risk international

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TCOR to XCOR

Expanding the scope of cost of risk to include total enterprise risk

Traditional Total Cost of Risk

Captures current and historic costs

- Total Cost of Risk (TCOR) is the traditional measure of risk management costs to an organization. It's intended to capture all costs associated with hazard risk financing, and is made up of:
  - Insurance Premiums
  - Administrative Costs
  - Broker Fees and Commissions
  - Fully Developed Self-Insured Losses
- TCOR is usually expressed on a Cost-Per-$1000-of-Sales basis

Traditional Total Cost of Risk

Captures current and historic costs

- TCOR is tracked by the Risk and Insurance Management Society (RIMS) in partnership with Advisen, Inc., and allows organizations to benchmark their costs relative to peers.
- Advisen dataset provides:
  - An annual summary of insurance statistics from 85 primary industries
  - Data from 52,000+ insurance programs
  - In-depth information from 1,500+ companies, including more than half of all Fortune 500 companies

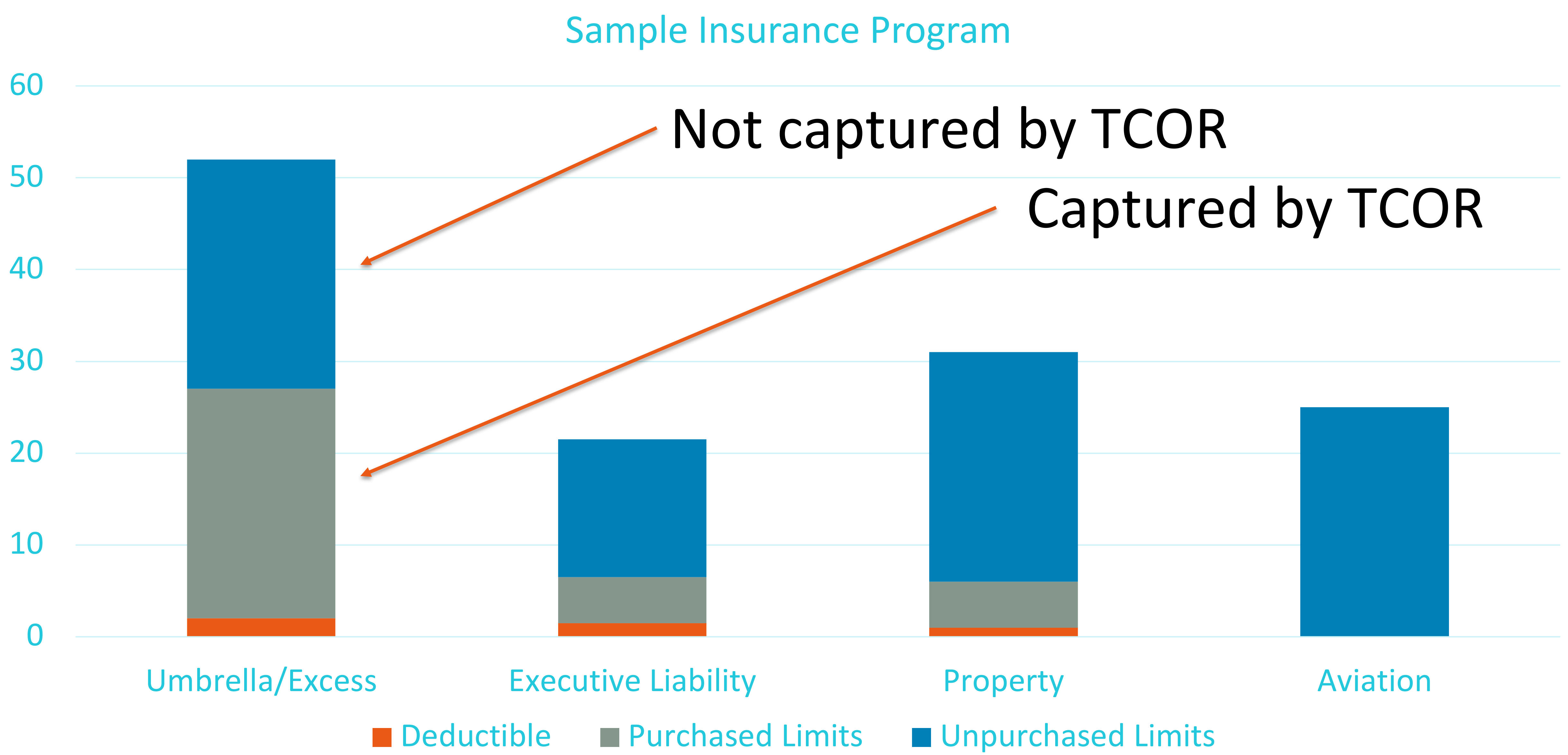
Traditional Total Cost of Risk

Captures current and historic costs, ***but***…

- Total Cost of Risk (TCOR) is the traditional measure of risk management costs to an organization. It's intended to capture all costs associated with ***hazard risk financing***, and is made up of:
  - Insurance Premiums (***but only for purchased insurance***)
  - Administrative Costs (***but only related to P&C insurance***)
  - Broker Fees and Commissions (***but not contingents***)
  - Fully Developed Self-Insured Losses (***but not variability***)

Gaps in Traditional TCOR

Serious limitations in the current model



Gaps in Traditional TCOR

Serious limitations in the current model

CCOR

What is it?

Why it is a useful indicator?

What is the appropriate rate?

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What is CCOR?

- Captive Cost of Risk
- Calculates the percentage that an insured entity pays from its gross revenue towards its captive insurance policies

What is CCOR?

Simple Example

Amount of Premium Insured Pays to Captive:	$1,000,000	equals	2% CCOR
Amount of Insured Gross Revenue:	$50,000,000		

Amount of Premium Insured Pays to Captive:	$1,000,000	equals	12.5% CCOR
Amount of Insured Gross Revenue:	$8,000,000		

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Why Use CCOR?

- Simple and easy to use and explain
- Designed as indicating low and high risk captives, is not designed as a safe harbor.
- Suggested use for a CCOR
  - Revise Notice 2016-66 so that the filing obligation is only on those captives with a CCOR over a certain amount. Burden on IRS and taxpayers is reduced. Companies with a CCOR like Avrahami will still file. Those with a CCOR like Rent-A-Center will not.
- All 831(b) election companies will continue to disclose their transaction on their federal tax return regardless of their CCOR.
- IRS retains power to audit any business regardless of CCOR.

When is CCOR Not Useful?

- Growing companies with risk exposure growing faster than revenue.
- Real estate holding companies that are not income producing.
- Unique business models that carry more risk than peers.
- Not as precise as a formal TCOR analysis or other study.

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What % Is Appropriate?

Captive Industry Benchmark

- Rent-A-Center's CCOR approx 2.5% ($60m captive premium/$2.4b revenue)
- Avrahami's CCOR approx 13% ($1.2m captive premium/ $9m revenue)

Transfer Pricing Industry Benchmark

BEAT – applies to companies with gross receipts at least **$500 million** AND have made **related party deductible payments totaling 3% or more** of the corporation's total deductions for the year. (for most, this math results in a benchmark a little under 3% of gross revenue). Interesting how Congress applies this tax only to larger companies and only above a *de minimis* 3%.

RIMS Survey

Survey data shows that companies below $1b in sales have a higher cost of risk compared to over $1b in sales. (a factor often of 2x or more). Survey also shows that cost of risk varies by industry (factor varies).

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Calculating the Benchmarks

If Rent-A-Center was a $2.4 billion company with a CCOR of 2.5%, what is the appropriate CCOR for a similar store that is 100th the size (or $24 million)?

If RAC was at	2.5%
Factor up for size	2.0x (a business 100th the size may factor above 2x)
Factor for industry	1.0x (same industry)

RAC equivalent by size **5.0% CCOR**

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Next Step: Econometric Cost of Risk

Fills in the gaps…

- Econometric Cost of Risk (ECOR) is a new measure of risk management costs to an organization. It includes:
  - Insurance Premiums (adjusted to ***optimal*** structure)
  - Administrative Costs (includes % of mgmt costs)
  - Broker Fees and Commissions (adds contingents)
  - Fully Developed Self-Insured Losses (adds variability)

Final Step: Existential Cost of Risk

Establishes maximum annual risk threshold

- Existential Cost of Risk (XCOR) is the final measure of risk that sets the maximum theoretical “premium” that would be incurred by an organization if it could insure all enterprise risks
- Equivalent to the annual opportunity cost of the organization’s investors
- XCOR = Annual premium of a theoretical captive insurer underwriting the risk of the organization’s continued existence

TCOR vs ECOR vs XCOR

Full spectrum of risk is captured

Sample $1B Company COR Spectrum			
	TCOR	ECOR	XCOR
Nominal Cost	$10M	$18M	$84M
Cost % of Sales	1%	1.8%	8.4%
Cost/$1000	$10.00	$18.00	$84.00

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