avoid having to post letters of credit under a deductible plan. This strategy is, of course, not an option for workers compensation.
