Nonprofit Risk Management Center

Love Those Deductibles!

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Love? Shouldn't it be "Hate Those Deductibles?" — those devilish clauses in many property and liability insurance policies that make us as insureds pay the first part of almost every loss? Isn't it because of deductibles that insurance never seems to do the whole job — always leaving us to pay a good bit of every loss before the insurer pays anything? And if the loss is less than the deductible, the insurer never pays anything — even though we always pay our premiums. What a deal?for insurers, that is!

"In property policies, the insurer is not involved at all with losses that fall within a deductible. The insured pays both for the loss itself and for the 'loss adjustment,' which is the cost of arranging for the repairs — cleaning up, getting bids, obtaining building permits, and the like."

I appreciate these thoughts, and hopefully I understand why many leaders of nonprofits, hostile toward deductibles, try to choose the smallest ones that their insurers will allow. Yet I will try here to be "the devil's advocate," to explain why any organization, nonprofit or profit seeking, should choose the largest deductibles it can safely afford. My central point: opting for the biggest affordable deductibles (1) lowers an organization's long-run average loss costs, (2) motivates its staff and management to operate safely, and (3) leads to the best allocation of its overall insurance budget.

Types of Deductibles

This reasoning applies to any type of deductible. The most popular form of deductible is a straight per-loss deductible. For example, a $500 straight per-loss deductible in a $20,000 property insurance policy, an insurer pays nothing for any loss that is $500 or less; It pays $1 for a $501 loss; it pays $600 for an $1,100 loss; and only for a loss of at least $20,500 will this policy pay its $20,000 face. In contrast, with a $500 franchise deductible, this $20,000 policy again pays nothing for losses of $500 or less, but it pays the full amount of any loss that exceeds $500: $501 for a $501 loss; $1,100 for a $1,100 loss, up to the $20,000 for a $20,000 loss. In still further contrast, a $500 disappearing deductible, disappearing at $10,000, would still pay nothing for a loss that did not exceed $500, but it would pay the full amount of any loss that was between $10,000 and the $20,000 face amount of the policy. For any loss between $500 and $10,000, the policy would pay more than 100% of the portion of the loss over $500 — this percentage increasing as the loss approaches $10,000.

"Dollars not spent to cover fairly routine, reasonably budgetable, automobile collision losses usually are better spent to buy higher limits of business interruption or professional liability insurance, insurance against the truly catastrophic events that, potentially but very truly, can destroy an organization, ending its pursuit of its mission."

These types of deductibles — straight per-loss, franchise, and disappearing — all apply to each event that a given property or liability insurance policy covers. As an alternative, deductibles can apply to time periods, such as a year, with the deductible aggregating all the insured losses that occur during that time period.

For example, a $100,000 annual aggregate deductible in a $1 Million general or professional liability policy would pay nothing toward any of three otherwise covered judgments $50,000, $6,000, and $40,000 — against an insured that may occur early in this insured's policy year. These judgments would total only $96,000, or $4,000 short of the $100,000 annual aggregate deductible. But if the next judgment against this insured were $25,000, the insurer would pay $21,000 of it, which is the remainder of the total claim after the insured has absorbed the $4,000 left of the $100,000 annual aggregate deductible. For any further judgments during the rest of this insured's policy year, the insurer would pay the full amount of the judgement, up to $1 Million per judgment.

Still thinking about different types of deductibles, there is one more important difference between deductibles in property policies and in liability policies. In property policies, the insurer is not involved at all with losses that fall within a deductible. The insured pays both for the loss itself and for the "loss adjustment," which is the cost of arranging for the repairs — cleaning up, getting bids, obtaining building permits, and the like. A property insurer is happy leaving these administrative costs to the insured when the loss clearly falls within the deductible. But in liability insurance, there is almost always the possibility that even the most minor claim, if improperly handled, may mushroom into a very large lawsuit. To prevent this, most liability insurers want to be informed of every claim and to supervise and to absorb the cost of settling or defending every potentially insured claim. In liability insurance, defense is too crucial to the ultimate cost of even the apparently smallest claim to be left to an insured. Hence, in liability insurance, only the actual amount of paid claims (not the liability loss adjustment costs) are charged as part of the deductible the insured must absorb. This background on deductibles makes it clearer why embracing deductibles in its insurance policies lowers an organization's loss financing costs, motivates better loss control throughout its operations, and helps it allocate its insurance budget to the loss exposures for which insurance is most needed.

Cut Premium

Rates and Risk Financing Costs

Hopefully, none of us insures against such foreseeable, budgetable losses that we all know are coming in our personal lives: automobile tires that go flat or broken backdoor windows, for example. These are "accidents," conceptually no different than automobiles crashing on highways or hurricanes blowing down whole houses. Yet, if we were to try to insure against flat tires or broken backdoor panes, think how our Homeowners and Family Automobile policy premiums would skyrocket! And it might take an insurance adjuster weeks to come see our flat tire — three weeks we couldn't drive our car with the flat tire. It is just cheaper and easier to pay these losses ourselves and save our insurance for the big things!

The same is true for organizations. It is a fact of nature that small losses, the "flat tires? of an organization's normal activities, happen rather frequently in the overall scheme of an organization's life; the hard-to-foresee "head-on collisions" in the life-span of an organization are really quite rare. By relying on insurance for only these potentially catastrophic events in an organization's life, we can cut down both our organization's insurance premiums this year and, in the long run our total costs of paying — from our own organization's pocket, or through truly needed insurance for major, unforeseeable casualties — for all the setbacks our enterprise may suffer. By choosing the types and levels of the deductibles in our insurance policies, we can control how much we reduce our organization's costs of the events we can truly consider "major accidents" as opposed to prudently budgetable costs.

Encourage Loss Control

Another way to make more costs of “accidents” more predictable is to encourage safety as part of the organization’s “way,” or “culture,” in performing everyday activities. Emphasizing insurance deductibles to let management and staff know that we all have to “eat” the first dollars of most otherwise-insured losses — and that these dollars come out of a department’s or the whole organization’s reported financial results — can be a strong motivator for safety, for everyone’s personal “ownership” of the overall safety record. For better safety to be an effective motivator, it usually must be presented as a positive reward for the group, not as a negative threat to individuals so unfortunate as to have been involved in particular accidents. Focusing on financial results as affected by choices of deductibles provides a positive, objectively impersonal framework for conveying this message.

Improve Allocation of Insurance Budget

Insurance premiums and overall risk financing dollars that are saved by choosing substantial deductibles in insurance policies for controllable exposures become dollars that can be put to higher and better risk management uses. Dollars not spent to cover fairly routine, reasonably budgetable, automobile collision losses usually are better spent to buy higher limits of business interruption or professional liability insurance? insurance against the truly catastrophic events that, potentially but very truly, can destroy an organization, ending its pursuit of its mission.

Once again, save the insurance for the really big, otherwise unmanageable, unforeseeable events in your organization’s life. Love the adequate high limits of insurance you need for the really rare occasions when only adequate policy limits can save your enterprise; and love the deductibles for helping you reach the decisions through which you make the best use of your risk-financing and overall risk management dollars.

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