At a premium

Every day hundreds of tourists take photographs that juxtapose the Tower of London with the looming 'gherkin' built for the Swiss Reinsurance group. Meanwhile the west front of the Tower is reflected in the adjacent glass facade of the massive new Marsh building, and Willis (the world's third biggest insurance broker) has commissioned a spectacular structure that is approaching completion next to Lloyds of London's high-maintenance building. Any treasurer who visits the City, where these three marvels can be found, will be acutely aware that the brokers' magnificent premises are funded entirely by buyers of insurance.

Bankers' bonuses make the news, but rather less well known is the fact that the top insurance underwriters in the London market – and at least as many of the brokers who feed business to them – also receive six and seven-figure bonuses. This cash, too, can come from only one source: insurance premiums.

AGENT FOR WHOM? It is a truism in risk management circles that insurance buyers are supine in the face of the legal fact that insurance brokers mostly act as the agents of the insurers rather than the firms whose 'risks' they are so expensively 'placing' in the insurance market. Despite the imposition, following the Spitzer inquiry into the US insurance brokering market, of an element of transparency on the relationship of the insured to their broker, insurers still permit brokers to take their cut directly from the premium and thereby shift resources speedily from the 'client account' to their own.

Covert payments by insurers to brokers have certainly not been eradicated, and the Association of British Insurers' draft code for terms of business merely offers buyers the right to ask what commissions are being charged. Yet the punters generally continue to perceive the intermediary as 'my broker', although some have not been duped by the proposition that the broker is a disinterested adviser on 'total risk solutions'. Large corporations continue to buy essentially the same insurance contracts as their equivalents did half a century ago, through the well-worn channels from which comfortably more than 50% of the quoted premium can be absorbed in transaction costs.

SCORING POINTS Captive insurance vehicles enable companies to meet the legal obligation to buy insurance (for motor fleets, employer liabilities, and so on) with reduced transaction costs. And by providing management services for their captives, brokers and other insurance-based suppliers maintain a lien on that sector of the business. From time to time companies allocate non-compulsory insurances to their captives, usually on the advice of a broker who sees danger signals in a client's protestations about the cost or limitations of conventional cover. These devices subtly ensure that firms do not consider alternatives to insurance by giving them the impression that they have got one over the market.

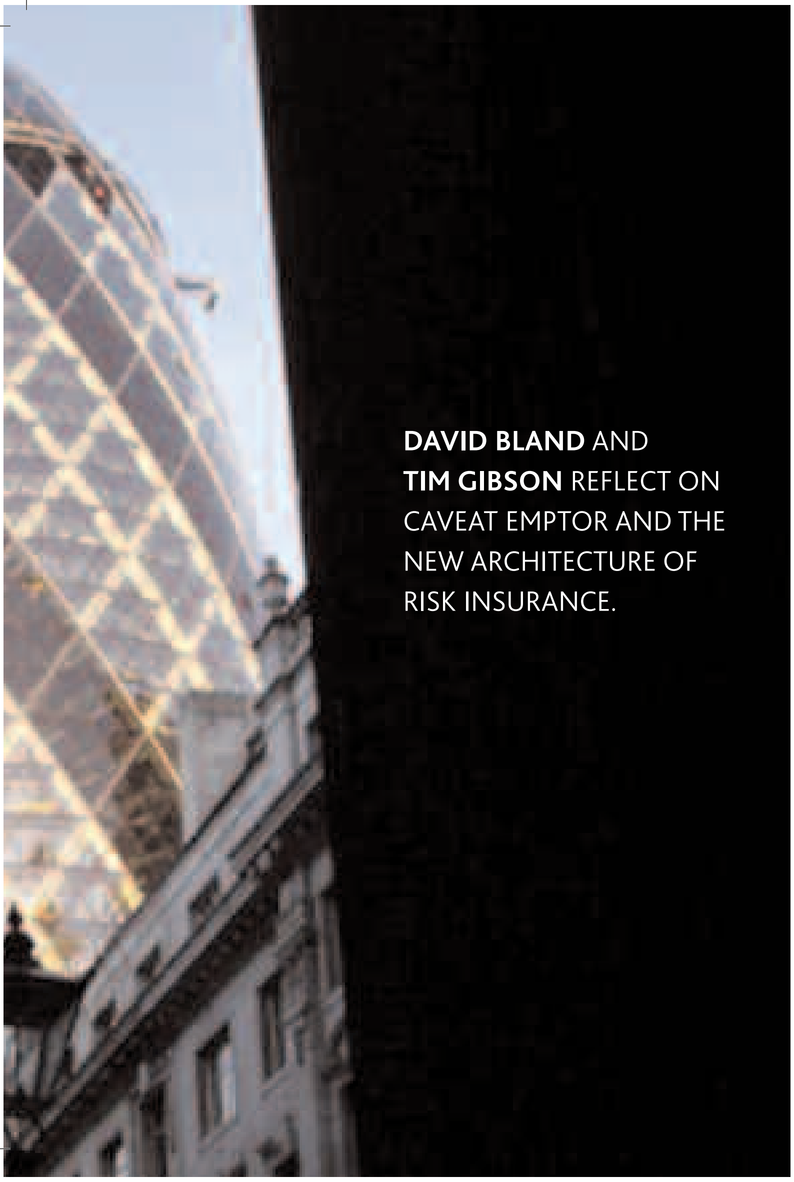
Compulsory liability insurance – particularly employers' liability – constitutes a system of pay-as-you-go risk finance. The reinsurers observe the cashflow in and out of the market sector, month by month, and the potential accrual of emergent liabilities, and set reinsurance rates accordingly. This dictates the parameters within which primary insurers can fix premium rates for clients on the basis of their claims record. The law requires employers' liability cover to be effected with a licensed insurance provider, so the brokers get their cut regardless of whether they negotiate a rate with a primary insurer or set up the reinsurance treaty that underwrites a captive.

The board of directors of a non-finance-sector company is ultimately responsible for decisions whether or not insurance should be bought to finance any specified risk to the firm, its assets or its activities. In some cases where a captive is not considered the appropriate mechanism for carrying a mandatory insurance cover, part of the premium may be rolled forward to another year, or rebated, or offset against another financial instrument, under the

Executive summary

- Treasurers must reassess the whole profile of their risk financing and be bolder in assessing the most suitable means of addressing the potential financial needs consequent on risk events.

34-35 Risk Premium Oct06 2/10/06 5:05 pm Page 35



DAVID BLAND AND **TIM GIBSON** REFLECT ON CAVEAT EMPTOR AND THE NEW ARCHITECTURE OF RISK INSURANCE.

'burning cost' or 'finite' concept. This remits part of the premium if risk events are avoided.

These contracts are very complex, making it virtually impossible for a firm to avoid the intermediacy of a broker. Nor are they straightforward insurance agreements. That leaves it open to doubt whether future international regulatory standards will tolerate contracts that are open to such a wide latitude of interpretation according to the insurer's perception of events.

Traditional insurance pricing is based on the assumption that (within a narrow range of variance) firms facing similar risk exposures adopt similar risk-mitigation methods. That means their exposures should be approximately equal probabilistically – although they vary in scale, depending on the size of the exposure – and therefore the premium can be set for all players at a normal rate per million pounds of exposure.

In other words, each insured firm is sharing the risks of its competitors. In an early-industrial market with many dozens of closely similar competitors, this was a broadly fair basis for the business. And it still works for small businesses to which the law of large numbers can be applied, and to many of the subcontactors (especially in emergent economies) which provide components and services for larger firms globally.

Very few significant competitors in each major market segment – automotive, aircraft, software etc – have very different geopolitical production and distribution strategies. More value exists in the brand than in physical assets, and in these conditions it is irrational to provide a major proportion of your competitor's risk financing potential. The exception is where a risk is equally shared, and equally fortuitous for all competitors. Pooling risk finance with direct competitors is still a rational option in the case of property/casualty cover for earthquake in California, storm in Florida, and terrorism almost anywhere.

By contrast, a bundle of risks to brand value, intellectual property and other crucial assets – either within a small group of direct competitors, or garnered from a larger random range of firms in various business sectors – does not provide a viable statistical basis for a rational pricing policy by an underwriter. It does, however, generate a great return for the negotiating intermediaries, who are keen to promote such products to both insurers and client firms.

Over the past quarter-century, corporate treasurers have been seduced by the challenge that the cybertraders have thrown to them: to understand – and then accept – offers to engage derivatives to 'remove' elements of risk from a large volume of transactions and situations. The fact that the insurers and their reinsurers have used derivatives to pad their balance sheets may be a cause for some concern about the medium-term sustainability of insurance reserves, but hitherto the insurance business has in general paid out on all legitimate claims, although an increasing proportion of high-value cases has gone to litigation. In many of these court hearings, the broker's competence becomes a central issue, yet the types of business exposed to these risks continue to increase.

RECOGNISING THE RISK The 'total' solution of a corporation's risk exposure can never be achieved, but huge benefits can be gained by engaging with the widest possible range of affordable risk-financing options, especially if each is the most fit-for-purpose solution in the circumstances. This requires a system for naming each potential risk, then determining if the risk exists as an exposure for the firm in question. That must be followed by the application of techniques for identifying and quantifying the risk, training staff in the skills to recognise the risk and to be aware when a risk event in that category is actuated, and assessing the probability of occurrence and potential impact of major risk events in that category.

With increasing querulousness emerging among banking sector commentators about the relevance of value-at-risk modelling, there is a burgeoning need for proportionality in risk financing for firms that are clients of the financial services sector. This is especially the case where potential over-exposure to derivitisation could trigger a systemic risk event for one or more major global institutions. As the signals increase that (recently abundant) capital is going to become scarcer and more expensive, the risks of retaining risk on the firm's own balance sheet increase. That, in turn, means that the cost of engaging risk transfer mechanisms is likely to increase at least proportionally to the increased cost of capital.

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The authors have developed a non-insurance product that can increase the range of risks for which firms can make pre-event provision to maintain their solvency. The product is not designed to compete directly with futures, options, derivatives or insurance, but to encourage treasurers to reassess their risk financing profile and boldly assess the options.

Do you disagree with – or, indeed, heartily endorse – the opinions expressed in this article? Email us at editor@treasurers.org.uk and tell us how you think treasurers should approach risk financing.