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Strategic Risk Financing
and
Alternative Risk Management Methods

ALTERNATIVE TO WHAT?

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{SLIDE 1}

GOOD MORNING,

AS THERE IS NO ORDAINED CONSULTANT ON THE PANEL, I HAVE BEEN ASKED TO GIVE THIS MORNING'S BENEDICTION:

LET US PRAISE THE GREAT PARADIGM, WHICH EMPOWERS US AS TEAM PLAYERS, WITHIN THE HOLY BANDS OF JOB FAMILY ARCHITECTURE, TO FREELY PARTICIPATE IN MULTI-FUNCTIONAL TASK FORCES, IN A CORPORATE ENVIRONMENT OF ENRICHING DIVERSITY, SO THAT WE MAY UTILIZE OUR PERSONAL AND COLLECTIVE TOOL KITS AND SKILL SETS IN PERFORMING NEVER-ENDING SELF ASSESSMENTS, ALL, IN ORDER TO FAVORABLY IMPACT THE FORTUNES OF THE ALMIGHTY STOCKHOLDER. AMEN.

LATER ON WE WILL PASS THE TEMPLATE.

BASED ON THE TITLE OF THIS SESSION YOU MAY CONSIDER IT SOMEWHAT SUBVERSIVE WITHIN THE CONTEXT OF THIS CONFERENCE. IT APPEARS TO REPRESENT A COUNTERPOINT TO THE GENERAL THEME. HOWEVER, THAT IS NOT THE INTENT. I HAVE ALWAYS MAINTAINED THAT THERE IS NO ONE WAY TO ADDRESS RISK, JUST AS THERE IS NO ONE WAY TO DESIGN AN INVESTMENT PORTFOLIO.

WHAT I DO SUGGEST, HOWEVER, IS THAT JUST AS NO ONE APPROACH SUITS ALL ORGANIZATIONS, SO TOO NO ONE APPROACH WILL FULLY SATISFY ALL THE NEEDS OF ANY ONE FIRM. POTENTIAL, RISK FUNDING SOLUTIONS FOR ANYONE FIRM WILL CONTINUE TO EMBRACE ALL THE METHODS UNDER DISCUSSION AT THIS CONFERENCE INCLUDING SELF INSURANCE, FINITE RISK, CAPTIVES, PERHAPS THE CAPITAL MARKETS, TRADITIONAL INSURANCE, ETC. IN ADDITION, I WILL ALSO DISCUSS UTILIZING TRADITIONAL INSURERS IN COMPLETELY UNPRECEDENTED WAYS. IN A SENSE, THE INCLUSION OF THIS SESSION WITHIN THIS CONFERENCE SERVES A HOLISTIC PURPOSE, ENSURING THAT ALL POTENTIAL SOLUTIONS ARE CONSIDERED.

WITH RESPECT TO THE INVOLVEMENT OF CAPITAL MARKETS IN INSURANCE, THERE ARE SEVERAL IMPEDIMENTS. THE FIRST, WHICH IS OFTEN NOTED, IS INVESTOR DESIRE FOR GREATER RETURN ON CAPITAL THAN THAT ACHIEVED IN INSURANCE, ESPECIALLY GIVEN THE FIERCE COMPETITION FROM REINSURERS. HOWEVER, AS IMPORTANT, MAY BE THE DESIRE OF INVESTMENT BANKERS TO SECURE THE GREATEST POSSIBLE RETURN ON THE ALLOCATION OF THEIR INTERNAL RESOURCES. AT A TIME WHEN INVESTMENT BANKS ARE STRAINING THEIR RESOURCES TO MEET THE DEMAND FOR INITIAL PUBLIC OFFERINGS, MERGERS AND ACQUISITIONS, ADVISORY WORK AND OTHER TRADITIONAL, HIGHLY LUCRATIVE INVOLVEMENTS, THERE IS A SIGNIFICANT OPPORTUNITY COST INCURRED IN DIVERTING RESOURCES TO ADDRESS THEORETICAL INSURANCE OPPORTUNITIES. IN ADDITION INVESTMENT OFFERINGS ARE HIGHLY REGULATED, REQUIRING EXTENSIVE DISCLOSURE, WHICH CAN LEAD TO A RATHER RIGID STRUCTURE.

{SLIDE 2}

IN THE PAST, I HAVE HEARD IT SUGGESTED THAT AN ORGANIZATION SHOULD DETERMINE ITS “APPETITE FOR RISK.” THE IMPLICATION BEING THAT THIS WAS A SINGLE DEFINABLE LEVEL . IT HAS BEEN SUGGESTED, FOR EXAMPLE, THAT IF A FINANCIAL INSTITUTION CAN RISK \$100 MILLION OR MORE IN A TRADE, A LOAN OR AN INVESTMENT, THEN THAT FIRM SHOULD HAVE HUGE RETENTIONS WITH RESPECT TO INSURANCE, INDEED, IF IT PURCHASES INSURANCE AT ALL. THIS SEEMS A SIMPLE LOGICAL ARGUMENT BUT AS SOMEONE ONCE WROTE “LOGIC IS ONE THING AND COMMON SENSE ANOTHER.”

THE BASIC FLAW IN THIS ARGUMENT IS THE FAILURE TO DISTINGUISH AMONG THE VARIOUS TYPES OF RISKS FACED BY AN ORGANIZATION. FOR EXAMPLE, AN \$800 MILLION DOLLAR OFFICE BUILDING CAN BE FULLY INSURED BY A HIGHLY PROTECTED RISK INSURER FOR 2 BASIS POINTS OR .02%

IF THE “APPETITE FOR RISK” APPROACH, AS I HAVE DEFINED IT, IS FOLLOWED, THE BUILDING COULD BE SELF INSURED FOR THE FIRST \$100 MILLION, AND, ASSUMING IT WAS NOT ALREADY AT A MINIMUM PREMIUM LEVEL, A RELATIVELY SMALL SAVINGS MIGHT BE DERIVED.

{SLIDE 3}

I WOULD LET THOSE WHO CONTEND THAT “A RISK IS A RISK IS A RISK” EXPLAIN TO STOCKHOLDERS THAT A \$100 MILLION LOSS WAS INCURRED BECAUSE THE BUILDING OWNER WAS JUST TOO SOPHISTICATED TO SPEND A FEW THOUSAND DOLLARS.

THERE ARE A VARIETY OF RISKS FACED BY AN ORGANIZATION AND THEIR NATURE AND RELATIONSHIP TO THE FIRM’S BUSINESS WILL DICTATE THE MANNER IN WHICH THEY SHOULD BE ADDRESSED.

{SLIDE 4}

I SPEAK FROM THE PERSPECTIVE OF A FINANCIAL INSTITUTION BUT I BELIEVE YOU CAN EXTRAPOLATE TO YOUR OWN TYPE OF ORGANIZATION. TO USE THE CURRENT TERMS OF ART, I BELIEVE SOME RISKS FORM THE CORE COMPETENCY OF THE ORGANIZATION. THESE ARE THE RISKS FROM WHICH THE FIRM DERIVES ITS REVENUE. HOWEVER, IN PURSUING THIS REVENUE THE FIRM IS EXPOSED TO

{SLIDE 5}

OPERATIONAL RISKS. IT WAS NOT THE COMPLEXITY OF THE FINANCIAL RISK OR THE NATURE OF DERIVATIVE INSTRUMENTS THAT BROUGHT BARINGS DOWN, OR WHICH CLOSED THE DOORS OF FRANKLIN NATIONAL BANK ALMOST 25 YEARS AGO. IT WAS POOR OPERATING CONTROLS. SOME OF THESE RISKS HAVE TRADITIONALLY BEEN INSURABLE AND MORE ARE NOW BEING CONSIDERED AS CANDIDATES FOR INNOVATIVE FUNDING APPROACHES.

{SLIDE 6}

THE THIRD TYPE OF RISK WHICH STEMS FROM FORTUITOUS EVENTS SUCH AS FIRES, EARTHQUAKES, ETC. IS WHOLLY EXTRANEOUS TO THE CORE COMPETENCY OF THE FIRM AND IS IN FACT THE CORE COMPETENCY OF ANOTHER TYPE OF FIRM I.E., AN INSURANCE COMPANY. INSURERS WILL NOT ONLY ASSUME THIS RISK BUT HAVE HISTORICALLY DONE SO AT AN UNDERWRITING LOSS.

{SLIDE 7}

YOU MAY HAVE HEARD THE STORY ABOUT THE INDIVIDUAL THAT DECIDED TO MANUFACTURE A PRODUCT KNOWING THAT HE WOULD LOSE MONEY ON EVERY UNIT SOLD BUT EXPECTED TO MAKE UP THE LOSS THROUGH VOLUME. CONSIDER THE INSURANCE INDUSTRY, WHICH EVERY YEAR LOSES UP TO 15 TO 20 CENTS ON EVERY DOLLAR OF PRODUCT SOLD BUT MAKES UP FOR THE LOSSES IN VOLUME, I.E., THE MORE PREMIUM TAKEN IN THE MORE INVESTMENT INCOME TO BE EARNED. (THOUGH THIS IS NOT THE APPROACH TAKEN BY THE MOST SUCCESSFUL INSURERS.)

AS WE CONSIDER ALL OF THE RISK FUNDING OPPORTUNITIES BEING PRESENTED AT THIS CONFERENCE, IT WOULD BE A SERIOUS OMISSION TO OVERLOOK INSURANCE, THROUGH WHICH LITERALLY BILLIONS OF DOLLARS OF RISK TRANSFER ARE AVAILABLE AT A COST WHICH CAN BE WHOLLY INSIGNIFICANT TO THE FIRM. ON THE OTHER HAND IT WOULD BE FOOLISH TO SUGGEST THAT TRADITIONAL INSURANCE IS ALWAYS THE ANSWER. WITH RESPECT TO SOME PERILS, COMMERCIAL INSURANCE HAS

NOT BEEN AVAILABLE ON AN ECONOMICALLY COMPELLING BASIS FOR OVER A DECADE. HOWEVER, I DO BELIEVE THAT THE TRADITIONAL INSURANCE MARKET SHOULD ALWAYS BE CONSIDERED, EVEN IF THE RISKS TO BE ADDRESSED HAVE PREVIOUSLY BEEN UNINSURABLE. WHAT I AM TALKING ABOUT IS MAINTAINING A SENSE OF BALANCE NOT ONLY BETWEEN THE TRIED PRODUCT AND THE NEW BUT ALSO THE TRADITIONAL RISK TRANSFER PARTNER AND RECENT ENTRANT. THERE IS POTENTIAL FOR PARTICIPATION BY ALL.

AS WE ENTER THE TWELFTH YEAR OF A THREE YEAR INSURANCE CYCLE WITH CAPACITY CONTINUING TO INCREASE AND A REVITALIZED LLOYDS MARKET ANXIOUS TO COMPETE, THERE ARE STILL THOSE WHO WARN OF THE NEXT MARKET CORRECTION. CLEARLY WE MUST REMAIN SENSITIVE TO THE POTENTIAL FOR CHANGE. HOWEVER, TODAY'S MARKET IS RADICALLY DIFFERENT THAN THAT WHICH EXISTED AT THE TIME OF THE LAST CORRECTION OR FOR THAT MATTER AT ANY PRIOR TIME. CAPACITY IS EXPONENTIALLY GREATER AND NO ONE MARKET SECTOR EXERCISES CONTROL.

{SLIDE 8} (“BLENDED IS NOT NECESSARILY SPLENDID”)

I WOULD LIKE TO CHECK ON THE COMPOSITION OF OUR AUDIENCE THIS MORNING. BY SHOW OF HANDS HOW MANY TREASURERS AND CFO'S DO WE HAVE.... HOW MANY RISK AND INSURANCE MANAGEMENT TYPES.....

I WILL NOW PROCEED TO SELL THE FINANCIAL MEMBERS OF THE AUDIENCE A BLENDED INSURANCE PROGRAM. JUST THINK OF THE ADVANTAGES. AT

THIS TIME, YOU PROBABLY HAVE PERHAPS 10 OR MORE SEPARATE INSURANCE CONTRACTS, WITH 10 DIFFERENT RENEWALS ON AN ANNUAL BASIS, PERHAPS 30 DIFFERENT NEGOTIATIONS OVER THREE YEARS. LETS PUT EVERYTHING INTO ONE CONTRACT, PUSH THE RETENTION UP TO MAKE IT MORE REFLECTIVE OF YOUR APPETITE FOR RISK, SLAP ONE AGGREGATE LIMIT ON IT AND WRITE ONE POLICY FOR THREE TO FIVE YEARS. THERE MAY EVEN BE SOME PREMIUM SAVINGS. SIGN HERE.

I RECENTLY READ A QUOTE FROM A RISK MANAGER ON THE FRONT PAGE OF AN INDUSTRY PUBLICATION TO THE EFFECT THAT, BLENDED POLICIES WILL BE PURCHASED BECAUSE CFO'S LIKE THEM. THE LOGIC OF THIS ARGUMENT ELUDES ME, CONSIDERING THE FACT THAT CFO'S AND TREASURERS WILL READILY ACKNOWLEDGE THAT THEY HAVE A LIMITED UNDERSTANDING OF INSURANCE.

THE OPERATIVE WORDS IN THIS SLIDE ARE "NOT NECESSARILY". I AM NOT SUGGESTING CATEGORICALLY THAT BLENDED PROGRAMS ON A PRIMARY LEVEL MAY NOT MAKE SENSE FOR SOME ORGANIZATIONS, PARTICULARLY THOSE WITH A DISTRESSED LOSS HISTORY. SUCH PROGRAMS MAY BE THE ONLY WAY FOR SOME ORGANIZATIONS TO SECURE CERTAIN COVERAGES AND PRICES. AGAIN THE KEY WORD IS BALANCE.

WHAT ARE A FEW OF THE ISSUES YOU SHOULD CONSIDER IN EVALUATING A BLENDED APPROACH.

{SLIDE 9}

BLENDED PROGRAMS TEND TO ELIMINATE OCCURRENCE COVERAGE AND PLACE ALL COVERAGE ON A CLAIMS MADE BASIS. THIS IS NOT A DETAIL. A CLAIMS MADE POLICY LITERALLY COVERS CLAIMS MADE DURING THE TERM OF THE POLICY. AN OCCURRENCE FORM COVERS ALL CLAIMS ARISING OUT OF EVENTS WHICH TOOK PLACE DURING THE POLICY TERM. IT IS ON THIS THEORY THAT COURTS HAVE AGGREGATED THE COVERAGE OF DECADES TO APPLY TO ASBESTOS AND ENVIRONMENTAL ISSUES. IN FACT, CLAIMS MADE COVERAGE IS A DEVICE SPECIFICALLY INTENDED TO LIMIT THE POTENTIAL LONG TERM LIABILITIES OF THE INSURANCE INDUSTRY. BEFORE ELIMINATING ALL OCCURRENCE COVERAGE, CAREFUL CONSIDERATION SHOULD BE GIVEN TO FUTURE LIABILITIES WHICH MAY ARISE FROM PRESENTLY UNIDENTIFIED EXPOSURES.

{SLIDE 10}

IN A TRADITIONAL PROGRAM ONE COVERAGE TYPE WILL HAVE ONE ANNUAL AGGREGATE LIMIT. THE INSURED CONTINUALLY MONITORS CLAIM ACTIVITY TO DETERMINE IF AND WHEN THAT AGGREGATE MAY BE DEPLETED AND WHEN IT IS APPROPRIATE TO PURCHASE A REINSTATEMENT OF COVERAGE. A BLENDED PROGRAM CHANGES THIS SITUATION IN TWO WAYS. FIRST THE MULTI-YEAR ASPECT STRETCHES THE PREVIOUS ANNUAL AGGREGATE OVER PERHAPS 36 MONTHS. WHILE A PREMIUM SAVINGS IS NATURALLY ASSOCIATED WITH THIS, SO TOO IS A MAJOR REDUCTION IN COVERAGE E.G., A FIRM WITH A \$100 MILLION ANNUAL AGGREGATE LIMIT, OVER 36 MONTHS ENJOYS \$300 MILLION IN COVERAGE. IF THIS FIRM CONVERTS TO A 36 MONTH \$100 MILLION AGGREGATE, IT HAS REDUCED ITS COVERAGE BY $\frac{2}{3}$ OR \$200 MILLION.

REINSTATEMENT OF LIMIT CAN BE PURCHASED BUT THIS DECISION IS FURTHER COMPLICATED BY THE BLENDING OF COVERAGES. IT IS DIFFICULT ENOUGH TO MONITOR ONE COVERAGE TYPE, A BLENDED PROGRAM COMPLICATES THE ASSESSMENT BY HOMOGENIZING DIRECTORS AND OFFICER LIABILITY, CORPORATE PROFESSIONAL LIABILITY, CRIME, COMMERCIAL LIABILITY, PROPERTY AND OTHER COVERAGES UNDER ONE AGGREGATE.

WHEN EVALUATING BLENDED PROGRAMS I SUGGEST YOU ASK ABOUT AGGREGATE DEPLETION. WHAT IF YOU FAIL TO REINSTATE AT THE PROPER TIME? HOW OR WILL EXCESS LAYERS DROP DOWN? YOU MAY FIND THAT DEFINITIVE ANSWERS ARE SIMPLY NOT AVAILABLE BECAUSE THE PRODUCT IS LARGELY UNTESTED AND DIFFERENT INSURERS HAVE VARYING PERCEPTIONS. IN SHORT, DO YOU WISH TO MAKE A LONG TERM COMMITMENT TO AN IMMATURE PRODUCT OR WAIT UNTIL IT HAS BEEN FURTHER REFINED?

I HAVE NO INHERENT PROBLEM WITH THE MULTI-YEAR CONCEPT. WHEN I ENTERED THE BUSINESS, FINANCIAL INSTITUTION CRIME INSURANCE WAS WRITTEN ON A CONTINUOUS BASIS WITHOUT ANY SET EXPIRATION. HOWEVER, THESE BONDS WERE AT THAT TIME SUBJECT TO PER LOSS RATHER THAN ANNUAL AGGREGATE LIMITS. IN FACT, I STILL CONSIDER ALL CORPORATE COVERAGES AS CONTINUOUS FINANCIAL RELATIONSHIPS WITH VERY LONG TERM INSURERS.

{SLIDE 11}

IN MOST BLENDED PROGRAMS A SIGNIFICANTLY HIGHER RETENTION IS ALMOST AUTOMATIC. AS WE DISCUSSED EARLIER, UNLESS A HIGHER RETENTION RESULTS IN A CLEAR ECONOMIC BENEFIT, SUCH AS A MATERIAL SAVINGS IN PREMIUM, IT IS DIFFICULT TO JUSTIFY. THERE IS A BASIC PROBLEM WITH PAYING THE SAME OR MORE FOR LESS. SOME OF THE PROGRAMS I HAVE SEEN, WHICH IMPOSE VERY HIGH RETENTIONS DO OFFER SIGNIFICANT SAVINGS, SO LONG AS THERE ARE NEVER ANY LOSSES. THERE ARE ALSO THOSE WHO SAY EVERY FIRM WINDS UP PAYING FOR ITS OWN LOSSES OVER TIME SO RETENTIONS ARE IMMATERIAL. THIS IS SIMPLY NOT TRUE BECAUSE THAT IS NOT HOW THE MARKET OPERATES.

{SLIDE 12}

ONE OF THE ARGUMENTS IN FAVOR OF BLENDED PROGRAMS IS THAT ALL COVERAGE CAN BE CENTRALIZED WITH ONE STRONG CARRIER. HOWEVER, MAKING THIS CHANGE BY DEFINITION TERMINATES ALL THE OTHER RELATIONSHIPS, WHICH MAY HAVE BEEN FOSTERED OVER MANY YEARS.

AS A RISK MANAGER OF A FIRM WITH A FAVORABLE LOSS HISTORY, I TYPICALLY DO NOT CHANGE INSURERS ON CORPORATE COVERAGES UNLESS A CARRIER'S FINANCIAL RATING IS DOWNGRADED OR ITS UNDERWRITING PHILOSOPHY CHANGES.

OBVIOUSLY, THIS KIND OF CONTINUITY WOULD BE LESS TYPICAL FOR A FIRM WITH AN ADVERSE LOSS HISTORY. BUT DEMONSTRATED COMMITMENT PERMITS US TO PERIODICALLY GO TO OUR INSURERS, AS

THE MARKET SOFTENS FURTHER, AND SIMPLY REQUEST MORE MARKET REFLECTIVE PREMIUMS, INVOLVING ANNUAL REDUCTIONS OF 25% AND MORE. WHILE WE DON'T SEEK TO DESTABILIZE OUR RELATIONSHIPS BY CUTTING TO THE BONE, WE DO NOT WISH TO SUBSIDIZE OTHERS WHO DO. IN ADDITION, THESE LONG TERM RELATIONSHIPS ALSO RESULT IN A WILLINGNESS BY INSURERS TO PROVIDE UNUSUAL COVERAGES.

SO BEFORE DECIDING UPON A BLENDED PROGRAM ON THE BASIS OF COST SAVINGS, YOU SHOULD NOT ONLY ASSESS THE EFFECT OF THE HIGHER RETENTION BUT ALSO CONSIDER WHAT SAVINGS CAN BE NEGOTIATED UNDER EXISTING ARRANGEMENTS.

VARIOUS FINANCIAL CONCEPTS HAVE BEEN SOMEWHAT CORRUPTED IN THEIR APPLICATION TO INSURANCE. ONE SUCH IS RETURN ON INVESTMENT. THIS CONCEPT HAS BEEN MISINTERPRETED BY SOME WHO ASK WHAT FINANCIAL RETURN THEY HAVE ACTUALLY RECEIVED FOR THE PREMIUMS EXPENDED. I WONDER IF THESE INDIVIDUALS ASSESS THEIR LIFE INSURANCE PREMIUMS ON THE SAME BASIS. INSURANCE IS AN INVESTMENT BUT IT MUST BE EVALUATED IN TERMS OF THE AMOUNT CAPITAL ALLOCATED IN RELATION TO THE AMOUNT OF CAPITAL PROTECTED.

{SLIDE 13}

ONE CRITICAL FINANCIAL CONCEPT THAT SEEMS TO HAVE BEEN FORGOTTEN IN CONNECTION WITH BLENDED PROGRAMS IS THAT OF DIVERSITY. IN MORE TRADITIONAL APPROACHES, A DEVASTATING LOSS IN

ONE COVERAGE LINE MAY HAVE ABSOLUTELY NO AFFECT ON ANY OTHER ASPECT OF THE INSURANCE PROGRAM. HOWEVER, IN A BLENDED PROGRAM ONE MAJOR LOSS IN ANY OF THE AREAS INCLUDED CAN DESTROY THE WHOLE PROGRAM AND THE RELATIONSHIP WITH THE INSURER, WITH ALL PRE-EXISTING RELATIONSHIPS HAVING ALREADY BEEN SEVERED.

{SLIDE 14}

AS WE SUGGESTED EARLIER, GIVEN ALL OF THESE CONSIDERATIONS, IF YOU HAVE HAD REASONABLE LOSS EXPERIENCE, ARE YOU PREPARED TO MAKE A LONG TERM COMMITMENT TO AN IMMATURE PRODUCT.

IN THOSE CASES WHERE INSURANCE ISN'T AVAILABLE OR IS JUST TOO EXPENSIVE, THIS CONFERENCE IS PROVIDING US WITH INFORMATION ON A WIDE VARIETY OF ALTERNATIVE OPPORTUNITIES. AS YOU MAY HAVE SURMISED FROM MY COMMENTS I TEND TO FAVOR THE MOST COST EFFECTIVE APPROACH, HOWEVER UNGLAMOROUS IT MAY APPEAR. FOR EXAMPLE, WHEN CERTAIN SUBSIDIARIES OF A LARGE HOLDING COMPANY ARE CALLED UPON BY CLIENTS OR REGULATORS TO MAINTAIN COVERAGE WHICH IS NOT AVAILABLE ON AN ECONOMICALLY COMPELLING BASIS, VARIOUS ALTERNATIVES ARE AVAILABLE.

{SLIDE 15}

A CAPTIVE FEASIBILITY STUDY CAN BE PERFORMED, RENT A CAPTIVES EVALUATED, OFF SHORE ENTITIES CAPITALIZED, A CAPTIVE MANAGER SELECTED ETC. OR

{SLIDE 16}

AN INSURER CAN BE ASKED TO ISSUE A POLICY TO THE SUBSIDIARY, WITH AN INDEMNITY FROM THE PARENT TO THE INSURER IN THE EVENT OF LOSS. THIS IS REAL INSURANCE ON ONE LEVEL WITH THE ONLY RISK ASSUMED BY THE CARRIER, THE CREDIT WORTHINESS OF THE PARENT. DEPENDING UPON THE PARENT, THE TOTAL COST MAY BE NOTHING MORE THAN A MINOR ADMINISTRATIVE FEE.

{SLIDE 17}

AS SUGGESTED EARLIER, OTHERWISE SOUND FINANCIAL CONCEPTS CAN BE MISAPPLIED WITHIN THE CONTEXT OF THE INSURANCE MARKET. MODELING, FOR EXAMPLE, IS A CRITICAL TOOL IN FINANCE, WHICH HAS GREAT VALUE IN CERTAIN INSURANCE APPLICATIONS. MODELING CAN BE VERY HELPFUL IN THE ASSESSMENT OF AN INSURER'S CONCENTRATION OF EXPOSURE WITH RESPECT TO CERTAIN POTENTIAL NATURAL DISASTER SCENARIOS E.G., EARTHQUAKE AND WINDSTORM. ALTHOUGH A MODEL CAN BE A POWERFUL ENGINE IT REQUIRES SUFFICIENT FUEL TO OPERATE EFFECTIVELY. TOO OFTEN, WITHIN THE CONTEXT OF PROPERTY AND CASUALTY INSURANCE, AND CERTAINLY WITHIN THE CIRCUMSTANCES OF ANY ONE INSURED FIRM, HOWEVER LARGE, THE STATISTICAL UNIVERSE OF INFORMATION IS QUITE LIMITED. IN ADDITION, A MARKET DRIVEN

INDUSTRY, WHICH IN FACT DOES NOT DERIVE ITS PROFIT FROM UNDERWRITING, OFTEN ENGAGES IN IRRATIONAL BEHAVIOR.

MY FIRST EXPOSURE TO THE ACTUARIAL BASIS OF PROPERTY AND CASUALTY INSURANCE WAS AS A FIDELITY BOND UNDERWRITER IN 1972. EVEN BACK THEN WE HAD COMPUTER RATING. WE WOULD INPUT THE VARIOUS RATING FACTORS: NUMBER OF EMPLOYEES, NUMBER OF BRANCHES, LOAN TO DEPOSIT RATIO, LOSS MODIFICATION FACTOR ETC. THE COMPUTER WOULD THEN PROVIDE WHAT WAS REFERRED TO AS THE 100% OF MANUAL PREMIUM. WE WOULD THEN TAKE THAT NUMBER AND DEPENDING UPON COMPETITION CHARGE ANYWHERE FROM 20 TO 700% OF IT.

WHEN I ASKED WHY WE WENT TO THE TROUBLE TO DEVELOP A NUMBER WE DIDN'T USE, I WAS TOLD THE REGULATORS FELT BETTER KNOWING OUR PREMIUMS HAD AN ACTUARIAL BASIS.

AGAIN, I AM SUGGESTING THAT WE LOOK BENEATH THE SURFACE. JUST BECAUSE A CONCLUSION IS SAID TO BE BASED ON A MODEL OR RESULTS FROM AN ACTUARIAL STUDY, DOES NOT MEAN THAT IT IS NECESSARILY VALID. A PARTICULAR MODEL MAY, IN FACT, HAVE A USEFUL LIMITED VALUE WHEN USED IN CONJUNCTION WITH OTHER TOOLS AND ANALYSES. HOWEVER, IT SHOULD NOT PROVIDE US WITH AN UNWARRANTED SENSE OF CERTAINTY.

I HAVE SPOKEN ABOUT THE NEED FOR A BALANCED APPROACH, OF WEIGHING THE PROS AND CONS OF ALL AVAILABLE ALTERNATIVES TO

ACHIEVE OVERALL SOUND SOLUTIONS. IN THAT SPIRIT, I WOULD LIKE TO NOW TELL YOU HOW I BELIEVE A BLENDED PROGRAM COULD BE ARRANGED, WITHOUT ANY OF THE POTENTIAL NEGATIVE IMPLICATIONS I HAVE DESCRIBED. I CREDIT OUR CONSULTANT FRIENDS FOR FOSTERING THE CONCEPT OF LATERAL THINKING. BY THIS I MEAN THE IDEA OF THINKING ACROSS THE BUSINESS ENTERPRISE CONSIDERING ALL OPERATIONAL AND FORTUITOUS RISKS WITHOUT CATEGORIZING THEM AS FOR EXAMPLE INSURABLE OR UNINSURABLE.

I WOULD LIKE TO STRESS THAT I AM SPEAKING SOLELY FOR MYSELF AND NOT ON BEHALF OF MY EMPLOYER. WHETHER OR NOT THE FIRM CHOOSES TO EFFECT THE KIND OF PROGRAM I AM PRESENTLY EXPLORING IN THE MARKET WILL DEPEND ON A NUMBER OF FACTORS.

MY CONCEPT IS TO PRESERVE ALL EXISTING PRIMARY INSURER RELATIONSHIPS, AT LEAST UP TO THE \$100 MILLION DOLLAR LEVEL, EXCESS OF \$100 MILLION, I AM EXPLORING THE MARKET'S APPETITE FOR A \$500 MILLION DOLLAR INSURANCE PROGRAM THAT WOULD LATERALLY EMBRACE THREE CATEGORIES OF RISK: THAT WHICH HAS BEEN PREVIOUSLY UNINSURABLE, THAT WHICH HAS BEEN INSURABLE BUT NOT ON AN ECONOMICALLY ATTRACTIVE BASIS AND FINALLY, TRADITIONALLY INSURABLE RISK BUT ON A MORE CATASTROPHIC BASIS, AS EXCESS COVERAGE OVER EXISTING POLICIES.

{SLIDE 18}

THE FIRST CATEGORY OF PREVIOUSLY UNINSURABLE RISK MIGHT INCLUDE COVERAGE FOR UNAUTHORIZED TRANSACTIONS, BUSINESS INTERRUPTION NOT CAUSED BY PHYSICAL DAMAGE ETC. ONE MUST ASK WHY WE HAVE ROUTINELY, AND FOR OVER A CENTURY, INSURED AGAINST DISHONEST AND NEGLIGENT ACTS BUT NOT THE POTENTIALLY DEVASTATING AND SOMETIMES CRIMINAL, INTENTIONAL UNAUTHORIZED ACT. IF THE ISSUE HAS BEEN THE ATTACHMENT POINT, THIS APPROACH MAY BE THE ANSWER. WE HAVE ALSO ROUTINELY INSURED THE BUSINESS INTERRUPTION EXPOSURE. THIS EXPOSURE IS ESSENTIALLY THE SAME REGARDLESS OF THE CAUSE, BUT WE CAN ONLY INSURE THOSE INTERRUPTIONS STEMMING FROM PHYSICAL DAMAGE, AS OPPOSED TO SOFTWARE AND HARDWARE FAILURE, BUILDING EVACUATION ETC.

WITH RESPECT TO THE SECOND CATEGORY OF RISK TO BE INCLUDED, WHICH HAS BEEN INSURABLE BUT ARGUABLY NOT ON AN ECONOMICALLY ATTRACTIVE BASIS, I REFER, FOR EXAMPLE, TO MONEY CENTER FINANCIAL INSTITUTION PROFESSIONAL LIABILITY. WITH RESPECT TO THE THIRD CATEGORY OF RISK TO BE INCLUDED, EXCESS COVERAGE, THIS PROGRAM COULD PROVIDE ADDITIONAL CATASTROPHIC PROTECTION OVER EXISTING DIRECTORS AND OFFICERS, CRIME AND OTHER POLICIES. I INCLUDE PROPERTY ONLY WITH RESPECT TO THE BUSINESS INTERRUPTION ASPECT I MENTIONED.

IF YOU CAME TO THIS FORUM TO BE AT THE CUTTING EDGE, YOU WILL BE INTERESTED TO KNOW THAT THE PROPOSED PROGRAM IS PRESENTLY UNDER CONSIDERATION BY INSURERS THROUGHOUT THE WORLD AND HAS MET WITH CONSIDERABLE ENTHUSIASM. AGAIN WHETHER THE PROGRAM

IN FINAL FORM WILL PROVE TO BE OF INTEREST TO MY FIRM AND OTHERS REMAINS TO BE SEEN. HOWEVER, I DO BELIEVE IT REPRESENTS A METHOD OF UTILIZING THE CURRENT CIRCUMSTANCES IN THE MARKET TO IMPROVE THE PROTECTION OF STOCKHOLDERS WITHOUT SACRIFICING ANYTHING TO ACHIEVE IT.

{SLIDE 19}

I TRUST I HAVE NOT BEEN TOO SUBVERSIVE IN MY ATTEMPT TO STRESS A BALANCED APPROACH. IN TODAY'S HIGHLY COMPETITIVE ENVIRONMENT NEW APPROACHES AND ALTERNATIVES ARE BEING PRESENTED DAILY. SOME ARE CLEARLY NO MORE THAN THE SALES HYPE OF BROKERS, CONSULTANTS AND INSURERS. SOME ARISE OUT OF RISK MANAGERS' EGO GRATIFICATION. HOPEFULLY THROUGH FORUMS LIKE THIS WE WILL ALL BECOME BETTER ABLE TO IDENTIFY THOSE METHODS WHICH TRULY REPRESENT STRATEGIC RISK FINANCING.

TO THAT END, I WILL LEAVE YOU WITH THE WORDS OF MARK TWAIN:

“WHEN YOU FIND YOURSELF SIDING WITH THE MAJORITY, ITS PROBABLY TIME TO REASSESS YOUR POSITION.”

THANK YOU

