Nonprofit
Risk Management
Center

“Everything's Fine? We've Got Insurance!”

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Have you heard these jubilant words from your staff or board lately? Even worse, do you comfort yourself with this thought whenever some accident strikes your nonprofit? If so, then everything definitely is not fine within your risk management program.

Our Key Thought

The central theme of this article is that a better risk financing strategy puts insurance last, not first, among the sources of funds for financing recovery from accidental losses. Before relying on insurance, which at best only lets your nonprofit share covered losses with an insurer, it’s best to explore various ways of using your organization’s own financial resources to finance recovery from accidental losses. The more you can rely on your own resources, the less expensive accidents will be for your nonprofit and the more you and your staff will become focused on preventing losses. Over time, this sharper focus on safety will increase the financial and other resources you can direct toward achieving your mission. This will decrease the amount of your organization’s money that flows into insurers’ profits.

Let’s look at the several specific points that underlie this central theme.

1. Insurance Never Pays for Everything
First, when you insure, the insurer never pays your entire loss, you are always left with a significant share: Often there is a deductible you must pay, a deductible that leaves you paying most or all of the smaller, more frequent losses. Then there are the really big losses, the ones that exceed the top limits of your insurance. Any costs beyond these top dollar limits on what the insurer will pay for any one loss or for a series of losses in any consecutive 12 months, are yours to pay.

Then there are the losses that fall within the exclusions written into your organization’s insurance policies (“We do not pay for?”). Again, these are not covered by your insurance.

Finally, the work of collecting the money an insurer will pay you costs you money. These include:

- maintaining insurance records,
- documenting your claims,
- spending your and others’ time,
- negotiating with insurance adjusters or attorneys, and
- going to court, if necessary, to protect your rights.

These are all costs your nonprofit must pay to get the benefits your insurance is supposed to provide.

2. Retention's More Cost-Effective
Moreover, insurance premiums are only the beginning of the true costs of the insurance your nonprofit buys. Part of every premium dollar that you spend — from a few pennies to a dime; and rarely two dimes or a quarter for coverage of losses that are very unusual but can be catastrophic when they strike — are coins that you do not need to spend if you can just find ways to be ready to pay for accidental losses out of your own resources rather than buying insurance. Relying on your organization's own resources to pay for accidents is known in risk management circles as "retention."

Some retention alternatives to explore as ways of reducing your costs of accidents include:

- drawing on your current revenues to absorb minor losses (like wind-damaged roofs or dented fenders),
- setting up reserves for losses like defects in any products your nonprofit sells or shortfalls in fund-drive collections,
- borrowing from banks or other lenders to replace damaged machinery, and
- requiring outside contractors to assume liability for any losses that arise out of their work, regardless of fault, as a condition for winning the contract.

These strategies are all ways of retaining exposures to loss — relying on your organization's own internal resources (including bargaining power with outside contractors) — rather than turning to insurance. In the long run, retention is less costly than insurance, leaving your organization with more resources to fulfill its mission, by surrendering less to insurers' bottom lines. Insurance certainly can stabilize your accident-related costs, but at a significantly higher long-term cost than if your organization plans for these fluctuations and absorbs these more directly.

3. Insurance May Encourage Carelessness
Beyond wasting money on insurers' profits one of the reasons insured losses tend in the long run to be much greater than internally financed (retained) losses is that insurance reduces people's incentives to be careful. If someone else (an insurer) is paying, there is — at least for many people, some of whom surely work in your nonprofit — a greater human tendency to be less cautious, thus more willing to take needless chances.

Consider an analogy. When you are someone's dinner guest at a fine restaurant you do not visit very often, especially when your host is not a particularly close friend, do you spend a bit more than you would spend if you were paying the bill yourself? Most people, perhaps not you but most people, have to admit "Yes" if they are being honest. The "damages" most people cause through an evening's restaurant bill often are greater if someone else is paying. Being even subconsciously aware that someone else, especially a seemingly distant and impersonal insurance company, will pay if anything goes wrong, allows many people to relax, allows inattention and perhaps a bit of carelessness to creep into the work habits of even the best of us. In short, an insurance-will-pay mindset opens the door to more frequent, and/or more serious accidents.

In contrast, if safety and efficient job performance is everyone's responsibility — and if everyone knows this is a shared responsibility — caution becomes a group norm. (If we're splitting the restaurant bill equally, most of us will not order a crab cocktail and a filet mignon when we see that the others are having soup-of-the-day and chicken fingers.) But for this shared responsibility to improve safety to work, everyone must know — perhaps must be reminded occasionally — that accidents impose real costs that fall personally on everyone committed to your nonprofit's mission. Retaining many conceivably insurable losses within your nonprofit underscores this shared commitment and gives everyone an opportunity to demonstrate through individual safe work practices a personal dedication to that shared mission.

So Plan to Retain; Cut Your Resource Drain

Insurance clearly has its proper, but limited, place in risk financing, which is to pay the truly unpredictable, truly catastrophic loss for which no one can plan or take effective precautions. Relying more on retention for lesser, more predictable and preventable losses, however, leaves your nonprofit with more money and a more safety-conscious staff, and better prepared to treat at least some seemingly accidental losses as rather routine expenses. When smaller, more-predictable losses become expenses that over the long run are handled as basically normal "retained" expenses, your nonprofit will spend less on insurance, thereby devoting more resources to its mission.

Effective planning is key to changing the seemingly unpredictable costs of many accidents into budgetable expenses. This planning begins with the losses — both accidental and business — that your nonprofit and similar organizations have suffered in the recent past (perhaps since 1995) if this data is available. Some very important questions are:

- What were the causes of these losses — and, therefore, what can we do now to prevent similar future losses?
- For each cause of loss, how often did the losses occur?and, therefore, how often can we expect future losses to strike?
- For each cause of loss, what were the smallest and the largest losses — and could we have sensibly and comfortably planned to pay for some of these smaller losses ourselves rather than spending money on insurance?

For some causes of loss — perhaps vehicle damage, robbery, product defects, or windstorms — your answers to these questions will lead you and your board or finance committee to examine the wisdom of retaining all but the largest losses rather than trying to insure against every possible loss. Retention may be especially attractive if you have economical, effective loss control measures against these potential losses. For other causes of loss — perhaps employee injuries, earthquakes, fire, and automobile liability claims — the losses may be so unpredictable and potentially very severe — that insurance is your only sensible financing option. Each cause of loss (each “peril” to use insurance-policy language) must be evaluated separately, and different nonprofits will quite correctly find different answers to how extensively it should retain rather than insure against losses from each peril.

Each organization’s best set of “how-much-to-retain” answers depend on its history, objectives, resources, ability to limit its loss exposures, and tolerance for risk. But, an automatic “O boy, we’re insured!” is almost never the right, the responsible, the mission-responsive answer.

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