Insurance cost allocation can be a powerful risk management tool for companies with multiple business units or locations. Lockton Analytics® helps our clients develop allocation strategies that best align culture, goals, and objectives in order to drive risk control behavior throughout their companies and reduce total cost of risk (TCOR).

There are multiple methods for allocating insurance costs, ranging in complexity and responsiveness to actual loss experience. Advanced risk management organizations consider the objectives of an insurance cost allocation model as well as the advantages and unintended consequences of various methodologies before implementation.

**Allocation Objectives**

The primary goal of an insurance cost allocation model is to distribute costs associated with insurance fairly. When a business unit can relate safety and claims management to its profitability metrics, the cost of insurance becomes more relevant.
No one allocation model fits every business or industry. Industry type, propensity for risk, insurance structure, ownership structure, operating metrics, geographic spread, and incentive compensation are just a sampling of the variables that can impact the selection of an allocation model. However, an allocation model should meet these five objectives:

1. Aligns with risk management goals while encouraging desired safety and claims management behaviors.
2. Is fair and equitable: proportionate to the potential for loss without creating an undue burden to any individual unit.
3. Is simple to understand and administer, to ensure ownership and avoid unintended behaviors.
4. Is responsive to loss experience yet balanced for credibility.
5. Represents the company’s total cost of risk.

Companies should determine the appropriate balance between responsiveness and cost stability at the business unit level. Likewise, the balance between precision and simplicity will differ based on each business’s financial structure and the business unit’s capacity for volatility.

**What Costs to Allocate?**

The first determination in building an allocation system is deciding which components of the total cost of risk to allocate.

**THESE COMPONENTS CAN INCLUDE:**
- Retained losses
- Insurance premiums
- Collateral costs, including volatility charges and buy-down charges
- Third-party administrator costs
- RMIS expenses
- Broker fees
- Internal Safety, Claims, and Risk Management staffing costs
- Facility costs
Insurance Cost Allocation Methodologies

The costs above can be divided into fixed costs (e.g., insurance premiums) and variable costs (e.g., retained/deductible losses) within an allocation methodology. The method used for fixed costs may vary from the method used for variable costs, or all costs may be subject to the same methodology.

Exposure-based allocation

An exposure-based allocation uses the percent of total exposures to determine a specific business unit’s percentage of the company’s total fixed and variable cost. This method can serve as the basis for allocating fixed costs within an organization. The exposure base could be as simple as head count, payroll, square footage, revenue, auto units, mileage, or production output. This methodology should be adjusted for jurisdiction, type of work, or mix of business.

<table>
<thead>
<tr>
<th>Exposure Base—Employee Count</th>
<th>Percentage of Allocated Workers’ Compensation Costs</th>
</tr>
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<tbody>
<tr>
<td>Location #1</td>
<td>20%</td>
</tr>
<tr>
<td>Location #2</td>
<td>30%</td>
</tr>
<tr>
<td>Location #3</td>
<td>50%</td>
</tr>
</tbody>
</table>

**ADVANTAGES**
- Can create stability
- Easy to understand and administer

**DISADVANTAGES**
- No direct incentive to control losses
- Potential for imbalance between exposures and loss activity
Loss-based allocation

Similar to an exposure-based allocation, a loss-based allocation uses the percent of total loss as a weight applied against the costs to be allocated. The number of years used should be short-term enough to hold the business unit accountable, but it should be long-term enough to avoid large fluctuations. Typically, this will be two to three years of loss experience, and a cap on individual claims should be carefully considered to not swing results too broadly from year to year.

<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
</tr>
</thead>
<tbody>
<tr>
<td>🕔 Can create stability</td>
<td>⏳ Potential for high allocated-cost fluctuation</td>
</tr>
<tr>
<td>🎁 Incentive to control loss activity</td>
<td>📊 Complexity of administration (e.g., number of years to include, cap on large losses)</td>
</tr>
</tbody>
</table>
Internal deductibles or per-claim charges

A variation of the loss-based allocation is to apply an internal deductible on the claim activity at a specific business unit. This approach allows the business unit to experience the results of its loss activity without bearing the burden of the entire organization’s retention structure.

Specific per-claim charges can also be set, depending on the type of claim. The levels should be amounts that are meaningful to each and every business unit without being punitive. These methods are less complex to administer. The balance of the claim costs can be allocated based on a weighted exposure method.

<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
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<tbody>
<tr>
<td>Easy to understand</td>
<td>Complexity of reconciling to TCOR</td>
</tr>
<tr>
<td>Incentive to control loss activity while limiting the impact of large losses</td>
<td>Can create a moral hazard related to reporting claims</td>
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</table>
Performance-based allocation

This method ties various metrics, such as return-to-work, reporting lag, PPO usage, claim counts, or OSHA recordable events, to a performance score.

<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
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<tbody>
<tr>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Promotes conformity with established procedures and standards</td>
<td>Complexity of reconciling to TCOR</td>
</tr>
<tr>
<td>Metrics chosen must have a direct connection to actions</td>
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Multifactor- or credibility-weighted allocation

Advanced models can use a combination of the previously mentioned methods. For example, an organization may choose to apply a location-specific experience modifier as a weight, or it may give 10 percent weight to the exposure-based methodology and 90 percent weight to the loss-based methodology. This allows for equal treatment across locations and is easy to explain. However, the weight selected may not be optimal for all locations, especially when there is a mix of smaller and larger locations. In this situation, it may work best to use credibility weighting as opposed to equal weighting.

<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
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<tbody>
<tr>
<td>+</td>
<td>-</td>
</tr>
<tr>
<td>Can create stability (especially for small locations)</td>
<td>Can be difficult to understand at the unit level</td>
</tr>
<tr>
<td>Highly flexible</td>
<td>Complexity of reconciling to TCOR</td>
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<td></td>
<td>Administratively burdensome</td>
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Capping year-over-year changes in allocated costs

This method can use a single methodology (exposure-based, loss-based, performance-based) or a multifactor-weighted methodology.

**ADVANTAGES**
- Can create stability (especially in budgeting)

**DISADVANTAGES**
- Complexity of reconciling to TCOR
- Can be difficult to understand at the unit level
- Administratively burdensome
Additional Considerations

Complex models can be difficult for business units to understand. Cost allocation can improve risk control outcomes only if the business units understand the connection between their actions and the impact to their company’s total cost of risk. Complex models also have a greater administrative burden to keep the model up-to-date.

If there has been an emphasis on a particular metric, such as return-to-work or report lag, some allocation models can be configured to be responsive. However, it requires data collection that captures these metrics and is updated frequently to reflect postloss activities. This allows for the immediate impact of the claim to be felt by and visible to the location manager.

Conclusion

An allocation model is limited only by the creativity of the organization. As the model is being created, the risk management team needs to continually ask the questions:

- Are we incentivizing the correct behavior?
- Is the appropriate field management team being rewarded or penalized for their unit’s loss experience?
- Can the field understand the model?

If the above answers are “yes,” then the allocation model becomes yet another tool to drive down an organization’s cost of risk.

Deciding which method will work best for your company can be complicated. Your Lockton team is experienced in advising clients on allocation issues and can help you determine the best fit.