The Politics of RISK

Are Nonprofits More Vulnerable than You Think?

A new law now makes insurance pooling a better option to reduce insurance costs.

BY PAMELA DAVIS

Nonprofits that appear to compete with for-profit businesses are having their tax exemption challenged at every turn. Yet in 1996 Congress extended 501(c)(3) tax-exemption to certain insurance pools owned by nonprofits. Why did they carve out this special niche?

The Gorilla Foundation—dedicated to protecting endangered primates—benefits from affordable insurance through NIAC.

Are you perched on a fault line? You may be, if you're not part of an insurance pool.

Thirteen years ago, nonprofits across the country were taken by surprise when a financial service they took for granted, liability insurance, became unaffordable. Headlines in major periodicals across the country declared a "liability insurance crisis." Targeted as a "high-risk" market segment, the nonprofit sector was among the hardest hit.

The insurance industry is a complicated financial market, and what occurred during the mid-1980s has consumed thousands of pages of analysis. But, put very simply, this is what happened:

In the early 1980s, competition between insurance companies was fierce. Insurers competed so vigorously that they didn't charge high enough premiums to cover the claims that besieged them years later. To maintain solvency during the mid-1980s, insurers had to simultaneously increase prices and reduce the number of insurance policies they wrote. Business considered "risky," such as municipalities, daycare centers, and nonprofits, struggled to find insurance at any price. Many nonprofits were forced to cut programs and staff to pay for skyrocketing insurance premiums. Some couldn't get insurance at all.

What You Don't Know Can Hurt You

My graduate research revealed that the crisis in the mid-1980s was not a fluke. Rather, it was the seventh cycle the insurance industry had experienced since World War II.

Because of this research, a few nonprofit leaders in California recognized that coping with the insurance industry is a bit like living on a fault line: Just because there hasn't been a major earthquake for several years doesn't mean the risk is gone. Even as the insurance crisis of the mid-1980s was waning, we set about preparing for the next one.

From a public policy perspective, it became apparent that the insurance industry could become the de facto gatekeepers of social services simply by refusing to insure those they considered too "risky." These decisions weren't based on reliable statistics but instead were driven by a few high-profile claims, particularly incidents of sexual abuse and molestation. The potential for insurers to limit the range of nonprofit services was frightening.

By 1989, it was clear that something had to be done. Seeking stability for nonprofits in this unpredictable insurance market, six funders provided start-up capital for a liability insurance pool—the Nonprofits' Insurance Alliance of California (NIAC).[1]

This new company was to be wholly owned and operated by the 501(c)(3) nonprofits it would jointly insure. Put simply, nonprofits created their own insurance mechanism, complete with the responsibility for paying claims against the member-insureds.

NIAC is motivated to provide adequate coverage even for difficult-to-insure nonprofits like Challengers Boys & Girls Club of Los Angeles.

Nonprofits that take kids on outings—like Trips for Kids of Mill Valley—can look very "risky" to commercial insurance companies.

Enormous credit goes to the initial six foundations and others who contributed start-up support to NIAC. Even though the funders carefully researched this model project, it was a high-risk investment. NIAC was a start-up company planning to offer a complex financial product that the commercial industry sector was unwilling or unable to provide for many nonprofits. To complicate matters, they were going to establish this model in the most litigious state in the nation. Risky as this endeavor was, the funders concluded that the risk of doing nothing was greater.

NIAC's experience embodies foundation "venture capital" at its best. In a calculated decision, these foundations risked their assets to gain control of an important financial product. They got that and a whole lot more.

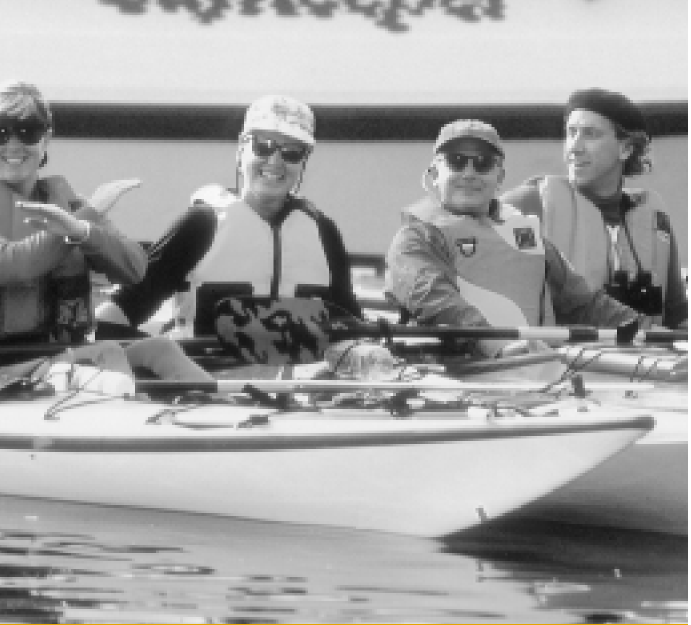
The Power of Nonprofits Working Together

In its tenth year of operation, NIAC now insures more than 1,800 member-owner 501(c)(3) nonprofits in California. These range from grassroots groups with no paid staff to multi-service nonprofits with hundreds of staff, dozens of locations, and scores of vehicles. With more than $12.5 million in annual premiums and nearly $40 million in assets, NIAC provides broad coverage at stable and affordable prices. Yet it has managed to generate $3.6 million in retained earning in ten years.

NIAC's impact is broader than saving nonprofits money and leveraging foundation funds. Because of NIAC's record of service to nonprofits, Congress expanded the tax law in 1996. The new law gives tax-exempt status to insurance pools which are owned by 501(c)(3) nonprofits and meet certain criteria.[2] We estimate that this exemption will save $400,000 for NIAC and its members in 1999 alone.

Organizations like NIAC enhance the nonprofit infrastructure in many ways, including:

Turning information into power. During the mid-1980s, I testified often before the California legislature about the unconscionable prices being charged nonprofits for liability insurance. However,



◀ ***Nonprofits like San Francisco BayKeeper—which reports environmental violations in the Bay area—find it hard to get insurance from commercial insurers because of the potential to be sued by those they report as possible polluters.***

I had no data to prove that prices were unfair compared to the cost of claims paid. Insurers, who were presumed to have that information, stuck by their story that prices were appropriate for the risk.

California nonprofits never will be in that position again. NIAC now has 10 years of data about claims against nonprofits and we know that the prices charged during the mid-1980s were too high. In 1989, NIAC began charging rates that were 25% below those recommended by the industry. NIAC has never increased its rates, resulting in a real decrease over 10 years of another 15%. And we have data to support the adequacy of the rates we're charging. In fact, during 1999, NIAC began offering nonprofits insurance and coverages that aren't available from any commercial insurance company.

The potential for insurers to limit the range of nonprofit services was frightening.

Helping nonprofits reduce claims. Having settled almost 2,500 claims against nonprofits, we have learned how nonprofits get themselves into trouble and are working with them to reduce avoidable accidents. For example, nearly one-third of our auto accidents involve only one moving vehicle—often a van. Many drivers for nonprofits are asked to drive vans with which they're unfamiliar. Accustomed to the clearance required of a regular auto, untrained drivers back into and sideswipe all types of things.

We've also learned that 10 percent of liability claims involve allegations of negligent supervision. However, that 10 percent results in nearly 50 percent of the dollars paid out in damages. These claims tend to be high-profile cases, which must be handled by claims managers and attorneys who understand their sensitive nature. NIAC is using this claims information to help nonprofits provide safer environments for their staffs, clients, and volunteers and reduce their cost of risk.

Gaining leverage in the insurance marketplace. Individually, even large nonprofits have little financial clout with insurance companies. Small to medium-sized nonprofits have virtually none. Things change, however, when nonprofits own and operate their own insurance mechanisms. They may control premiums worth hundreds of millions of dollars. Collectively, they gain tremendous financial leverage for the nonprofit sector.

Including public policy considerations in the bottom line. At NIAC, our byline is "a head for insurance, a heart for nonprofits." In short, we consider a nonprofit's potential risks, while keeping in mind our mission to support a sector that's frequently prodding society to change in uncomfortable ways. Be it horseback riding for disabled children or a crisis center for abuse victims, we learn all we can about what an organization is doing and how it's doing it. A commercial insurance company may find the premium insufficient to take time for such analysis. But our motivation is to find a way to provide adequate coverage even for those difficult exposures.

Nonprofits in the Insurance Business?

You may ask, "Should nonprofits be in the insurance business?" To that I happily respond "No." However, the same question phrased differently is, "Should nonprofits control a financial service that is essential for their operations if they can do it better and more economically than the commercial market?" To that, I give a resounding, "Yes!"

The key to operating these self-insurance mechanisms is insisting on sound financial backing and quality operations day in and day out. As with any operation, risk pooling can be done responsibly and it can be done poorly. Done well, it can immeasurably enhance the infrastructure for nonprofits and provide a stellar opportunity to leverage charitable dollars.

Should the California Model Be Replicated?

Is an eighth insurance crisis on the way? There is much debate about whether another crisis will appear. There are many signs that we should be in crisis, and people are scratching their heads about why we aren't. Since a new cycle usually develops every five to seven years, why has this last one gone on for more than 10 years? Some say we're already 10 years into a five year cycle in which inadequate pricing has been masked by exceptional investment returns.

Whether another crisis is looming or not, it makes good sense for nonprofits to gain a measure of control over this important financial service.[3] Not wanting to face the uncertainty of another liability crisis, physicians, municipalities, churches, hospitals, universities, attorneys, accountants, and many others have had the foresight to create risk pooling mechanisms. In fact, more than one-third of the commercial insurance market has "retrofit" their insurance purchasing by taking part in some type of alternative insurance arrangement.

Those who remain alone in the commercial insurance marketplace are perched on the edge of a fault line. They can only hope that "insurancequakes" are a thing of the past. ■

Footnotes

[1]These funders are the Ford Foundation, David and Lucile Packard Foundation, Marin Community Foundation, San Francisco Foundation, Wallace Alexander Gerbode Foundation, and Walter S. Johnson Foundation.

[2]Religious organizations gained tax exemption for their insurance mechanisms in 1986. The new 1996 law (effective in 1997) allows secular nonprofit pools which meet the requirements of the law to receive the favorable tax status long enjoyed by insurance companies owned by religious organizations.

[3]The Nonprofits' Insurance Alliance of California received a $150,000 grant from the David and Lucile Packard Foundation in March of 1998 to do a business plan for expanding NIAC outside of California.

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