**Rethinking the Role of Insurance**

By Simon Beynon

A Brief History of Insurance

Coping with exposure to loss, harm, or other adverse outcomes has been a challenge for people engaged in commerce for thousands of years. As far back as 3000 BC, Chinese traders, with merchandise exposed to loss from dangerous river crossings, sought to share risk among fellow traders. By redistributing their cargo across the group’s many vessels, these traders limited the loss to any one trader in the event a boat capsized. Around a thousand years later, the Code of Hammurabi recorded how Mediterranean traders would repay additional sums to lenders who funded shipments, if the lenders guaranteed to cancel the loan if the shipment was stolen.

From 1550 B.C to 300 B.C, the Phoenicians and the Greeks populated the Mediterranean coastline, and maritime trading expanded as they freighted their vessels with products from Egypt and Assyria. This activity generated a need for similar types of insurance for their seaborne commerce but the requirements extended to loss from other perils. Over time, rates for the loans differed according to seasonal weather patterns, indicating a growing appreciation of the pricing of risk as exposure changed. In the 14th century, marine insurance became well established among the seafaring countries in Europe. Insurance continued to evolve and become more sophisticated. By the end of the 17th century, London was established as a focal point for international trading. In the late 1680s, merchants and ship-owners met at Mr. Edward Lloyd’s coffee house to share information on shipping, trading and cargo losses. People seeking to insure cargoes and ships along with those willing to underwrite such ventures would meet here and a marketplace was born. Today, Lloyds continues as a significant insurance market for marine and other specialist types of insurance.

Further innovation in insurance emerged as a consequence of the Great Fire of London. In 1666, England’s first fire insurance company, “The Fire Office,” was established to insure brick and frame homes. Shortly thereafter, insurance companies began implementing loss prevention measures such as private fire brigades that protected their customers’ properties.

Role of Risk Management

A recurring theme from this brief history of insurance has been a strategy by merchants of reducing the challenges of uncertainty and unpredictability of exposure to loss by pooling and sharing risk among many; risk transfer was the primary method to manage risk and protect assets. Over the last 50 years, as commerce and trade expanded significantly, so have the methods used to confront these challenges, especially in the context of predicting, managing and financing exposure to loss from various risks. Upon reflection we see one common thread weaving this brief history of insurance together—risk management.

The role of Risk Management today can be explained as the practice of eliminating or reducing the impact of a negative outcome through a process of risk identification and the subsequent application of certain techniques to effectively handle risks. This process requires exposure identification and a risk evaluation of the likelihood of those exposures materializing. Once completed, companies need to then manage the resulting damage through one of two methods; risk control or risk finance.

- **Risk Control** employs measures to prevent or reduce losses and can be achieved through avoidance by not engaging in the activity that presents the risk or reduction of risk by applying preventative measures. For example, a company seeking to avoid exposures from a certain manufacturing activity may decide to buy the product from third parties instead of producing it themselves.

- **Risk Finance** represents any financial technique employed to pay for a loss when it occurs. These techniques include risk assumption/retention, risk transfer or more frequently, a combination of these techniques. Risks are often controlled with preventative measures and the remaining exposures to loss are financed by a mix of retention and risk transfer insurance.

Although the insurance industry has been able to develop products as new exposures and risks emerge, the foundational principal of selling an insurance product was that companies buy insurance to transfer risk. Consequently, insurance companies create and market insurance products aimed at meeting this demand. The type of conversations and negotiations once held in Mr. Lloyd’s coffee shop may often be repeated in today’s insurance markets. However, with the growth of dedicated Risk Management professionals exploring and developing different
strategies to manage risk and finance loss, it is becoming apparent that insurance companies and brokers now need to better focus on their clients’ corporate risk management strategies and the driving motivation behind them.

New Strategies

As the global environment (including economic, climatic and technological influences) is constantly changing, new obstacles and threats are constantly emerging. As companies strive to innovate and improve, the risks they face continue to evolve and new risks emerge, e.g., cyber liabilities and regulatory risks. The insurance industry has created numerous types of insurance products to address virtually any problem. These products often attempt to avoid the transfer of predictable losses or, alternatively, build the cost for such losses into the coverage. Risk transfer is designed to protect against unpredictable or catastrophic losses. However, the growth of more and more sophisticated risk management strategies requires different solutions than those of the past that only considered basic risk reduction and risk transfer techniques.

Ongoing advances in scientific techniques combined with continual improvements in data collection and management enable companies to better understand, monitor, predict and control risks. In this ever-changing environment it is more important than ever that companies periodically review their policy for managing risk and the role insurance plays in that strategy to ensure they employ a robust risk management process that most effectively meets their specific needs. As a company’s risk profile continues to change based on operations and locations, risk management strategy and utilization of insurance techniques need to be tailored accordingly.

Some large, complex companies – e.g., integrated oil companies, large mining companies, global financial institutions and multinational manufacturing companies – that have become more sophisticated about managing risk are looking to more effectively control and internally allocate insurance costs by combining risk transfer and risk retention strategies. Such an approach often gives these companies more control to achieve their risk management objectives as they become the ultimate decision makers on how the risk will be financed. In certain situations, the inability of insurance markets to adequately respond to customer needs (e.g., due to risk appetite, limited capacity, lack of adequate underwriting data or adverse loss experience) may give corporations no alternative but to pursue risk assumption/retention strategies.

Discussions between sophisticated practitioners of advanced risk management strategies and their insurance partners have changed significantly. Rather than talking about transferring risk for a predetermined price, discussions are focused on gaining a better understanding of risk management objectives in order to create insurance programs and structures tailored to those requirements. Other topics might include insurance providing an alternative to capital funding requirements, insurance facilitating a reduction in letters of credit required to fund collateral requirements for regulatory or business purposes, or insurance strategies for improving liquidity or assisting in cash flow management.

Unlike the limited opportunities the Babylonian traders had in dealing with their risks 4,000 years ago, today’s companies have available to them a variety of advanced risk management tools and techniques along with a wide range of risk financing vehicles. For many companies, risk transfer is not the sole or even the primary factor driving the insurance purchasing decisions. Without a sharp focus on the client’s motivation, this fact might remain unknown to the client’s broker and insurance company.

Why Companies Buy Insurance

In order to appreciate why an arrangement involving an insurance policy that does not ultimately transfer risk to an insurance company may be of value to a company, we need to consider why companies buy insurance. This approach may generate one or more of the following explanations:

- To transfer risk to a third party and protect the company’s balance sheet
- To better manage cash flow by spreading expense over time
- To comply with regulatory requirements
- For tax planning reasons
- To conform with certain accounting issues
- As a marketing tool to increase sales
- To provide access to insurance company services or expertise
- To establish the ability to sit behind an insurance company (i.e., an independent third party in front)
- To fulfill a requirement of a third party, e.g., a bank, customer, supplier or a landlord

A conventional insurance policy accomplishes all of these objectives, but its pricing factors in the costs associated with many other benefits the company may not need or want. A company’s primary objective may be for the insurance to:

- Allow cash flow benefits and access an insurer’s claim-handling skills
- Provide evidence of insurance to a regulator or customer
- Minimize or reduce the cost of transfer risk
- Address a third party or joint venture partner’s concern about a risk that they themselves are comfortable retaining
- Better manage and implement a global insurance strategy that accommodates different insurance needs for different operations in different countries, while allowing the risk to be maintained on the parent’s strong balance sheet rather than on the subsidiaries’ balance sheets

The most significant pricing consideration of a conventional insurance policy is the cost of the risk being transferred. If a company does not want or need risk transfer, then it may be overpaying for its insurance policy.
For example, a client wants to buy $25 million of property insurance, including earthquake coverage. If the client wanted all of the benefits of insurance, it could purchase a standard, guaranteed cost, single year, risk transfer policy. But, what if in discussions with the company about its motivation for insurance, it is determined that its insurance objective was:

• Solely to provide evidence of insurance to a regulator
• Purely to allow cash flow benefits and access an insurer’s claim handling skills
• Not to take an earnings hit in a given quarter, but it has no concerns about paying for a loss over time should it occur
• To transfer the risk because it could not afford the loss
• To obtain broader coverage than the insurance market was willing to provide

An insurance program can be structured to address each of these needs, but the financing mechanism behind it would vary to accommodate the objective. The financing solutions could range from:

• Fronted program with the risk transferred to the client through a reinsurance contract or an indemnity agreement,
• Funded program where an insurer issues, or fronts, the insurance policy, but the insured essentially funds the full limit over a period of time,
• Blended structured program or
• Combination of the above.

It is possible that, like the Phoenicians, the company would prefer to transfer the risk to others. However, because of its risk profile or loss experience, insurance carriers may have no desire to assume that risk or the price to do so is unattractive to the company. In such a situation there are risk financing techniques that can be utilized that may be a preferable alternative to retaining the risk on an uninsured basis.

Leading insurance companies have utilized a variety of techniques to solve many different types of risk financing problems. The challenge is how to apply these techniques to come up with the right solution.

For example:

• **Fronted programs** enable the customer to provide evidence of insurance yet retain some or all of the risk through a reinsurance or indemnity structure. As this approach reduces or eliminates underwriting risk, much of the cost is eliminated from the transaction and replaced by a credit risk which is often provided for a much lower cost.

• **Structured programs** may be a solution for clients willing to self-finance their risks, but require assistance in establishing a financing plan over a longer period of time. Such funded programs can be useful in reducing uncertainty in the cost of funding a loss by establishing the funding in advance rather than trying to raise funds at the time of loss when the cost of debt or the economic environment is unknown. Such structured programs may also be a solution for insurance market dislocation caused by an adverse loss experience from the client and help facilitate risk transfer capacity at a higher attachment level.

When we understand why companies buy insurance we can “unbundle” the standard insurance policy and construct a tailored solution to better meet clients’ needs. With the right client, this approach enables insurers and brokers to have a much more sophisticated and meaningful conversation. As insurance carriers and brokers try to partner with all levels in the clients’ organizations and engage with more senior executives about how they should think about risk and insurance, these are the types of conversations that need to be had.

**The Right Conversation**

The right conversation involves a lot more listening than talking. We need to understand what is really driving the insurance acquisition process. What are the critical issues the company is looking to address? What is the ultimate best case scenario for the customer? Who is the true beneficiary of a solution – legal, finance, operating divisions? What does the ultimate solution allow the customer to achieve? When a company can answer questions such as these, it can develop an effective insurance strategy to implement nontraditional insurance solutions for its unique risks.

There is already a roadmap to have this conversation that uses as its foundation something everyone is familiar with – the declarations page of an insurance policy. Discussing each component of the declarations page helps focus on what the client’s true needs are:

• Insured – who, why, where are they located
• Insurer – admitted, surplus lines, onshore, offshore, is an insurer even needed
• Term – what is the length of the exposure period and how long do they need the coverage
• Limits – how much protection do they really need and why this amount
• Premium – how much are they willing to pay to address the problem and over what time period
• Retention – how much risk do they want to retain
• Coverage – what is the nature of the risk, what exactly do they need to cover and why, do they need the same level of coverage for all entities for the same period of time

We need to be addressing these questions to the “right person” at the company. That “right person” knows the issues, has credibility in the organization, is personally invested in solving the problem, and is in a position to get it done, preferably with decision making authority to execute.

We need to be identifying the “right problem” – a problem that the company cares about solving, and one that is definable and
solvable. We also must be sure that the company has the sufficient resources to solve it.

We need to be having the discussion at the “right time”. Confirm the company is not too far into the problem that they have tried everything else and are so worn down that even if the right solution came along they don’t have the energy to pursue it. We also need to plan for sufficient time to analyze the problem and execute the solution.

There is no doubt that rethinking the role of insurance presents many challenges and requires a change in mindset: ask different questions, think first about looking for the problem and not the solution, and then deeply probe to find out what it is we are really trying to solve. For those individuals and companies willing to embrace this approach, the rewards can be meaningful. Risk managers can become a vital part of the problem solving process. Finance executives can see greater opportunities to use an insurance product to address significant problems. Chief Executives can focus on creating and implementing strategies without obstacles that have been challenges in the past.

Innovation in approaches to managing risk can be traced back over 5,000 years. The process has evolved and developed over time. The role of the Risk Manager has emerged as critical in identifying, evaluating and developing strategies to mitigate and finance risk to protect the organization’s assets. This role needs to continue to evolve by exploring new ways to partner with insurance providers to address existing and emerging risks. Risk managers also need to engage with senior executives in their organization to educate them and provide a comprehensive understanding of emerging insurance structures and how they can be applied to the changing role of managing and financing risk. The result can be new and effective ways to support corporate strategies and develop a competitive advantage.

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