

# insurance management policy & guidelines

FOR GENERAL GOVERNMENT SECTOR

# **Insurance Management Policy & Guidelines for General Government Sector**

**September 2007**

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This document deals with insurance and the use of insurance in the Victorian general government sector within the context of a properly structured risk identification and management plan.

This policy should be read in conjunction with the *Victorian Government Risk Management Framework*<sup>1</sup>

All general government sector entities are expected to comply with the Victorian Government risk management framework. This policy supplements that framework as it relates to risk, insurable risk and guidance on insurance.

#### **Obligations relating to this policy**

1. All participating bodies are required to obtain their insurance from the Victorian Managed Insurance Authority.
2. All participating bodies are required to account for the risk of self-insured and under-deductible losses appropriately.
3. If an agency or department chooses not to insure an insurable risk, that entity is liable to meet the financial impacts of an adverse event from its existing resources and should not seek, and cannot expect to receive, financial supplementation from consolidated revenue.
4. All participating bodies are to provide quarterly claims data to the Victorian Managed Insurance Authority regarding under-deductible claims.
5. All participating bodies are required to implement claims management arrangements consistent with this policy.
6. All participating bodies are required to engage with the review processes undertaken by the Victorian Managed Insurance Authority in relation to the agency's risk management framework and agree ongoing action plans to increase their risk maturity.

# 1. Introduction

The community expects a high degree of efficiency from Government in its use of resources and assets. In that regard the use of risk management is essential for entities within the government sector departments and agencies to make the best use of resources and assets and minimise loss to the community and consolidated revenue.

Insurance is one of a number of risk management tools available to agencies to manage and transfer the risk which arises from fulfilling the functions they provide on behalf of the Victorian Government.

The use of insurance should be part of a wider risk management strategy consistent with the Australian/New Zealand Risk Management Standard. The use of insurance should be considered in light of:

- the risks facing each individual agency;
- the availability of alternative risk management and minimisation strategies; and
- the financial consequences for the individual agency of choosing not to insure.

# 2. Identifying risk is the first step

Before an agency can make a decision about insurance it is necessary to identify risk exposures.

# 3. What is risk?

Risk is an uncertainty about loss, injury or gain and is an unavoidable part of doing business, any risk may have a positive or negative impact.<sup>1</sup> Risk increases as the likelihood (frequency of occurrence) increases and/or the impact on the business (consequence), usually measured in dollar terms, increases.

Risks may relate to financial or non-financial objectives, entity specific, intra-agency and can relate to an entity's assets, resources or potential exposures to liability claims. Risks can be categorised as operational, financial, compliance or strategic. Within these four categories individual risks could relate to reputation, information technology, people, knowledge, contractual, regulatory, legal, accounting, reporting, economic and social risks.

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<sup>1</sup> The Australian/New Zealand Risk Management Standard defines risk as "the chance of something happening that will have an impact on objectives".

There are four basic risk management strategies:

- avoidance (avoid it);
- loss prevention and reduction (minimise it);
- retention (accept the risk); and
- share (let someone else assume all, or part of).

A typical categorisation of primary risk management strategies, based on frequency and severity of loss, is as follows:

		Frequency of Loss (likelihood)	
		Low	High
Severity of Loss (consequence)	Low	Retention	Loss prevention and reduction
	High	Share	Avoidance

It should be noted that this table illustrates primary, not exclusive, strategies. In many cases a combination of strategies will be used. For example, taking precautions against fire, such as removing fire hazards, fitting a sprinkler system and also purchasing fire insurance combine elements of risk avoidance, loss reduction and risk transfer.

Determining the appropriate strategy or combination of strategies is generally based on minimising cost in the long term or short term. Relevant factors in deciding this include:

- direct annual outlays, for example, costs that will be incurred even if the risk does not materialise (e.g. insurance premiums, payment of security guards, amortised capital cost and annual maintenance cost of items such as sprinkler systems, security fences, etc); and
- expected and maximum losses if the risk does materialise (e.g. capital cost of replacing buildings and equipment, business interruption costs such as revenue foregone, and cost of hiring other premises, etc).

On this basis a more detailed analysis would suggest:

- retention is preferred where the benefits of loss prevention and reduction do not justify the costs;
- loss prevention and reduction is preferred where the cost is less than it would be to assume or share the risk;
- share is preferred where loss prevention and reduction or retention of the risk are not viable options in their own right, or the cost of sharing the risk is less than the cost of retaining it; and
- avoidance is preferred where prevention and reduction strategies are not appropriate in their own right and the agency can choose to discontinue the activities to which the significant risk is aligned.

Within each category there are various tools that can be used to manage specific risk exposures.

For further information on risk management tools government sector agencies should contact the Victorian Managed Insurance Authority.

### **Toolkit: Let's talk about risk**

The terms outlined above that describe risk, and relate to the management of risk, help to illustrate the range of risk exposures within any organisation; however, they can create confusion.

When discussing risk it is important to develop a common understanding of the purpose of identifying risks and the meaning behind the terms that are being used and discussed within each organisation. Therefore, there may be value in keeping it relatively simple in the first instance.

An organisation may wish to commence an internal dialogue at the level of operational risk and strategic exposures or internal versus external risks (or any other segmentation it feels is most appropriate). Initiating such a dialogue, in addition to commitment and leadership from senior executive, will encourage a culture of risk awareness, which will assist to identify, tolerate and deal with risks appropriately.

## **4. Insurance is a risk management tool**

Insurance is a risk management tool. The purchase of insurance is generally regarded as a method of risk transfer as it actually transfers the financial risk of loss, contractually, from the insured party to the insurer. However, sometimes not all of the risk can be transferred nor is it always cost beneficial to do so.

Insurance is a financial arrangement for redistributing the costs of unexpected losses where the insurer agrees to compensate the insured for its losses. The primary function of insurance is the payment by insurers of claims for losses incurred by those insured.

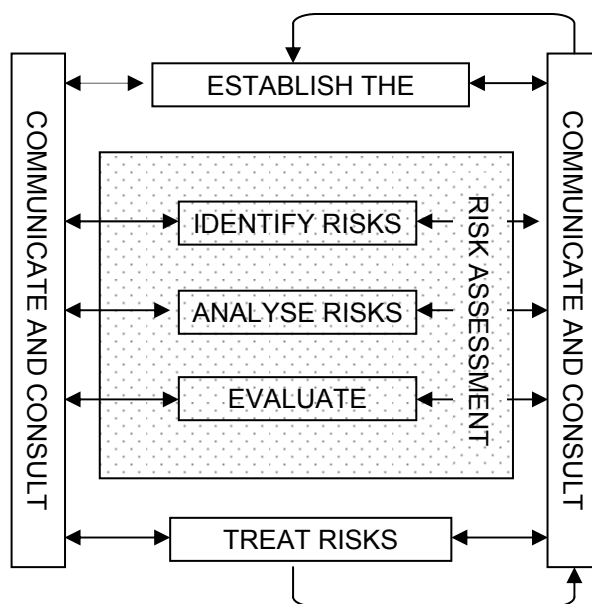
Most insurance policies specify a minimum value of loss or self-retention per claim (a 'deductible', 'retention' or 'excess') that the insurer will not pay. Increasing this deductible amount will usually reduce the annual premium but will also expose the insured to a larger loss if the risk materialises.

## 5. Use of an appropriate risk management plan

In general, an appropriate risk management plan will identify risk exposures within an individual entity, showing risks that are present and why they constitute risks. Such a plan should be as comprehensive as possible.

This includes establishing the context, the organisational environment, and setting the scope and boundaries. A useful risk management process, reprinted from the Australian/New Zealand Risk Management Standard 4360 with the permission of SAI Global Ltd., is set out below<sup>2</sup>. The risk management plan as well as outlining specific risks should identify the proposed responses to an adverse event, which may vary with the severity of the event.

All participating bodies are expected to have risk management plans consistent with the Australian/New Zealand Risk Management Standard or similar. The Victorian Managed Insurance Authority is charged with reviewing the risk management frameworks of all participating bodies, consistent with the *Victorian Government Risk Management Framework*.



<sup>2</sup> The standard can be purchased at <http://www.saiglobal.com>. The job number is SAIG Ref. 0704-c045.

## Toolkit: How to identify risk

Risks exposures vary between organisations and within parts of individual entities. In this regard the process of identifying risk needs to be broad enough to identify as many risks as possible. While the advice of consultants, and for the government sector, the advice of the Victorian Managed Insurance Authority, may be very valuable, the following tools can be used within an organisation to facilitate the identification of risks.

- **Internal staff interviews.** Staff within each entity are a source of expert information as while conducting their daily tasks they will be acutely aware of many of the issues that are likely to arise.
- **External interviews.** Clients, customers and stakeholders are likely to have a different perspective on the organisation than staff. Tapping into the knowledge they have about the operations of an entity can shed additional light on potential risks. Likewise, dialogue with similar organisations is likely to inform the risk identification process.
- **Brainstorming exercises and focus groups.** As with interviews, utilising the knowledge of those who work in and deal with the daily operations will help identify exposures.
- **Historical data.** Data gathered from past claims history, industry experience, audits and reviews can provide specific insights into the risk exposures of an organisation.
- **SWOT analysis.** A formal analysis of strengths, weaknesses, opportunities and threats will provide appropriate mechanisms to identify risk exposures.
- When utilising these tools the following questions should be asked:
  - What are the organisation's objectives and what risks arise from delivering these objectives?
  - What is it that the organisation holds (which may include property owned by others) that could be at risk?
  - What are the types of risk and how might they be affected by factors from within the organisation, from the operational environment and forces outside the organisations control?
  - What are the potential impacts of the risks being discussed and identified?
  - Which risks require priority treatment?

The following resources are recommended as part of the toolkit for insurance management across the general government sector.

The Victorian Managed Insurance Authority provides risk management advice to the State Government and individual clients, and can be contacted for more information or support on risk management planning including assistance around the application of tools and methodologies.

The State Services Authority has produced the *Good Practice Guide on Governance for Victorian Public Sector Entities*, which also provides further information on risk management.

The Victorian Auditor General has produced a valuable document *Managing Risk Across the Public Sector, Good Practice Guide: Auditing in the Public Interest*.

The Australian/New Zealand Risk Management Standard is a comprehensive starting point for organisations and is the preferred standard for all agencies in Victoria. HB436 *Risk Management Guidelines* is an informative guide that explains the standard further.

**Example: Swimming pools and office halls**

While risks may be shared, the severity of specific risks and the methods available to control them may differ from organisation to organisation depending upon operations, interactions with members of the public, facilities and services provided.

The potential for liability claims arising from personal injury due to 'slips and trips' is a risk likely to be shared by many organisations. But should the response to these risks be the same for every organisation?

While it may be practical to establish procedures to clean up liquid spills that decrease the potential for slipping incidents in the office kitchen by providing a sign and a readily available mop, is this the case for other facilities?

A community swimming pool's operations depend upon water-based activities and no amount of mopping is likely to maintain a dry environment around its facilities. In these instances the response to the risk of slipping on wet surfaces is likely to be significantly different, and may include: warning patrons of the danger; prohibiting running whilst on the premises; covering floor surfaces with non-slip protection; and a comprehensive insurance regime.

Additionally, the likelihood of injury from slipping is significantly higher for a community swimming pool than an office environment because of the different nature of the activities that are conducted at each site and the number of people likely to visit the facility. Therefore, the need for insurance to cover potential injuries is greater at the swimming pool.

While a very simple example, this illustrates how the preferred approaches to risk identification and risk management will differ between organisations.

## 6. When to use insurance

For each risk identified under a risk management plan, the two key questions relating to insurance are:

- is the risk insurable?; and
- if the risk is insurable, should it be insured?

### Is the risk insurable?

While there is considerable theory regarding the key features that a risk must have to be considered insurable (such as a well-established statistical basis for quantifying the probability and severity of an adverse event) in practical terms the key issue is whether there is a reliable underwriter willing to issue a policy to cover the risk at a reasonable price.

In the case of the Victorian general government sector, the Victorian Managed Insurance Authority is the insurer for all participating bodies.

The Victorian Managed Insurance Authority runs a fully-fledged general insurance operation which includes underwriting and claims management. The Victorian Managed Insurance Authority purchases its own insurance (reinsurance) where appropriate to provide the necessary cover for its client base and the State as a whole. The Victorian Managed Insurance Authority is able to provide any insurance cover that is reliably available in the commercial market.

The Victorian Managed Insurance Authority is able to provide advice on the appropriate individual insurance program taken out by participating bodies taking into account the client risk profile, historical claims experience and the financial strength of the particular organisation. Victorian Managed Insurance Authority will advise participating bodies whether it is able to cover particular risks and, as part of its assessment of risk management plans, can advise non client bodies whether commercial insurance is available to cover identified risks.

If a risk is not insurable, the agency's risk management plan should specify alternative responses to an adverse event, using an alternative and appropriate risk management tool.

Even if a risk is insurable, the agency's risk management plan should specify whether pre-event actions can be undertaken to reduce the probability of occurrence or severity of the outcome of an adverse event, and provide a cost-benefit analysis of the possible actions.

### **Example: Deductibles**

A (hypothetical) agency responsible for large rural facilities will be exposed to specific risks which it should have identified in its risk management plan. One type of risk, which is common to most facilities but possibly more significant for this agency, is that of fire damage. A fire can result in a range of property loss outcomes, from minor smoke and water damage with minimal interruption through to total loss of property and major interruption. As well, there may be injuries to employees or members of the public, and also business interruption.

In these circumstances the agency will need to determine what level of insurance, if any, it will require in relation to this risk.

Following its risk analysis (and potentially with the benefit of incidence data which demonstrates the agency's experiences in previous years), the agency might determine that the likely impact on business of smaller fires is fairly minimal. Such risks can also be reduced by the agency taking pre-event actions such as installation of fire control measures (extinguishers, appropriate training of staff, etc) and management of hazards around the site (e.g. fire risks). On this basis the greatest risk is a fire commencing when no one is on site or as a result of a bushfire.

For these reasons, the agency's main concern is the high cost of a severe fire, in the limited circumstances outlined above, adversely impacting on the agency's budget and its ability to continue services pending repairs. The agency's assessment suggests the potential replacement cost for one of their facilities, including equipment, would be between \$7 million and \$12 million.

Therefore the agency needs to calculate, with the assistance of the Victorian Managed Insurance Authority, the likelihood of such an event occurring and the ability of the agency to absorb costs from such events. In this instance the agency concludes that the likelihood of fires causing damage in excess of \$1 million is remote. However, it also concludes that given the size of its budget it does not have the capacity to absorb costs in excess of \$1 million. Therefore, it takes out cover with a deductible of \$1 million. This means that the agency needs to budget for the possibility of fires occurring which may cause damage of less than \$1 million for which they will be liable. It is anticipated if any fires occur they are likely to fall within this range. Any fire above that range will be covered by the insurance policy they have arranged with the Victorian Managed Insurance Authority.

An agency with significant resources may assess a \$1 million deductible as being too low for this type of risk. It may feel it appropriate to have a deductible of up to \$3 million, thereby, reducing their reliance on the insurance policy and possibly increasing the demand on internal budgets. While this agency's insurance costs are likely to be lower, it will need to take greater steps to account for the costs of possible claims. Conversely, some agencies may seek a policy with a minimal deductible, say \$20,000, and have all events in excess of that amount covered by insurance. Whichever deductible limit is selected the agency needs to make provision in its budget for possible claims to the level of the deductible as it will not be transferring that risk to the Victorian Managed Insurance Authority. The above deductible risk has been transferred whereas the below deductible risk is retained by the agency. In determining deductibles an entity should consider the following:

- the financial capacity of the organisation to fund losses from internal resources and the ability of those internal resources to manage losses that are effectively self-insured;
- the organisational appetite for risk; and
- historical data and potential losses, including an analysis of premium costs versus losses over time.

## If the risk is insurable, should it be insured?

The fact that a risk is insurable does not necessarily mean that it should be insured.

Assuming that a particular type of insurance cover is not mandated by law, the availability of insurance should not be the only factor considered in a decision to insure against a particular risk or set of risks.

In developing risk management plans, insurance should be considered where an adverse event would mean that the entity concerned would be required to commit significant resources to overcome the impact of the event.

In some cases (e.g. the loss of a building with low level heritage value that had no functional purpose outside its heritage status and did not have significant public value), the financial impact of the loss would be minimal, as the public body is unlikely to attempt to reverse the loss or expend resources to substitute for the loss (as the heritage building could not be recovered in its original form). In other instances the reverse may be true in that the heritage building was of such public significance any change or destruction would require rebuilding. In that case comprehensive insurance may be essential. Alternatively, paying insurance premiums may be an inferior risk management choice, and other actions (e.g. installing fire detection and prevention equipment) may be preferred.

In other cases, even where there would be significant financial loss from an adverse event, cost-benefit analysis may demonstrate that the quoted insurance premiums are not good value for money, and that alternative risk management solutions should be adopted.

### **Note: Self-insurance**

Self-insurance generally refers to risk assumption in circumstances where insurance is legally required in most circumstances (for instance workers' compensation requirements are compulsory but allow for some facility to self-insure). However, self-insurance can also refer to arrangements whereby an agency identifies a specific insurance need and chooses to allocate resources internally to meet that need and not transfer the risk to an insurer.

As with the level of deductible or excess that an agency sets for insured risks, a strategy to self-insure represents an acceptance of a particular risk. The acceptance of this risk, while removing the need to pay an insurance premium and positively affecting cash reserves, also places obligation on that agency to manage and meet the costs of adverse events. In this regard the management of risks and the funding balance needs to be appropriate so that losses can be paid.

To be considered "self-insured", the agency's approach to risk management must include:

- a thorough identification and assessment of the risks;
- analysis of the cost of risk response options;
- analysis of the financial resources available to the agency; and
- a specific determination that retention of the risk and management of that risk and its consequences within the agency is a superior strategy.

Non-insurance, where insurance is not purchased by the agency because risks and responses have never been adequately assessed and no decision on a preferred set of responses ever made, is a failure of risk management, not self-insurance or a risk management strategy.

### **Toolkit: How much risk can an agency manage?**

In relation to self-insurance and deductible levels the effects of an adverse event should not have a material impact upon the organisation's budget. In this regard the measures set out below may be useful guides as to the level of risk that an organisation can afford to absorb.

- **Capital inflows.** A standard benchmark for business is usually 5% of earnings. However, as this may be less relevant for government sector entities; a more appropriate measure may be a percentage of annual appropriations. Therefore, the capacity to self-insure or set high deductibles could be measured in terms of the amount of funding and revenue that an entity receives in any one year or over a series of years. A useful benchmark may be less than 2% for all adverse events in any one year, given that 2% is a relatively significant amount which is likely to impact upon the delivery of outputs.
- **Capital inflows.** As it relates to single losses, a usual guide would be that no single loss be more than 0.1% of the annual appropriation in any one year. However, for some large entities the size of such a potential loss may be in excess of what is considered appropriate.
- **Working capital.** Often used in the private sector, but likely to be less applicable to government sector agencies, a range of 1% to 5% of working capital could be set aside for self-insurance losses. A more tangible guide could be a percentage of approved capital budget to meet risks which are a result of work relating to that expenditure.
- **Accumulated surplus.** Another indicator is a percentage of accumulated surpluses. Agencies who have an accumulated surplus, as a guide, could choose to self-insure to an amount which represents a small percentage of that accumulated surplus. As a rule the amount should be relatively small.

In assessing when to use insurance an entity should consider the following principles on insurable risks.

- Insurance is generally only recommended for pure risks, not speculative risks. Pure risks are those risks that only represent a chance for loss or no-loss, whereas speculative risks may result in a range of outcomes and more commonly a loss or gain outcome. A speculative risk would include purchasing shares or placing a bet at the races whereas a pure risk would include being robbed or your house burning down.
- The insured should have an economic interest or a legal insurable interest in the subject of coverage. Furthermore, the entity's influence over the probability of an event occurring and whether the event is within its control should be considered.
- The policy must cover specific events that may occur in the future.
- The likelihood of loss should be reasonably predictable (even though the timing of the loss occurring is unpredictable). This may range from an event likely to occur every year, to an event likely to occur every 100 years. A level of understanding of the frequency is required to enable the risk to be priced by the insurer and appropriate premiums to be paid. If the likelihood of loss cannot be predicted it may be likely the premiums charged by the insurer may not represent a value for money outcome for the entity.
- The loss should be financially measurable. While this may include a range of outcomes, an understanding of the financial implications of an occurrence is needed. In other words, what will be the cost to the agency should the event occur? Will it be \$10 000, \$1 million or more? This may require consideration of both the maximum possible loss and of the most likely (expected) loss.

- The loss should be accidental or fortuitous.
- The underwriting conditions, including but not limited to exclusions, endorsements, definitions, limits and memoranda, set by the insurer need to be understood and evaluated in the context of the risks identified as needing to be covered. If a class of risk includes a number of significant risks which are excluded under the terms of the policy, then the value of the entire policy may be limited and alternative options may be appropriate.
- As a general rule agencies should insure against large or catastrophic losses and consider absorption of smaller losses. In this context the entity needs to set an appropriate deductible.
- Broad coverage is likely to provide better value than narrow coverage. Insuring one risk at a time is unlikely to maximise savings for an agency.
- The purpose of the insurance should be clear to the organisation whether it be protection from substantial loss, desire to even costs out over a number of years or another purpose.

Determining when to insure and to what extent is dependent on a range of factors and each entities insurance arrangements should be reviewed at least annually, to ensure that it is still adequate to cover the entities expected losses. The Victorian Managed Insurance Authority's role is to provide assistance and advice to participating bodies on the suitability and structure of their insurance programs.

If a decision is made by an agency or department not to insure an insurable risk, that agency (unless Government policy states otherwise) is liable to meet the financial impacts from its existing resources and should not seek, and cannot expect to receive, financial supplementation from consolidated revenue. The Government re-endorsed this principle in 2005 and the 'no supplementation policy' is managed by the Department of Treasury and Finance's Budget and Financial Management Division.

## 7. Claims management

Agencies with few claims are unlikely to be able to retain the appropriate expertise and experience in claims management. This means there is likely to be less than optimal management of claims, identification of claims with precedent setting implications and policies on payment of claims. On this basis the use of a claims management service provider is advisable.

On 6 October 2005, as a consequence of a substantial review, the Government endorsed the introduction of an insurance framework supported by increased accountability for risk management. The proposal sought to:

- introduce transparency and accountability for the management of claims across agencies to a standard;
- establish incident and claims reporting arrangements that will allow Government to make informed decisions for determining the best way in which to structure claims management so as to maximise value for money over the long term;
- establish an effective and appropriate method of dealing with potential precedent setting claims which may have Government implications;
- contribute to improvements in each entity's risk management outcomes, which has positive implications for entity budgets and on whole-of-government expenditure; and
- contribute to the identification of incidents currently being funded through budget supplementation, which should be covered through (possibly existing) insurance arrangements or via the payment of a premium.

Subsequent to this decision, the Department of Treasury and Finance's, Economic and Financial Policy Division developed a composite model, in consultation with agencies, which was approved by the Minister for Finance and required, as a default arrangement, agencies to use Victorian Managed Insurance Authority for below deductible claims.

Entities are permitted to opt-out of the default arrangement by appointing an external claims manager able to meet the criteria determined by the Minister for Finance. This requires the external claims manager to provide incident and claims data to the Victorian Managed Insurance Authority in the required format.

Entities are also permitted to opt-out of the default arrangement and manage claims in-house in accordance with a number of conditions regarding internal capacity, reporting requirements, precedent management, and annual attestation.

## 8. Where to start

The policy document is primarily concerned with insurance and claims management. However, it is clear that the decision to use insurance cannot be isolated from broader risk management decisions.

Therefore, within the context of an appropriate risk management plan, each agency needs to carefully consider the use of insurance as a risk transfer mechanism and how the use of insurance fits within its overall risk management strategy.

The Victorian Managed Insurance Authority is a valuable contact for ongoing pertinent information on risk management and insurance for all agencies, including agencies that do not purchase insurance from the Victorian Managed Insurance Authority.

## 9. Contacts

Further details regarding this policy can be obtained from:

Victorian Managed Insurance Authority

Tel: 9911 6900

Department of Treasury and Finance,  
Economic and Financial Policy Division,  
Assistant Director, Insurable Risks Policy

Tel: 9651 5200