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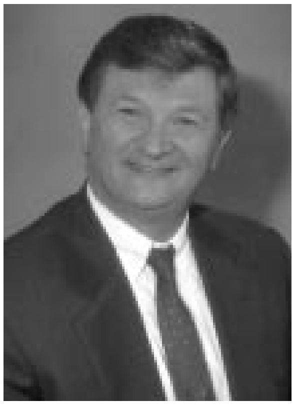
Risk Management Quarterly RMQ

Volume 21 Number 1 March 2004

From the Chairman's Corner

by George J. Kolczun Jr., CPCU, ARM, AAI



■ **George J. Kolczun Jr., CPCU, ARM, AAI,** is account executive and chief operating officer of Rooney Insurance Agency. He has earned a bachelor of arts degree from Heidelberg College; and the Chartered Property Casualty Underwriter (CPCU), Association in Risk Management (ARM), and Accredited Adviser in Insurance (AAI) designations. He currently serves as chairman of the CPCU Society's Risk Management Section Committee, and has served on many governmental and charitable boards of directors.

The 2003 Annual Meeting and Seminars is behind us. We have some great new CPCU graduates that have joined our ranks and some transferees from other sections. *Welcome!*

The Risk Management Section sits in a unique position among all of the other CPCU Society sections. Our interests and responsibilities transcend into almost every other section. Most of you that have selected the Risk Management Section as your choice of sections probably have an interest in each of the other sections. It is our hope that one day we will be able to share the knowledge of each section including the newsletters. Presently, this can not be done. Until this can be accomplished, it is your section committee's responsibility to find articles and issues of all disciplines that might be of interest to you. That is our commitment to you as we go forward in preparing future issues of *RMQ*.

In order to do this, I am calling upon all of our section members to please help. If you are an author of an article that would be of interest to your fellow section members or if you have read an article that you would like to share with the rest of the section, please send it to our editor or co-editors. It would be helpful if you could help identify the author and address. If you know the author, that would even be better since we are required to have a release signed by the author in order to print the article. If you know the author, you can help us get the release. Help us make *RMQ* the best it can be.

The Risk Management Section Committee leadership has committed to develop seminars that would be of specific interest to you to the Annual Meeting and Seminars. Presently we are discussing a couple of joint venture projects with some of the other sections to be presented at the Annual Meeting and Seminars in Los Angeles. We should have this pinned down by mid-year, and I will report our progress to you in our next *RMQ*.

Looking past this year's Annual Meeting and Seminars, the Risk Management Section intends to be a leader in presenting seminars that are of interest not only to the members of the Risk Management Section but to all members of the CPCU Society. To be sure that we are able to do this, we again need each section member's help. As a start, send us topics in which you have an interest. Suggest speakers and others that can help us put on the seminars. You can send them to me or to any member of the Risk Management Section Committee or to John Kelly, CPCU, ARM, at the Society's headquarters. This is your section and Society. Help us complete our mission!

Your Risk Management Section leaders are committed to making the Risk Management Section the section of choice for all members of the Society. Help these folks accomplish their goal! ■

What's in this Issue?

Reputational Risk: Managing the Hidden Corporate Asset

by Zac Overbay, CPCU, ARM

"I seriously doubt the traditional job description for a risk manager makes that person responsible for managing reputational risk. But in my view, that is the largest risk on our plates today—and it affects each one of us."

—Ken Thompson, President and CEO, Wachovia Corporation
FDIC Risk Management Symposium
July 31, 2002

Zac Overbay, CPCU, ARM, is the claims manager at Woodruff-Sawyer & Company, insurance brokers and risk managers in San Francisco, CA. He can be reached at zoverbay@woodruff-sawyer.com.

Editor's note: This article originally appeared in the August 2003 *CPCU eJournal.*

For corporations, managing their reputation is of unparalleled importance. The loss of reputation and the public's trust can have a calamitous affect on stock price and future sales. We'll explore the notion of "reputational risk," its causes and effects, and discuss its role in enterprise risk management planning.

Arguably, no issue is more prevalent on the minds of corporate leaders than protecting the company's corporate reputation. Risk managers and insurance brokers alike are being charged with managing and mitigating their companies' reputational risk. My research for this article led me very quickly to the following conclusion: the notion of reputational risk management (RRM) is poorly understood in the risk management and insurance community. The very topic begs the question—is reputational risk an independent risk factor with its own causes and effects or a secondary, indirect component of other risk factors? It is now evident that minimizing corporate risk is an important facet of any corporation's business strategy. But whether the risk can be managed and how to approach managing it remain difficult questions to answer.

If you search for a universally accepted definition of reputational risk you come up empty-handed. Reputational risk is loosely defined as the risks faced by a corporation through the course of its daily operations, corporate governance, and compliance policies that ultimately may cause damage to the reputation, image, brand, and/or good name of the organization. Reputation is widely viewed by corporate executives as their companies' single largest asset. Since risk management is the function of protecting a corporation's assets, risk managers, and, to a lesser degree, insurance brokers, must view their planning and program design efforts differently. They must not only be mindful of the traditional risks that erode asset preservation, but less defined, intangible factors such as reputational risk.

Causes of Reputational Risk

Many of the root causes of reputational risk are the same risks identified, evaluated, and protected against in traditional risk management programs. In a recent survey by Hill & Knowlton, a Canadian public affairs and public relations company, CEOs from various countries were asked what they felt were the biggest threats to corporate reputation. Although their responses varied in a number of areas, CEOs from all countries found print media criticism of their respective companies or products the single most concerning threat to corporate reputation. This presents a difficult challenge to risk managers, because controlling the media's coverage of companies and their products is one of the least controllable factors from a risk management viewpoint.

Reputational Risk: An Independent or Dependent Risk Factor?

Before we can ask ourselves to what extent an organization can effectively manage reputational risk from a risk management standpoint, it is imperative to ask: Is reputational risk an independent risk factor, deserving of its own risk management techniques, or a subset or secondary effect of larger, more traditional risks?

The answer is probably a combination of the two. Some elements of reputational risk are derived subsets of traditional risk management exposures. Such exposures include products liability, natural disasters, business interruption, and directors and officers/corporate mismanagement. Other risk factors are more subtle. Virtually all research on corporate reputation mentions, in one form or another, that corporate reputation is driven by the public's trust. Traditionally, management of a corporation's trustworthiness is not an explicit business enterprise strategy.

Corporations are realizing, however, that their greatest asset is not found on the balance sheet or income statement—they are realizing their greatest asset is their reputation. Recent studies pertaining to the effects of corporate reputation on stock price vary, but all generally lie somewhere between 30 and 80 percent. Ask any CEO or CFO exactly how much annual planning and resource allocation should be devoted to a single asset that drives 30 to 80 percent of a company's stock value, and you'll undoubtedly hear a proportionately large number.

Some companies are beginning to think a great deal of attention should be paid to reputational risk. This is why companies

like BP Amoco have directors with responsibility for managing this form of risk. This is why hundreds of companies, including PricewaterhouseCoopers, KPMG, and Ernst & Young are developing reputational risk management consulting practices. The market is primed and those companies that do not undertake an initiative to protect their reputation will ultimately find themselves exposed to greater financial loss.

Leading the Charge

But who should lead the charge? It would be difficult to assign reputational risk management to one department or individual. It could be assigned to the Human Resources Department because it is employees who create reputational risk. The Public Relations Department could be involved because they are the ultimate architects of public opinion. Information Technology designs and manages the company's e-commerce system, often a factor in RRM. The Finance Department has asset-preservation as its desired result, so it could be ultimately responsible. The Legal Department knows how to maneuver the minefields of legal actions and exposures facing the company.

Of course, the Risk Management Department is charged with managing the risks facing the organization, so should it lead the effort? Perhaps the best solution would be to create a new position, such as "reputation risk manager" or "director of reputational risk." The list is almost endless.

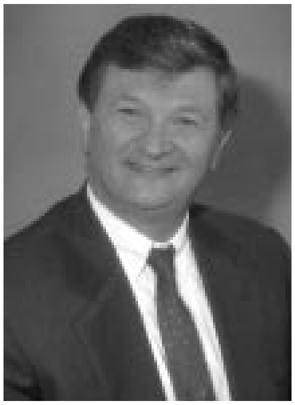
Most corporations have typically been reactive rather than proactive where RRM is concerned. That is to say, the concern for corporate reputation largely comes following a perilous event, rather than from planning and implementing a program or programs proactively. Why? It is certainly a fair question. I suspect it is because the task of RRM is simply too daunting, with too many variables, causes, and triggers, to be managed effectively by one individual or even one department.

The most effective solutions will likely lie in a holistic approach to RRM. Companies that create a task force to address building and preserving their reputation will fare best, because they will inevitably have the most well-rounded, balanced list of triggers to reputational damage. In addition, the task force will have the most segregated, diverse, and knowledgeable team to develop strategies to overcome those risks. Each facet of the RRM program can be directed to the individual or department best suited to address the exposure.

The corporation, through the RRM Committee, is developing an enterprise strategy for protecting its most significant asset. As additional insurance market products become available (such as "brand protection" and product recall insurance offered by Swiss Re Financial Services) the corporate risk manager and even corporate insurance broker will become valuable assets to the committee.

Programs already in place, such as the disaster contingency plan, the product recall program, consumer privacy policy(s), and enterprise risk management policy(s) should all be revisited and, if necessary, redesigned to align with preservation of corporate reputation strategy in mind. The effects may ultimately transcend corporate readiness and may have positive effects on the pricing of directors and officers and general liability insurance. Whether a corporation has never given consideration to reputational risk, or has a balanced, well-developed program to manage the risk, one thing is clear: the winners in this consumer-driven economy will be those whose primary corporate mission surrounds preserving this important hidden corporate asset. ■

Member Spotlight on George J. Kolczun Jr., CPCU, ARM, AAI



George J. Kolczun Jr., CPCU, ARM, AAI
Account Executive and Chief Operating Officer
Rooney Insurance Agency, Inc.
Tulsa, Oklahoma

George J. Kolczun Jr., CPCU, ARM, AAI, has served on the Risk Management Section Committee for more than 10 years and is the current section chairman. He brings more than 30 years of experience in the insurance industry to his present position of account executive and chief operating officer of Rooney Insurance Agency, Inc. in Tulsa, Oklahoma.

George has served a diverse range of clients including oil and gas exploration, drilling, manufacturing, chemical, oil and gas pipeline, aviation, and construction. He earned a bachelor of arts degree from Heidelberg College, in addition to the Chartered Property Casualty Underwriter in 1979 (CPCU), Associate in Risk Management in 1973 (ARM) and Accredited Advisor in Insurance in 1983 (AAI).

George joined Rooney Insurance Agency as vice president in 2000. Prior to joining Rooney Insurance, he served as senior vice president, client manager for Marsh USA. His previous positions also include executive vice president/branch manager, Johnson & Higgins, and senior vice president, Alexander & Alexander, Inc. He began his career with Devco Mutual Insurance Company as a technical representative.

In addition to his service to the insurance industry, George has been actively involved in his community as a member of the Tulsa Philharmonic Board of Directors, Junior Achievement Board of Directors, Tulsa Area United Way, the March of Dimes, and various local civic boards.

George continues to serve on the Risk Management Section Committee because he believes any contribution to the CPCU Society is really basic and that “all of the CPCU Society sections are really built upon the risk management discipline.” ■

Be sure to check out the CPCU Society’s Risk Management Section web site at

http://riskmanagement.cpcusociety.org

Who's Managing *Your* Success?

CPCU Society National Leadership Institute

Invest in Your Professional Development—and Take Charge of Your Career Success!

Spring 2004 CPCU Society National Leadership Institute
April 22-23, 2004 ◆ Tampa, FL

- Develop effective leadership, communication, and management skills to guide your company—and your career—to success.
- Gain real-world knowledge about managing and leading in the P/C industry.
- Prove that you have the drive and the know-how to get ahead in today's competitive marketplace.

Set Your Schedule for Success!

Thursday, April 22

8 – 11:30 a.m.

- Developing Resilience in a Rapidly Changing World

8 a.m. – 4 p.m.

- Effective Communication Skills
- Practical Techniques for Project Management
- Finance for Nonfinancial Managers
- Facilitative Leadership Skills
- Power Tools for Successful Negotiations

Noon – 1 p.m.

- Thursday Leadership Luncheon

1 – 4 p.m.

- Delivering Compelling Messages to Your Staff

1 – 4:30 p.m.

- Time Management—Managing the Only Non-Renewable Resource

5 – 6 p.m.

- Reception

Friday, April 23

8 – 11:30 a.m.

- Developing Resilience in a Rapidly Changing World
- Time Management—Managing the Only Non-Renewable Resource

8 a.m. – 4 p.m.

- Effective Communication Skills
- Practical Techniques for Project Management
- Finance for Nonfinancial Managers
- Facilitative Leadership Skills
- Managing Conflict in the Workplace

Noon – 1 p.m.

- Friday Leadership Luncheon

1 – 4 p.m.

- Becoming a Successful Leader

Register Today to Take Your Career to the Next Level!

Complete the registration form in your February/March issue of *CPCU News* and mail or fax it to the CPCU Society by April 9, 2004. Members can also register online at **www.cpcusociety.org**.

For more information, please contact the Member Resource Center at (800) 932-CPCU, option 4, or at **membercenter@cpcusociety.org**.

Captive Solutions

by Andrew Barile, CPCU

Andrew Barile, CPCU, is CEO of the Andrew Barile Consulting Corporation, Inc., located in Rancho Santa Fe, California (www.abarileconsult.com). He has more than 40 years of experience in providing unique offshore insurance solutions for clients, and was co-founder of Bermuda's first publicly held reinsurer. Barile is the author of numerous publications on related topics and may be reached by e-mail at abarile@abarileconsult.com.

Editor's note: This article was originally published in *Offshore Finance USA* magazine, and is reprinted here with permission.

At last count, there were almost 20 onshore states in America allowing the formation of a captive insurance company—and an equal number of foreign countries or territories describing themselves as captive domiciles—according to Kathryn Westover of Strategic Risk Solutions based in Burlington, Vermont.

Vermont is internationally recognized as the largest onshore captive domicile, and is the third-largest domicile in the world. The state is home to more than twice as many captive insurance companies as all other U.S. states combined. More than 557 companies (as of July 2002) are licensed in Vermont.

Opportunities in this market and the success of Vermont have not gone unnoticed by the competition. Three years ago, South Carolina passed laws to encourage captives to set up in the state or to relocate from leading captive jurisdictions like Bermuda and Vermont.

With rates rising and coverage decreasing for standard insurance, this is a ripe time to start a captive, William Troy, the director of alternative risk services for St. Louis-based Safety National Casualty Corp. told the Charleston-based *The Post and Courier*. "There is a tremendous amount of interest, perhaps more than any time in the past 10 years," he said.

The captive industry has already brought in more than $50 million to South Carolina, and officials expected to close out 2002 with at least 30 captive insurance companies domiciled in the state.

Good times have a funny way of smoothing things over. A wrong calculation in insurance premiums for a given risk, for example, can be over-looked when losses are being cancelled by impressive investment returns. But when the stock market safety net evaporates, errors in calculation can prove costly.

Faced with a bear market, staggering losses from the September 11 terrorist attacks—the estimated cost to the insurance industry is between $50 and $60 billion—and no end in sight to the number of lawsuits brought each year, insurance companies and their clients are in need of solutions.

Their initial response has been to increase premiums, but an increasing number from both camps are finding answers offshore.

To be more precise, captive insurance—where an offshore insurance company is established to manage risk in-house—is emerging as the preferred solution.

In addition, with commercial insurance rates having increased by up to 50 percent this year, it is making more sense for companies with good risk management structures to take over their own insurance business. Using a captive allows companies to reinsure their risk directly with the market, bypassing agent commissions, insurer profits, and taking advantage of tax benefits enjoyed by insurance companies.

Opportunities Knocking

Whenever the traditional insurance market abandons a class of coverage, the captive offshore insurance approach should be explored to provide a new solution. Should the Charter Bus Operators of America, for example, own a captive? Should my association own a captive? Should we spend the money for a feasibility study to form a captive? These are all relevant questions in an exciting time in the insurance industry.

The current "hard" insurance market promotes new insurance solutions. We now see captives being formed by real estate developers, contractors, nursing home operators, directors and officers associations, taxicab associations, and condominium associations.

Consider, for example, the New York advertising agency that was looking to provide bad debt insurance for its international accounts receivable. It was unable to find traditional insurance coverage for this type of financial risk. Structuring its Cayman Islands captive insurer to write this coverage and then reinsuring the excess exposures in the

European reinsurance market provided a sophisticated insurance solution.

Another example is the insurance agency in San Francisco that writes public entity insurance. The company wanted to own an agency captive in Bermuda.

> *Access to the worldwide reinsurance market affords greater opportunity for realistic reinsurance pricing.*

To proceed, the agency funded the Bermuda captive using a U.S. bank loan, with the stock of the agency given as collateral. It then obtained a program administration agreement from an A+ rated U.S. insurer. The viability of structuring the reinsurance behind the policy-issuing insurer was analyzed and verified using historical loss data.

This conservative approach started with the agency-owned captive insurer taking a small percentage of risk, and increasing its participation as the investment and underwriting income increased the Bermuda captive's net worth.

Years later, when the agency was sold, the owner received more money for its Bermuda captive than its San Francisco agency.

Over the years, most of the Fortune 500 corporations have utilized the offshore insurance market to write their workers compensation automobile and general liability exposures in their wholly owned captives.

Improvements Needed

Some improvements are needed, however. In the area of workers compensation insurance, for example, we need a movement to have captives provide direct insurance without having the need for "fronting" or "policy issuing insurers" to be involved.

The cost of fronting causes inefficiencies with offshore insurance solutions. Regulators must be trained to understand the financial statements of captive insurers and be able to evaluate their solvency as any other insurance company.

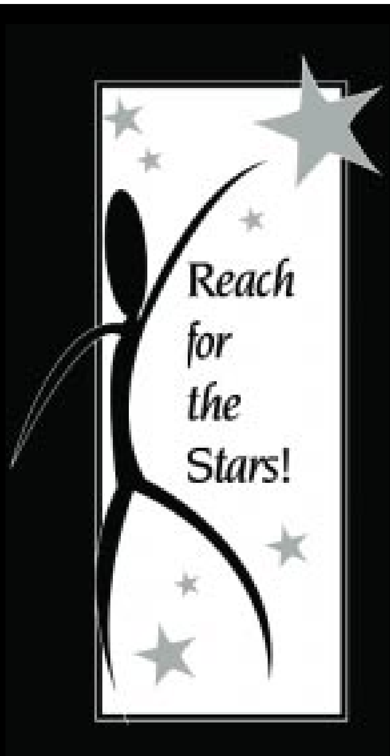
Many of the functional areas of the offshore captive insurer need constant monitoring and market evaluation. The fronting fee must be evaluated each year based on insurance company market conditions. The components of the fronting fee—state premium taxes, government schemes and assessments, company overhead cost, etc.—leave some room for negotiation.

Insurers themselves have also benefited from the offshore markets by buying reinsurance—a practice whereby an insurance company covers losses on its own policies by taking insurance from another insurance company. Insurers writing substantial books of professional liability insurance, for example, can effectively use the offshore reinsurer to provide long-term reinsurance structures.

Access to the worldwide reinsurance market affords greater opportunity for realistic reinsurance pricing. Although reinsurers are not putting in any investment income in their 2003 pricing models, reinsurance pricing can be stabilized on the basis of a profitable captive insurer.

Sufficient reinsurance capacity is, and always will be, available for captive insurers as long as there are realistic prices. Too often, our industry has said there is no capacity available for this type of reinsurance. All that means is that the pricing was too cheap.

Offshore insurance solutions have become a recognized option in the arsenal of risk management. Like any sophisticated insurance solution, careful analysis must be performed in discovering whether the offshore captive insurer provides a feasible and economical solution.



Save the Date!

Plan now to attend the 60th Annual Meeting and Seminars **October 23-26, 2004,** in Los Angeles, CA.

Look for future issues of *RMQ* for more information about Risk Management Section-sponsored seminars.

Risk Management Quarterly
is published by and for the members of the Risk Management Section of the CPCU Society.

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