StrategicRISK
May 05

# ROUNDTABLE 2005

## RISK RETENTION

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# Risk Retention

## An introduction to the StrategicRISK roundtable discussion by **Sue Copeman**

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Deciding how much risk to retain can be a challenging balancing act. You have to take account of a wide range of factors including the operational as well as the financial elements – not to mention the risk appetite of the board which could well be affected by the current trading conditions in your particular sector. And you have to decide whether the high comfort factor that might be provided by transferring risk to the insurance market is worth a possibly higher cost and, perhaps even more important, the imposition of restrictive conditions that could be detrimental to the way that you operate or even impact on your customer base. The issue of being in control of your own destiny was certainly one that was important for some risk managers participating in this discussion.

The decisions don't stop there. Do you put your risks into your own captive – if so, which risks? - and can you justify the relatively high costs of a captive anyway? Is establishing a mutual insurer an acceptable approach in your industry sector? Are there viable alternatives to traditional insurance and captives which you can use for uninsurable risks?

These are just some of the questions that our panel of experts discussed in this issue's roundtable. And the points that they raise are likely to strike a chord with many risk managers faced with the difficult problems surrounding retaining risk.

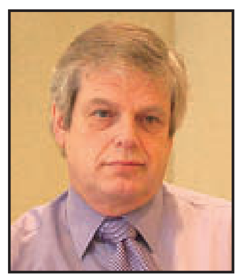
**Sue Copeman**
**Editor**

## Roundtable participants

**Sue Copeman, editor, StrategicRISK, chaired the discussion**

**Colin Campbell, group insurance and risk manager, Arcadia Group**

**Cary Depel, compliance and legal director, IFX Markets**



**David Ketley, insurance manager, Europe & Asia Pacific, Cargill Insurance**

**Kamran Malik, head of business risk solutions, Royal Mail**

**Martin Massey, director – analytical services Europe, Aon**

**Hugh Price, partner and director of insurance, Hugh James**

**Steve Stokes, risk manager, property and business services, 3i**

**Will Thompson, head of insurance, Motability Operations**

**Tony Tudor, director, Institute of Financial Services**

# Risk Retention

**SUE COPEMAN:** Before we get into the discussion, perhaps we could agree exactly what we mean by risk retention. By that I mean, do we class risk in a captive as risk retention, even though a captive would be reinsured on the open market to some extent? or are we talking purely about risk that's kept on the balance sheet? Has anybody got any thoughts about this?

**DAVID KETLEY:** I think risk retention includes everything that is retained within the company, including wholly-owned subsidiaries, which would include a captive. My view is if we keep the money in the captive the money stays within the company. If there are no claims the money stays in the company.

**SUE COPEMAN:** Following on from that, for those of you here who have a captive, how do you decide what to retain within your captive and what do you put into the insurance market or perhaps transfer in other ways?

**COLIN CAMPBELL:** The way we approach risk is that, rather than concentrating on risk retention, we constantly review what we call the risk register – a term which many risk managers may be familiar with. We update our risk register periodically as risks move up and down in importance and new risks appear. Our approach to risk retention is essentially based on a view from the top, right down to the bottom of the organisation. Essentially we consider the financial elements, but also the operational elements. If we were to place everything in the insurance market, clearly we could lose out financially, but we could also lose out in terms of flexibility. I think Will might like to add something on that point.

**WILL THOMPSON:** I totally agree. We have not got a captive at the moment, but it is one of the things we are actively thinking about longer term. One of the things that has disappointed or frustrated us in the past when we have transferred risk to the insurance market is that you are not only transferring the risk but you are also transferring the operational control to a large extent. Within our business we have got two very large risks. One is the depreciation risk of the residual values of our fleet. We have just short of 400,000 vehicles, so that depreciation risk represents a very large number.

The second risk is the road traffic risk of that fleet. We used to insure the residual value risk and that was pretty unique for a motor fleet. However, we found that insurers put us in an operational straitjacket, which went down to very fine detail. We were having to agree which dent on a vehicle would or would not be repaired because that would have an effect on its residual value at the end and so on. That was a stifling operational experience for us, and the impact on customers in respect of every little repair that had to be done was very bad for them. So the experience of insuring residual values was quite a painful one.

Increasingly we are realising that we need to be in control of our destiny from an operational point of view and that is actually the thing that is driving us towards self-insurance, considering where we have already got to now and where we might go. It is just the point you are making about the flexibility.

**COLIN CAMPBELL:** And of course that flexibility can either be increased or decreased by putting in a captive. The captive has its own restraints depending on which environment it operates in – and of course that is going to impact on how much restraint there might be. But there is no doubt that flexibility and operational ease are key to our business, in that we would like to ensure that we can manage our own destiny as opposed to passing it into the hands of others.

**HUGH PRICE:** Do you find there is a change in culture within the business if the business is looking after its own risk? I mean this in the sense that it is your money in the captive; you are taking on the risk yourself, whereas the tendency if you are insured may be to think that the insurers will sort things out and you don't need to worry. So risk retention could have a dual effect. On the one hand, you will probably fight harder, in the sense that getting it wrong could result in litigation and it's in your control. Secondly, I presume there could be an effect from a risk management/risk assessment point of view, because again it is your money, you can control the risk.

**WILL THOMPSON:** That's absolutely right. Certainly in our experience in respect of managing the condition of our cars, once we had insurance with all this insurance-led governance surrounding it, we basically took our eye off what we should have been doing in terms of repairing things which were not worth our while, because I suppose that we knew at the back of our minds that it was insured. The fleet insurer would pick up the damage, and as long as we got that vehicle fixed and it was in an approved condition then the residual value insurer would pick up any residual value loss. But everybody else was in pain. Our customers were in pain. It actually wasn't doing anything for us in residual value terms. The insurers were in pain. So having insurance there was creating a lot of pain for everybody. Now that we have taken that out, the ownership is much more within the business and it has been an improved experience all round.

**TONY TUDOR:** Colin, when you are analysing your risk and whether to put it through the captive, do you build the convenience factor into the assessment?

**COLIN CAMPBELL:** Absolutely. The main considerations have to be financial. There is no doubt that cash is king, and there is no point in having cash sitting in an offshore commodity if you can use it elsewhere in the business to better effect. But having said that I guess Martin might have some views on that area. Martin, what do you think?

**MARTIN MASSEY:** Obviously this is a very broad topic. When we are approaching this issue of risk retention I think the sort of questions that we need to be focusing on are, first, how much can the organisation retain? and then how much should it retain in the current market conditions? And then comes what we have been discussing already – how do you finance that retention?

We are spending a lot of time with our clients over the issue of optimising the retention structure before we make the decision as to how to finance it, ignoring the fact that they may have a captive or other risk-financing vehicles. You need to start from a blank sheet of paper, and what you are trying to develop is a framework to look at a programme structure that will minimise the expected cost of risk while keeping the volatility within the acceptable bounds of the organisation.

We have developed what could be described as a scientific approach, which uses a lot of mathematical modelling. We use actuarial techniques to model the cost of risk for a particular risk class; we then look at the insurance market; we then look at the risk transfer in terms of pricing, and we model the insurance pricing that prevails in the current market. That can be done by developing mathematical pricing models. We then have an optimisation routine that looks at risk on a portfolio basis, and by combining the assumptions on your actuarial inputs and your market inputs you develop an efficiency boundary – an efficiency frontier – which provides a number of efficient programmes that will give you the minimum cost of risk at a certain level of volatility.

One of the key issues that we are addressing with our clients is the level of risk, the level of volatility that that company has to retain. So given your current retention structure, there is probably a better way to rearrange those retentions with the same level of volatility, so that you might then actually minimise the cost of risk given the current market conditions.

The key thing that we have been looking at is that, because of the change in their risk profile and the change in insurance market conditions, a lot of companies have been reassessing their whole long-term strategy. We think that is perhaps an area that we can develop. In my view, a lot of companies have focused their decisions on looking at risk through a silo approach and also look at it on a very short-term basis. In terms of developing strategy, you really need to look at risk on a portfolio basis and also on a long-term basis, maybe with a 5 to 10 year horizon.

**COLIN CAMPBELL:** One of the problems with that is the fact that businesses themselves are not necessarily looking so long term. You come across this all the time. In our business, and I think all retailers would be similar, we are looking at the very short term. We are interested in what happened this morning as opposed to what might happen in five or ten years time. But you are absolutely right in that a captive has to be part of a strategy. There is no point having a captive if it is not part of a strategic approach, because without a strategic approach it is just an expensive dalliance.

**KAMRAN MALIK:** I think one of the words that comes to mind in terms of trying to capture what we are talking about is 'bouncebackability'. This describes the ability of an organisation that takes a hit to recover, and that has got to be a feed-in on the decision to retain. I think the point is very well made about the portfolio of risks and the captive being one option, but when we look at this portfolio, the other aspects we look at are things like outsourcing. For example, our IT operation, which is a massive operation, has been outsourced. Although we are effectively transferring the risk, it may not be labelled in that way. But perhaps the over-riding consideration is liquifiable assets. If something happens, do we have the cash? We may have a cost-effective solution, but at that point in time, do we have the cash? What that thinking has done is two things. One is that it has forced a tighter link with treasury. The other is that it is a far more active decision-making process. By retaining risks we are not saying, well, we pay the premiums – what's the next problem? We are actually saying – how do we control these risks better? That has been a very healthy process.

**DAVID KETLEY:** At the end of the day insurance should be the last resort when all your risk management has

**You are not only transferring the risk but also the operational control to a large extent**

**Will Thompson**

## When should you start to involve some of these alternative risk financing techniques?

**Steve Stokes**

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failed. That is how you should look at it, not start by asking what the insurance market has got to offer and what's the most cost-effective policy that we can buy. That's putting the cart before the horse.

**SUE COPEMAN:** How about you Steve? Is this how your company approaches its risk assessment and retention?

**STEVE STOKES:** We don't have a large risk portfolio, so we don't self-insure to any extent. But one of the things that I find interesting is at what stage in a company's development and at what size does it become worth while taking on these techniques? For big multinational companies it is relevant, but if you are a small or medium sized company, when should you start to involve some of these alternative risk financing techniques or consider a captive?

**TONY TUDOR:** I'll just pick up on something that Colin mentioned earlier, which is the relative short termism of the board. If you want to go for a captive – and that is a long term commitment – you have to convince them that that is the way you can handle the risk better. As you say, insurance then becomes the last resort. But I would think that the board are going to need a lot of convincing to focus on that, rather than on the immediate day-to-day competitive and regulatory pressures.

**SUE COPEMAN:** I think Steve made a very good point. How to do you judge when a company has got to such a size that it should be considering these kinds of techniques? Have you got any thoughts on this, Martin, as it must be something clients say to you very often? 'I am not big enough to have a captive'.

**MARTIN MASSEY:** Yes, that is quite a common statement. There are a number of issues here. One is the risks that we are dealing with. The premium volume is clearly a good indication. There is always a number that is bandied around. People say that you need a minimum premium spend of £500,000 before you should consider a captive. So it is not necessarily the size of the organisation. It is the premium spend and the risks. And obviously your loss profile is going to be quite important and where there are the opportunities in the market to save premium money. When you are a small company there are no reasons why you can't set up a captive, perhaps looking at a single class of risk, maybe focusing on property, and take a small retention. I think this links to one of the key benefits of a captive as a risk-financing mechanism – the ability to increase your risk bearing ability over time. Most captives are formed taking a reasonably limited amount of risk and then, as the company gets more used to running a captive and as the loss record stabilises or improves, it tends to take more of the risk over time. Again that ties in with the long term philosophy. You must have a view that you are going to retain more risk in the long run and that you can build up to that over, say, a three to five year plan.

**DAVID KETLEY:** You can retain risk without a captive by increasing your working excess or deductible. A captive is useful if your culture is that you want to pay any losses corporately; you can move money, especially if you are operating in more than one country. Having a captive does enable you to move money around without incurring tax. Against that, you have got to pay your fronting costs. And captives are not cheap to run.

**SUE COPEMAN:** Do you have any views on this, Cary?

**CARY DEPEL:** With respect to my own business, we would be too small for a captive insurance company. I think that if we were to be interested in it we would have to do a cost risk analysis and factor in the cost of having a captive, the benefits of having access to the reinsurance markets, and the federal tax treatment of the investment income accruing. But at this point we don't really have to think about it.

**SUE COPEMAN:** Will, I think mentioned the benefits of ownership when you are retaining quite a lot of risk yourself. Would anybody else like to expand on that because that seems to me to be a really good point? How much difference does it really make?

**WILL THOMPSON:** Just picking up a point that Hugh made about the cultural aspect, seven years ago our organisation was hugely, almost institutionally, risk averse. We have got a lot of stakeholders in our organisation; there is a charity sitting in the background; there are the owners of our organisation as well; there is the constituency of customers who are disabled, there is the Government sitting in the background too. So there are a lot of people who have got a view on anything we do in terms of risk. That was where we were seven years ago. But that has changed hugely within the last three years with all sorts of things happening. The organisation is performing better in operational terms; the customer proposition is better; there is more security all around, and that, as much as anything, is driving us towards retaining risk.

**DAVID KETLEY:** What brought about the change?

**WILL THOMPSON:** A whole series of factors. I think that our organisation as a car leasing company became more professional and was able to stand on its feet as a commercial organisation and get the trust of the owners, who in our case happen to be retail banks. Also it has got the trust of government. So there have been a lot of developments and a growth in the feeling of security about the management team within our organisation. That has allowed us to start retaining big chunks of risk on a gradual basis. So, 18 months ago we took in our residual value risk, a massive risk to the business. Six months ago, we took in the own damage to the fleet risk, another big chunk as we have 10,000 claims a month. These are huge chunks of risk coming into the organisation, and what is permitting that is the confidence levels – it's almost an emotional thing – within all those different stakeholders so that they are allowing it to happen. We don't do it in isolation. We have loss forecasting; we make sure that the volatility analysis says that this is the right thing to do before we do it.

**HUGH PRICE:** With my background of handling liability claims for insurance companies, sometimes I find that when you go into a company they are a bit irritated that you have had to come in to deal with this particular claim. It is a bit of nuisance because it takes up management time and so on. It occurs to me that those companies who have their own captive, or handle their own claims, or take on the problem of risk retention themselves, take a different view because it is their money, it is their company. There is no insurance company standing there as a sort of buffer or protector. It seems to me that in terms of culture and in terms of good business practice, there is a lot of sense in retaining as much as you can, because you control it. I am not suggesting that insurance companies necessarily do a bad job. But where risks are insured I think there is a tendency for them to be out of sight, out of mind. People say 'it's not my problem; someone else will deal with it', and a year later if a loss develops it's bit of nuisance. But I think the other point  in terms of risk management or risk assessment is that it's terribly important to keep statistical evidence. I am sure you do anyway. For example, in a retail company with lots of shops and stores, people fall over or snag their clothes; children injure themselves, and so on, and you need to track those. It is very difficult to outsource that to someone who is not really interested in the sense that it would not impact on them. If it impacts your own business it is very important.

**WILL THOMPSON:** We have found through changing our culture that there is much more alignment with what we want to do and what the insurers want to do. It is working together, whereas in the past we were almost working in opposite directions. So having some retention made a huge difference.

**CARY DEPEL:** Sometimes you don't have a choice. If you come from a highly-regulated industry, the obligations are on you to conform to whatever those regulations are. In our instance it is the Financial Services Authority. We are required to apply a lot of risk control techniques into retaining the risks ourselves. Firstly, fines and penalties tend not to be insurable and, secondly, it is hard to put a value on reputational risk with the loss of your licence or your ability to do business. By and large we are becoming more regulated, hopefully over time more intelligently regulated, and the regulators are just not allowing senior management not to have a firm control over their business. But I think risk retention is generally quite a good thing – we do not have a lot of choice in the industry I come from.

**DAVID KETLEY:** Emerging claims statistics are also an issue. If you change insurer, trying to get updated claims information from a previous insurer is a nightmare, especially if it is long term information.

**SUE COPEMAN:** Martin has talked about programme structure and taking a long-term strategic approach. Then we have Colin who says that his business is very much about what's happening at the moment. Do you think that risk managers have the ear of the board sufficiently to be able to caution them to look well ahead? Or are they at the whim of their CEO, who might change his mind overnight about things?

**MARTIN MASSEY:** What has become more important in recent years in developing a strategy is that you do get the buy in from senior management, that you talk to your finance people and get through to the board. Where risk managers are very successful is when they have developed a strategy and they have, for example, undertaken an independent risk-bearing capacity analysis with input from their finance departments or treasury departments. If they are, for example, looking to develop an aggressive strategy on retention, they need the buy in. I find a lot of risk managers have generally and historically been quite risk averse, but because of the hardening insurance market they feel that there is an ability to save money for the company. But by doing that the company is going to be taking on more volatility. Trying to explain and illustrate that to senior management has been one of the difficulties faced by a lot of risk managers, so undertaking a risk tolerance, or risk-bearing capacity analysis becomes more and more important. And how you do that is also quite an interesting subject in its own right.

There are a number of techniques in looking at corporate risk-bearing capacity. One of the areas that we have been developing for clients is to look at key financial targets of the company. Once we have developed optimum risk strategies, we can then set up future financial statements of the operation and develop either static or financial pro forma statements, run those strategies through and look at the impact of a variety of loss scenarios that could impact on those key financial targets. So you are looking at confidence levels – the

**We are required to apply a lot of risk control techniques**

**Cary Depel**

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## Make sure your risk-financing philosophy enhances the operation

**Colin Campbell**

probability for example of missing a strategic target such as interest cover, which is becoming more important in terms of debt repayment issues. That is where we have been exploring and developing our strategies with clients, and I think it has been a very important internal exercise for the risk managers concerned. Has anyone else any comments on how you have looked at this issue of risk bearing capacity or risk tolerance?

**KAMRAN MALIK:** Well one of the things that we are trying to do at Royal Mail is have a forward look at the corporate scorecard, not only in more detail but also on a more regular basis. That addresses two things; first, the timescale, because we are looking at 1-3, 3-5, 5+ so it forces us to look beyond that next set of published accounts. But the other aspect is to try and understand how aggressive or defensive the appetite of the board is. If it is aggressive they may see risk retention as an avenue of financing that aggression. If it is defensive with perhaps regulation having a bearing on this, there tends to be more caution, less volatility and therefore less of an appetite to take the risk in-house. But the corporate scorecard facilitates that discussion, and having that discussion is the building block to the final solution. We have found it quite a powerful way of getting the board's engagement.

**HUGH PRICE:** The financial aspect is obviously important, but you have got the operational side as well, which doesn't necessarily affect the finance director at board level. Is it a matter of perhaps having a two or three pronged attack at board level, or is it always invariably through the finance director?

**WILL THOMPSON:** In our case it was all operationally driven. The business was screaming about the operational impact on what we did with the management of our cars and the impact on the customer. It was those two things, and really the finance side simply facilitated the solution. The pressure was coming very much from the operational impact rather than the financial impact.

**COLIN CAMPBELL:** It's probably at the catastrophe end that you need to be working with the financial people. Below that clearly it is operational. I think we are talking about cultural issues, in that the approach to retention or otherwise is, as you were saying, about risk appetite. That tends to be partly to do with how engaged the board wants to be. You can come to them with many sophisticated risk analyses, products or scorecards or whatever, but at the end of the day they concentrate on their own business. Insurance is there to help them do that. Risk retention could well be something which might divert them from the issues of moving forward in their own business. But you are absolutely right in that whatever you do you don't want the insurance element or the retained element to interfere adversely with the operations of the business. What you need to do is turn it round to make sure that it actually has the opposite effect, in that your risk-financing philosophy – whether it is to go externally or retain, or a balance between them – actually matches up and enhances the operation as opposed to working negatively. In an area such as liability insurance, we have found many incidents of the kind that Hugh described. Managing those appropriately is all in our hands. And the way that we approach the management of third party claims actually helps our operation, because we can 'win win', not just in terms of financial settlements but also understanding the information and also frankly making sure the customer relations side works very well.

**TONY TUDOR:** How important is it to ensure that the volatility is within bounds? I can imagine in your situation you have got pretty good data and you can show that there is a fairly predictable series of calls on the business, whereas in something like liability you can get extremes and you have got reassure people that the volatility is handled.

**COLIN CAMPBELL:** I would say that in our liability portfolio extremes are far less than they are with something like assets, particularly buildings and trading. If you have a serious fire that is certainly going to upset the figures.

**HUGH PRICE:** Presumably, as far as the board is concerned, if you are coming up with some different idea, be it a captive or some other kind of retention, you have to do some kind of cost benefit analysis to show that the

new way is better than the old way, and that there is the added build on in terms of changing the culture and control of management information and so on.

**MARTIN MASSEY:** I think you have hit on a very important issue – the differences between organisations. If we turn it round in terms of looking at risk transfer, the value of risk transfer is much greater for volatile, highly leveraged and financially weaker organisations. There are clearly huge differences in the underlying volatilities that exist in a company and therefore the decision in terms of risk retention in terms of your insurance portfolio becomes much more important and therefore needs to be looked at in the light of the context of the overall operation. Just touching on an area of risk that we have been looking at – product liability for pharmaceutical companies – it is a completely different animal. It is probably one of the biggest risks in the world to be faced by a corporation, with very low frequency but high severity events that can run into billions of dollars. So there, the risk retention transfer decision is a very important strategic area for a company and the profile of the risk is critical. In an area such as product liability, you may see one company that hasn't had a loss in 10 years and another company that has had two losses of a billion.

One approach to dealing with this is to look at the whole, and that is what some companies are doing right now. Because risk transfer is so expensive with product liability, they are actually looking at not buying any insurance and making an evaluation of having no insurance or full insurance and whether there is an optimum between the two. That is really what the risk retention transfer decision is all about. You need to consider what it would look like if you didn't buy any insurance, then what it would look like if you have got all the insurance capacity available, but there is an optimum structure that sits in the middle. The pharmaceutical industry has been looking attentively at this recently, because of the changes in the market and the prohibitive cost of risk transfer.

**HUGH PRICE:** Some of these pharmaceutical and energy companies are so big that they are bigger than the insurance market. Do they segment the risk, placing the top layer on a reinsurance basis?

**MARTIN MASSEY:** BP started this. They looked at themselves and took the decision that they were probably bigger than most insurance companies. They were concerned – and probably this is a general concern at the moment - about insurers' ability to pay and, if you have a major loss, the reaction of the insurance market. When we do our studies we actually look at a pre and post large loss event, because when you are looking at your strategy you should be considering scenario analysis and asking how the insurance market would react to a major loss. That actually has an impact on the strategy. I know there is a lot of frustration out there at the moment in terms of insurers reducing coverage, and taking a long time to pay the legal costs involved. This is becoming a major issue – whether if you pay out your premiums you are going to actually get them back if you have a loss. So that is another general issue that companies are looking at in the context of retention.

**DAVID KETLEY:** That tends to ignore the reinsurance by your insurers. A lot of insureds have no idea actually where their risk is at the end of the day, how far it has been reinsured and whether at the end of the day it all comes back to major reinsurers like SwissRe and MunichRe. I think it is almost impossible to find out, if you have a very large loss, who ends up paying for it.

**HUGH PRICE:** It will be layered all over the place.

**TONY TUDOR:** To what extent does all this relate back to Turnbull in terms of reporting risk? If you are going to go for this retention process, I would think the board has to be convinced they can justify this in the accounts and talk about the way they are handling it.

**DAVID KETLEY:** I am not sure if the board has to justify it. It has to make a statement that it has looked at risk retention and decided that its current policy is the best for all involved.

**SUE COPEMAN:** When people are making these kind of decisions, how much benchmarking is done? This seems to me to be a classic area where people would really want to know what the chap up the road is doing with his risk.

**COLIN CAMPBELL:** We do a lot of benchmarking. Within AIRMIC we have the ability to benchmark without interfering with any legislation or competition issues. Also, organisations like Aon and other major brokers can give us information confidentially, which helps a great deal. I think businesses in a practical sense do like to benchmark, because that gives them some form of comfort that they are not totally out of alignment with their competitors or with similar businesses either financially or in the same sector.

**DAVID KETLEY:** You have got to be very careful with benchmarking that you are comparing apples with apples.

**COLIN CAMPBELL:** Absolutely. In the US they are big on it, and here I guess we are not quite so used to going public with information in a way that allows it to happen. Generally, we would look at what our competitors are doing, but on the other hand we would then see if there was a competitive advantage in doing something else. So while there may be some comfort in looking at what other people are doing, it doesn't necessarily stop you doing something which is slightly at odds with the rest.

**The value of risk transfer is much greater for volatile, highly leveraged and financially weaker organisations**

**Martin Massey**

**You have got to be very careful with benchmarking that you are comparing apples with apples**

**David Ketley**

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**SUE COPEMAN:** How about Royal Mail – in a sense you don't really have any competitors?

**KAMRAN MALIK:** The market is opening in 2006 so competitors are very eager to get in, but to date we have been the only industry, so it is difficult to get comparisons. I suppose the nearest would be looking at the Deutsche Post or the TPGs of this world. We don't do a great deal of benchmarking but we do rely on our brokers; that is our safety net. They are the experts, they give us advice and we have very close links with them. Through that route we try to make sure we have the optimum mix of retained and transferred risk.

**HUGH PRICE:** It must be a huge opportunity for brokers that they can make a proper comparison for benchmarking purposes as long as they are not giving away confidential information but generally helping their clients to assess their risks.

**STEVE STOKES:** I wonder to what extent some of those risks end up with the same insurer that has a preference for those types of risk.

**HUGH PRICE:** Some of them specialise, of course, like Zurich Municipal in local authorities' business. One could say there is an advantage in that, because, going back to comparing apples with apples, they are going to have a clear understanding of the issues that are going to impact on that particular type of risk. It is more difficult with a one-off like Royal Mail. As you say, Kamran, I suppose you would have to look abroad for any comparisons. But then again you must have a lot of information yourselves about how to operate – you've been doing it rather a long time now.

**KAMRAN MALIK:** Yes, but I suppose the difference is that the environment has changed. Although we are still owned by the DTI, the environment is becoming much more commercial, much more competitive and that has changed two things. One relates to the management structure. The other is the presence that risk management has in the business as a whole. Several years ago, we had quite a light touch risk management approach but now risk management is much closer to the centre of decision making. I think that is a big difference in the way we do business.

**CARY DEPEL:** There is a political element in your business as well that you have to try to deal with in the best way you can.

**KAMRAN MALIK:** Absolutely. We are in the public domain as much as most businesses so that is a key player in our decision making.

**SUE COPEMAN:** What about you, Cary? Do you have any risk information that you can benchmark against?

**CARY DEPEL:** I wish I could say we did, but we're a small financial services business publicly trading foreign exchange, metals and equity derivative products, including contracts for differences. It is unique, it kind of sits out on the fringes, it is not a 'down the hall' stockbroker firm. It is a specialist firm, and some of these products didn't exist 20 or 30 years ago so there is not a great history of insurance for them. Some of our competitors are much bigger and have more traditional aspects to their businesses so the aspects that we compete with them on just get folded into their larger insurance programmes. As far as I am aware at this point, there is not a specialist insurer for this.

**SUE COPEMAN:** Have any of you been in the situation where you were asked to retain a lot more risk than you were comfortable with by way of high deductibles or whatever?

**WILL THOMPSON:** I think that is certainly the case. In our insurance programme it is not so much higher deductibles but it is limits at the top end. The reinsurers won't take open-ended terrorism any more, they won't take open-ended third party property damage any more after the Selby rail crash. It is those sort of limits. Now we have never had a property damage loss of more than a quarter of a million anyway, so it is kind of academic. For other businesses, like those in the pharmaceutical sector where you do have that potential for the big one, it is a really serious scenario.

**CARY DEPEL:** I think insurers are far more shy about aggregation of loss these days because the ability to aggregate similar types of claims has been curtailed quite considerably.

**SUE COPEMAN:** We have talked about captives. How about other forms of alternative risk transfer? In fact, captives are now so widely accepted in the market that I don't know if you would actually call them alternative. But has anybody come across any things like weather derivatives or forms of hedging excess catastrophe loss?

**DAVID KETLEY:** One of our business units bought weather derivatives about three years ago. But I don't think there is any insurance element in such things. You don't have to prove indemnity. You pay a premium and if the event occurs you receive a fixed amount of money. It is just the same as making a bet.

**MARTIN MASSEY:** This brings in a broader issue that clearly most risk managers focus on traditional insurable risks. If you take a typical UK utility group, I would say that temperature volatility is possibly their greatest risk and they don't in the UK actually hedge that exposure. There are weather derivatives that can do that and I have actually been personally involved in developing a strategy where we, for example, modelled the temperature over the last 80 years to look at where we believed they should actually buy the derivative in relation to their exposure. But the interesting thing is that it is regarded as a 'new' risk, and companies don't necessarily communicate their concerns about these types of risk enough. They are not perceived to be traditional exposures that they should be hedging. But they are extremely important if you look at the actual volatility of these exposures, and why they are not hedging these exposures is something I am not sure about.

**KAMRAN MALIK:** That is an interesting point and it would be good to get your feedback on it regarding the confidence people have and the understanding of the product. They read about it in the press, but do they have the confidence to put the company's money behind a derivative? And people may be slightly nervous about what exactly they are buying. An example that comes to my mind happened some time ago with the Long Term Capital Management hedge fund – a different story but similar principles. People bought into something that was sold very well; the theory worked – but in practice it fell over. It's not the same thing, but in terms of people having confidence and understanding what they are buying, where do you feel that the maturity level is with products like derivatives?

**MARTIN MASSEY:** I think that is the key issue. It is understanding what the risk exposure is in the first place, and that is why it does require a lot of quantification work in understanding the risk. People have been going out buying derivative products and not necessarily appreciating the value they bear. They really need to do the leg work and actually develop a strategy as to what the exposure is and how they would need to hedge it. This whole issue of temperature volatility actually affects a lot of businesses that I have seen, for example in the food and drink sector, almost on a regular, weekly, basis. There are excuses about the performance of the company being related to the temperature volatility – and it is used as an excuse. I find it bizarre when there are ways of hedging those exposures. Why aren't companies really tackling some of those risks which are actually fairly strategic and also impacting the results of the business?

**DAVID KETLEY:** But taking the power-generating companies and global warming, there will be less demand in the winter as the winter is going to be warmer, but there will be greater demand in the summer for air conditioning as the temperatures get higher and higher. There is always an offset somewhere.

**MARTIN MASSEY:** Yes. A lot of these companies are global and that is one of the reasons. They have diversified products so there is an offset. But if you take a UK utility group that just distributes gas, 10% of their revenue may be totally dependent on the temperature between November and March and they are not actually hedging that exposure. I totally accept the point that it is very different with large organisations with a diversified spread of risks. Ultimately, if you actually analyse each area independently you would probably find that they weigh each other out.

**STEVE STOKES:** But is insurance the right place to hedge that risk?

**DAVID KETLEY:** This is not insurance that we are talking about. There is no indemnity. You don't have to have a loss or to prove a loss. You buy your product and if the temperature or whatever reaches a certain number, then the product pays up. You don't have to prove anything.

**STEVE STOKES:** I would have thought that hedging this type of exposure was a business strategy type decision that the board needs to be making rather than the risk manager.

**MARTIN MASSEY:** This brings in the issue of who is responsible internally. In this particular situation, when you talk about weather risks, I would say that there is nobody who is responsible for that particular exposure. Nobody has been allocated the responsibility to look at it from a company perspective. Often it is the risk manager who gets asked about it, and he is not really knowledgeable enough about the subject.

**CARY DEPEL:** You are dealing with your access to capital, and ultimately with your official capital structure; you are dealing with your ability to meet your revenue targets or overheads. It is undoubtedly a finance function, although it could be a risk management function some day.

**STEVE STOKES:** I think it might be deeper than that. If you have got somewhere where the business is open to a risk which is outside its control then maybe you need to change the direction of the business completely. It's a business strategy decision.

**COLIN CAMPBELL:** You could look at it the opposite way. The weather has been here always and people have been generating power for a very long time and dealing with those fluctuations in the weather. I guess they just trade their way out of it. That is the approach. My business is the same. We are very weather-orientated in terms of what we sell – have we got the right product in at the right time? – but we trade our way out of it. We might make excuses, but essentially they are just excuses, because the weather comes round eventually.

My view on finite risk products and similar is that they are highly complex. They are suitable for niche markets where there is a strong need that has been identified

**Where do you feel the maturity level is with products like derivatives?**

**Kamran Malik**

> **If it becomes uninsurable, you have to find some way of handling the risk**
>
> **Tony Tudor**

because there is a risk which is causing a huge financial burden on the company. But unless you are going to get some real buy-in from the very highest level in the company, it is just not going to happen. Is the risk manager the right person to drive it? You might get lucky and find that he is but, generally speaking, no. He is only tarred with that brush because it is deemed to be an insurance product and, as you say David, it frankly isn't.

**DAVID KETLEY:** I think that the risk manager has got to look not just at the weather, but also at global warming and the long-term effects of the possible rise in water levels, and look at his low lying locations. In the long term, we need to think about what we should be doing about those and perhaps thinking that eventually we may have to move them.

**TONY TUDOR:** Ultimately it becomes uninsurable, so you have to find some way of handling the risk.

**DAVID KETLEY:** That seems to be the way that people are talking at the moment. There are certain locations that will become uninsurable against flood.

**TONY TUDOR:** I think that is the role for the alternative risk transfer market – it's where you cannot buy cover elsewhere.

**DAVID KETLEY:** So what do you buy instead then?

**TONY TUDOR:** You might have to go for contingent capital or whatever. We have got lots of opportunities but the risk solution becomes a design product, not an off-the-shelf solution. You mentioned niche markets. That is exactly what has happened there. If you can identify the risk sufficiently and match it with something that is in the capital market – fine. But it is not that easy.

**SUE COPEMAN:** There seemed to be a number of what I would call two trigger products that were used at one time where a company reckoned that it could withstand a hit from one risk or the other but the two combined would be an absolute disaster. Are they still current in the market? Has anybody ever had any experience of them?

**DAVID KETLEY:** It was the sort of thing that if we had a loss over $20m and the share price had fallen below X amount then the policy would pay out. If either one of those happened on its own, then it wouldn't. You had to have this double trigger and one of the triggers was normally nothing to do with insurable risk. It would be based on the company's finances, whether it could withstand the loss. I haven't seen anything about them at all recently.

**CARY DEPEL:** People stopped buying them, which is why you don't see them at all now. They decided it wasn't worth the money.

**COLIN CAMPBELL:** Generally with this type of product you are benchmarking against something which is not your own company. It might be a price index, or a stock market index so it is not just your stock value, it is where the stock market is going This may be is fine, but it is difficult to know whether you are buying the right product or not. If the stock market is low is that a bad thing or a good thing for your company? Sometimes it is a good thing, sometimes it is not great. I haven't heard that people are buying those products.

**MARTIN MASSEY:** We are digressing into other areas of ART. But to come back to captives which we started talking about earlier, historically captives were fairly small subsidiary companies. What we have found, particularly over the last five years with the hardening insurance market, is that some of the captives have become extremely significant business operations for the running of risks for the corporate organisation. We have seen increases in retentions and also increases in the types of risks the captives underwrite, and that ties in with the previous discussion. There are a lot of uninsured types of exposures now placed within captives. They are being used more and more for difficult-to-place risks and are being used more as strategic vehicles. We mentioned earlier that the key benefit of the captive was being able to take control of the whole risk financing programme and the ability to develop and co-ordinate focused group-wide risk management strategy, and that includes for example global allocations. So captives have come a long way in the last few years and, with all these other ART type products that are out there, the captive almost has the ability to develop solutions in these areas.

**HUGH PRICE:** I was wondering whether there was any market for co-operative captives in the sense of a captive that operates for a specific type of business. I know that there are mutuals. I suppose the danger there is that you are sharing information with your competitors.

**WILL THOMPSON:** The marine business has been doing that for years, hasn't it?

**MARTIN MASSEY:** You have hit on a very good topic. We have actually been involved in quite a few mutual products in different sectors. Historically, there have been some fairly large mutuals established, particularly in the oil industry, that are still around and are very valuable to the oil industry. We have found in recent years that there is a lot more interest in forming mutuals – a lot of risk managers are quite interested. We mentioned benchmarking earlier – what are our peer group are doing? Maybe because of the frustrations in the insurance market there are ways of actually sharing risk with our peer group. We have been looking at the public sector recently and there has been a lot of interest in risk sharing. Perhaps it is because they don't have the competitive pressures, or they are looking for value for money but they have been quite happy to share risk with other local authorities. So there are a lot more opportunities in this area that we have been looking at – the electricity industry, the food and drink industry, even the football industry, have been looking at mutuals. If you are perceived to have exactly the same risk (and if you don't that's one of the key deal breakers) and if you have the same probability of having a major loss then it is likely to make sense to risk share that type of exposure.

**HUGH PRICE:** Taking local authorities, it seems to me there that there is a very good opportunity there because there is no competition. Local authorities do not compete with one another, NHS trusts do not compete with one another.

**SUE COPEMAN:** Well, they did have Municipal Mutual but that hit some problems and its business was taken over by Zurich.

**COLIN CAMPBELL:** I think one of the drivers for mutuals is where the insurance industry suddenly pulls cover. Terrorism risk has clearly been a driver in the aviation area and certainly, before the establishment of Pool Re, a mutual captive for terrorism was being quite seriously discussed in the retail environment. But there needs to be that huge driver, otherwise you are just not going to get buy-in in the competitive environment. It is very hard as you say, because you have to share information which may not be appropriate and, also, as you said, Martin, there is the problem of risk matching – in other words ensuring that all the risks are essentially equal – and that is not easy in a competitive environment either.

**SUE COPEMAN:** There was a pharmaceutical mutual established fairly recently that actually set down some quite specific criteria for membership and that seems to be doing well.

**MARTIN MASSEY:** That was for property. They were looking at setting up to cover liability but it was far more complex for long term risk. The short term risks, property risks, they are the ones that are more likely to succeed.

**CARY DEPEL:** The ones that I've heard about are the lawyers' mutuals. The competitive information isn't as apparent or even transferable for starters. When they do work, they work well because they are self-policing. It is only when a firm finds that its claims incidence starts shooting through the roof that all of a sudden it finds that it has got all its brethren jumping down its throat in the mutual boardroom.

**HUGH PRICE:** Yes I must admit that lawyers are becoming increasingly risk averse, I don't think there is much doubt about that. Take the rise in contingency fee agreements where lawyers themselves are taking the risk of losing the case. My firm handles cases for claimants, and we have a very strict risk assessment regime before we take those on.

**SUE COPEMAN:** At 3i your whole business really is risk assessment, deciding whether to invest in a company, isn't it, Steve? If you want to invest in a company do you look at their risk retention strategies – is this something you would do?

**STEVE STOKES:** We would definitely do due diligence. But one of the main things we are investing in is the people rather than the business. It is the people's ability to run the business. So what we are investing in is their business strategy and their future potential. It is more about the business than the actual assets of the business.

**SUE COPEMAN:** One point that we have touched upon already is companies' risk appetite. What are the drivers for changing that? We have mentioned changes in the insurance market, so obviously the ability or the inability to be able to transfer risk at an affordable amount is going to be one of them. But we have also said that risk appetite is related to some extent to culture. If the board or CEO changes suddenly, are we going to see a quite different attitude almost overnight?

**STEVE STOKES:** Definitely. A significant change at board level is going to totally change the direction of the business.



**I must admit that lawyers are becoming increasingly risk averse**

**Hugh Price**


**The good thing about handling and using your own data is that you are aware of what lies behind it**

**Colin Campbell**



**WILL THOMPSON:** Just picking up a point that was mentioned earlier in terms of what your trading environment is like, if your trading environment is good and you are doing well then the reserves are there to be built up. Your appetite to retain risk in the business rather than transfer risk is there. You can withstand the volatility because things are looking rosy. If you are not in that environment you have got to batten down the hatches where you can, take out the volatility, and then cost it in a controlled way. That is one of the things that is key for us, it is what your trading environment is like, how well business is going.

**KAMRAN MALIK:** It is quite an interesting time for us because the environment through competition is going to change. So our risk appetite will change. We will lose the cushion of a monopoly, so the way we assess risks has to change. In terms of the strategy and direction of the company it is almost being forced upon us, but in a constructive way. There is a lot more of an appetite for the audit reports that come out on control environments. Health and safety is a good example. There is an independent feed from the audit section on controls, etc, and you can't make a risk assessment decision without knowing what the effectiveness of the control environment is. That information stream has become of far more interest to the board. Every board member gets that report in its entirety now, whereas before there used to be a summary. I have seen that sort of change as an indicator of a feed to risk appetite.

**HUGH PRICE:** Is that a corporate governance issue?

**KAMRAN MALIK:** Under the broad umbrella it is – yes.

**TONY TUDOR:** The more confident we are in the data, the more likely we are to see some preparedness to handle risk in different ways. If you are able to analyse it and establish certainties, people are much more prepared to take the risk when there is a very volatile situation.

**KAMRAN MALIK:** Yes, it certainly increases confidence levels.

**TONY TUDOR:** Martin, you were saying about using actuarial models and mathematical models. That is quite a difficult one to sell into the board other than through treasury, the accounting side of the business, because they probably don't have that level of sophistication. So you have got to be very confident of the model, someone has got to endorse it.

**WILL THOMPSON:** Absolutely, we have got a very good example of that with our residual values. We've created a pricing and asset team, we've pulled together what we feel are the industry leaders in it and whereas in the past we have been using industry benchmarking as our indicator, we are migrating away from that and we take our own view on what the residuals are. That has allowed us to feel much more confident about taking the risk in because we know a lot more about it.

**COLIN CAMPBELL:** I would say the same. With all due respect to Martin and his team, when an actuary gets his hands on your data it is great and produces information, but the good thing about handling and using your own data is that you are aware of what lies behind it. That is why you need to work with people like Martin to make sure that the feeds and the information and what may have driven the differences year on year and what lies behind that information are actually understood by everyone.

**MARTIN MASSEY:** I totally agree with you. The actuarial profession has changed in the use of risk models. We have obviously got quite complex in-house models but to be honest you need to avoid the 'rubbish in, rubbish out' syndrome. We spend a lot of time in making sure data inputs are correct. And it is very important that we work with the client and the client understands the underlying assumptions that are made. So I think there has been a change in our approach in making sure that clients are fully aware of the assumptions going into these models because they are going to be making decisions based on the output. It's a valid point.

**COLIN CAMPBELL:** Is one of the difficulties just engaging people sufficiently – of getting people's attention for a sufficient length of time for them to understand what you are saying, essentially understand what is beneath the numbers?

**MARTIN MASSEY:** The real value from the work that I do is actually the interaction with the client. With some of these projects it can take anything from six months to a year to develop a framework for making decisions, so it isn't 'here's the data, go away and produce results', and 'here's your loss forecast'.

Where the value comes from is the whole process of digging deep into the data and arriving at a set of assumptions. On the pricing, for example, we spend a lot of time understanding the insurance market, then we provide that information to the client. Then we build pricing models, with again, getting all the assumptions agreed until we have finally built the framework for making decisions.

Where we would like to be, and what we are working towards, is ultimately for our presentation to be presented by the client himself internally to his board, so that he is actually presenting the results himself. That is a fundamental shift, and that is where there is a lot of value now in some of that detailed work. Whereas before it was apt to get a little bit lost. We produced a detailed report and it got put on the shelf.

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