

Editor's Note

by Jane M. Damon, CPCU, CPIW, CIC



Jane M. Damon, CPCU, CPIW, CIC, is assistant vice president/commercial account executive for Wachovia Insurance Services in Dallas, TX. Damon has more than 20 years of experience in the insurance industry. She works on large, complex accounts in the real estate, construction, and high-tech fields. She has more than nine years' experience with American Contractors Insurance Group on large construction contractors as a special account executive, where she administered the two largest privately held construction projects, at the time, under a Contractor Controlled Insurance Program (CCIP) through a captive program.

Damon is past president of the CPCU Society's Dallas Chapter, was national new designee representative, and currently serves on the Risk Management Section Committee as co-editor of the RMQ.

I am pleased to let you know that we have another outstanding newsletter for your enjoyment. Again our authors have provided us with information you can use.

Brian Jilek, CPCU, ChFC, ARM, AIAF, has provided us with an update from his last article, "It's Not If, But When . . ." based on the current events in the midwest to help you better understand the need for business continuity planning.

Also on business continuity planning, **David S. Medvidofsky, CPCU, CIC, AAI**, has provided an article on scenario-based versus response-based planning, which focuses on action and not causes when planning.

George L. Head, Ph.D., CPCU, CSP, CLU, ARM, ALCM, director emeritus, American Institute for CPCU, and a regular contributor to the RMQ, has provided an article to let you consider some ethical concerns agents face in servicing their accounts.

Another regular contributor, **Michael J. Moody, ARM**, has provided an article on the next step in enterprise risk management.

Vincent A. Oliva has also provided us with an article entitled, "Risk Management and Compliance to the Next Level," to assist in transparency starting with the insurers.

"New Challenges Require Insurance Agent Owners to Implement Strategic Advisory Boards," is a great article by **Andrew J. Barile, CPCU**, that will give you insight in how to select your board and the basic competencies needed.

Again, I think we have been able to provide you with a wealth of information from a risk management perspective.

As always, please feel free to let us know your thoughts on the articles, what you would like to see, and what you like and don't like. If you would be interested in providing an article, please contact me at jane.damon@wachovia.com. We welcome all authors and commentaries. ■

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Greetings from the Chairman

by Patricia A. Hannemann, CPCU



■ **Patricia A. Hannemann, CPCU**, is chairman of the CPCU Society's Risk Management Section. Her insurance career consists of more than 20 years' experience working in agencies and companies. Currently, she is working with The Insurance Society of Baltimore in promoting and teaching various insurance classes.

Hannemann served as the CPCU Society's Maryland Chapter president, and chaired both the Public Relations and Good Works Committees. The Maryland Chapter's CPCU Excellence Award was presented to her for spearheading the Good Works Committee and establishing the chapter's scholarship fund in connection with the SADD organization. Serving on the CPCU Society's Chapter Awards Task Force, she helped create and judge the current Circle of Excellence Recognition Program.

Hannemann received her CPCU designation in 1987, and holds bachelor's and master's degrees in music from the Manhattan School of Music, and a master's degree in business from Johns Hopkins University.

Our efficient editor, **Jane M. Damon, CPCU, CPIW, CIC**, has put together another "packed" RMQ. Our special thanks to all who contribute and keep us moving, learning, and interested in reading the RMQ.

By the time this issue goes to print, your section committee will have met at the Leadership Summit meeting (April 18–21) in Orlando, Florida. Shortly thereafter, **Marty Frappolli, CPCU, AIS**, our webmaster, will post new pictures and meeting minutes on the Risk Management Section web site for all section members to view and review. At this meeting your section committee reviews what we established as our annual goals and discusses whether we are on target, if adjustments are needed, or if new items can be included. It is with the suggestions from section membership and those who desire to work on the committee that all items are accomplished and new ideas emerge. Remember the old adage "if you don't like the way something is run, get involved (actively) to change it."

As I mentioned in the last RMQ, this year's Annual Meeting and Seminars is scheduled from September 8–11, 2007, in Hawaii. Just think, you can be in paradise and still learn about insurance. Who ever thought that was possible!!!!!!

In Hawaii, the Information Technology and Risk Management Sections have joined to present a session titled "Sustaining Profitability through Enterprise Risk Management and Enterprise Performance Management." In this issue, **Patricia L. Saporito, CPCU**, the leader for this joint session—provides us with a short synopsis of the information to be covered. The scheduled speakers for the session include **Patricia L. Saporito, CPCU**, from Business Objects Americas; **Dan R. Anderson, Ph.D., CPCU**, from the University of Wisconsin-Madison School of Business; **Richard G. Berthelsen, J.D., CPCU**, from AICPCU; and **Chris Suchar**,

FCAS, MAAA, from DFA Capital Management Inc. Make a point to attend this session to learn about cutting-edge information and support your sections.

June is fast approaching, and that is when committee members are appointed to sections. If you have a desire to help shape the future of risk management and to become a committee member, please e-mail **John Kelly, CPCU, ARM**, at jkelly@cpcusociety.org and ask him to send you an Application for CPCU Society Service or get one on the web site. Your committee is always open to new ideas and new faces; **you** need to let us know how we can better serve you and the insurance industry. ■



Business Continuity Planning: Scenario-Based versus Response-Based Planning

by David S. Medvidofsky, CPCU, CIC, AAI

"You know all those security scenarios we ran? Well, I'm smack in the middle of one we didn't think of."

—Nelville Flynn (Samuel L. Jackson)
Snakes on a Plane



■ David S. Medvidofsky, CPCU, CIC, AAI, is assistant vice president of corporate strategy for The Main Street America Group, a property and casualty insurer writing business through independent agents in 16 states; and general manager of Information Systems & Services, a subsidiary offering third-party administration solutions to property and casualty carriers. During his career, he has worked on the agency and company side, and has held staff and line positions in underwriting, marketing, and product development.

Medvidofsky is a summa cum laude graduate of Franklin Pierce College (B.S. degree in business management), where he was selected to the Alpha Lambda Sigma National Honor Society, and was the top graduate within his major. He also holds a master's degree in leadership from Franklin Pierce. He is active in educational pursuits, including CPCU instruction, and has been published in *The National Underwriter*, the *CPCU Journal*, *Underwriting Trends*, *Best's Review*, and *Technology Decisions*. He currently serves as chairman of the CPCU Society's Underwriting Section Committee, and has served on many Automobile Insurance Plan committees.

Picture yourself as the newly hired chief risk officer for a start-up airline. As part of your new duties you are asked to develop a business continuity plan to protect the financial viability of the business in the event of disaster. How might you proceed?

If you followed most prescribed methods, you would likely identify the potential risks, develop a business impact analysis, and create contingency plans to respond. To identify risks and create the contingency plans you may have a preferred model, or you might create one similar to the following two approaches: weighted ranking approach (see Table 1) or qualitative approach (see Figure 1).

The downside to using these approaches as a means to develop contingency plans is this: despite the assessment tool used, it is extremely difficult, if not impossible, to identify all current exposures. Therefore, the effort is limited to documenting risks that are either easily recognized, or are presumed most likely to occur. This introduces historical bias and judgment into the effort. In the fictitious example of *Snakes on a Plane*, Nelville Flynn clearly had not developed a plan to address the impact that snakes might have. Consider two real-life scenarios:

- The major airline that seemingly had not been able to execute an appropriate customer-focused response to the risk of severe weather delays recently.
- Our pre-9/11 world where many businesses did not have plans to address the risk of terrorism.

So, what is the alternative? One method is to use a **response-based** versus a **scenario-based** approach for designing business continuity plans. Under a response-based plan, the focus is on *actions* and not *causes*. Rather

than creating a list of potential risks for purposes of developing the business continuity plan actions, the impact areas are identified and plans are developed to respond to impairment to those areas. For example, impairments that threaten the financial viability of most businesses will ultimately impact only one of three areas:

- people
- physical plant
- equipment (including IT)

The risk manager works with functional leaders and support units to negotiate agreed recovery time objectives (RTO) for these impairment areas. The risk manager then works with functional leaders to develop response plans for resuming operations in the event that one of these items is impaired beyond the RTO. The RTO functions almost like a deductible where the organization assumes any impairment that can be corrected within the agreed standard—anything longer triggers the business continuity plan.

To assist with the plan development and to keep the effort focused, a simple matrix is used (see Table 2).

The risk manager and functional leader develop and continuously challenge the proposed plan against these impairment areas. They do this until they have an actionable and realistic plan that successfully allows the business to continue despite the source of the impairment.

The advantage of this approach is that it allows the creation of plans that are useful for the vast majority of risks the business faces. In addition to being pragmatic, it removes debate that often occurs when

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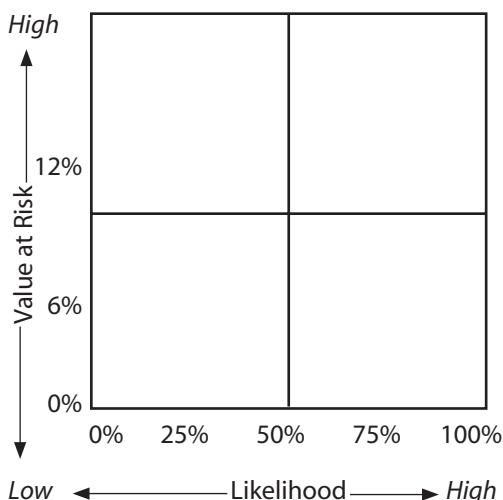
Business Continuity Planning: Scenario-Based versus Response-Based Planning

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Table 1
Weighted Ranking Approach

Emergency Type	Probability	Human Impact	Property Impact	Business Impact	Internal Resources	External Resources	Total
Hurricane/Tornado	4	4	5	5	5	4	27
Fire/Smoke	3	5	5	3	4	5	25
Explosion	2	5	5	3	4	5	24
Collapse	2	5	5	4	4	4	24
Telecommunication Failure	4	2	4	5	4	5	24
Computer Failure	4	2	4	5	4	5	24
Terrorism	1	5	5	4	3	4	22
Etc.							

Figure 1
Qualitative Approach



organizations overquantify or disagree on the likelihood or potential severity of specific risk exposures. With a response-based plan, it doesn't matter that the source of impairment is employee strike, civil authority, or avian flu—there is a defined plan to respond to any people impairment regardless of cause.

This is not to suggest that there isn't a place in organizations for scenario-based planning or for the use of the above models. In fact, an effective enterprise risk management (ERM) program will follow a structured process for event identification, risk assessment, and risk response. Scenario-based planning is also a very effective method for structuring testing and for developing mitigation plans. Still, for purposes of creating business continuity plans, response-based plans:

- Focus plan development on actions versus causes.
- Reduce the chance that adverse impacts may occur from risks that

Table 2
Response-Based Planning

Impairment Area	Yes	No
People		
Physical Plant		
Equipment (incl. IT)		

were either not foreseen or improperly assessed.

- Protect the organization from risks that were considered too infrequent.
- Motivate plan creators to create actionable plans.

The response-based concept is simple to explain and easier to understand. As a result, the level of organizational commitment is greatly increased. Functional areas see productive output much quicker than they would by becoming mired in the arduous tasks of risk identification and quantification. Line employees can tie the effort directly into their operations.

A crisis is a time for executing the plan, not for fighting snakes. A response-based approach to business continuity planning focuses the development effort reducing organizational risk and providing a more effective organizational response. ■

Maurice's Pieces

by George L. Head, Ph.D., CPCU, CSP, CLU, ARM, ALCM



George L. Head, Ph.D., CPCU, CSP, CLU, ARM, ALCM, is director emeritus at the AICPCU in Malvern, PA.

Author's note: Lisabeth A. Groller contributed significantly to the substance of this article.

In just two short years, Maurice Clay took his unique jewelry creations out of his Boston basement and into 20 top jewelry outlets nationwide. Los Angeles, Seattle, Chicago, Miami, New York—all the big cities began to showcase “Maurice’s Pieces,” and many vendors began to request that Maurice visit them personally to draw sales. Everything was looking big for Maurice, sometimes it seemed so big Maurice would go into panic attacks. How can a jewelry craftsman handle all the uncertainties of a booming business? What about all that flying? Suddenly frightened, Maurice longed for security, Maurice needed assurance, Maurice needed guidance, Maurice called his insurance agent.

A Plan with Problems

At first, Tina Pellimen was more than willing to come to the rescue. She was six months new to the Alpha Insurance Agency and ready to prove her worth. When Maurice Clay called her, his voice was shaking, but his request to buy flight insurance was practically a demand. “I need it now,” he stated. “Next month, I’m going on five flights. We have to do this today.”

Maurice had Tina’s attention, especially since this month’s insurance marketing special was on flight insurance, and Tina’s supervisor was constantly stressing the importance of growing her sales and the agency’s overall premium volume. Her supervisor had emphasized that selling those coverages that appealed to people’s emotions—flight insurance, pet insurance, and short-term life insurance on young children—was an easy way to build business. Since Maurice was so eager to buy flight insurance, meeting his wishes would be a great place for Tina to show her supervisor and the agency’s owners what she could do.

But Tina saw some problems—ethical difficulties if she just went ahead and sold Maurice all the flight insurance he wanted. Flight insurance pays only if the insured dies or is injured on a commercial airline flight, yet it was much more likely that, if Maurice were to die or be injured, it would happen somewhere else. Since Maurice wanted to protect his family if he should die or be injured regardless of where or when fate caught up with him, term life insurance—effective 24 hours a day, worldwide, providing coverage almost regardless of how Maurice was injured or died—would be a much more

cost-effective way for him to have that protection. Regular term life insurance would provide all that flight insurance would, and more besides, for very little additional cost to Maurice.

Tina knew in her heart that she had a duty to Maurice to discourage him from buying flight insurance, because that would be a relative waste of his insurance budget. Furthermore, Tina thought that Maurice faced a much greater threat to his burgeoning business—loss of his inventory of original, exciting jewelry creations, some of which traveled with him, much of which was on display throughout the country or in storage back in Boston. This inventory was the physical foundation of Maurice’s present and future business, but Tina expected that it was only minimally insured against just a few perils. Being a fine jewelry craftsman, almost completely unschooled in insurance and the other proven techniques to prevent or to pay for accidental losses, Maurice could be excused for this lack of risk management insight—but Tina knew she could not. She felt a strong ethical duty to steer Maurice in a clearly much better risk management direction.

Some Ethical Conflicts

Still, Tina knew she also had duties to the Alpha Agency—duties to grow its business and reduce its overall loss ratio so the agency could earn greater contingent commissions. Selling Maurice flight insurance and no more insurance on his jewelry pieces would increase the agency’s profitability much more than convincing him to buy the coverages that Tina knew he needed. Since the Alpha Agency dealt primarily with property-liability insurance, Tina knew that it would have to make special, costly arrangements to provide Maurice with the ordinary term life insurance Tina believed would better protect his family. Besides, flight insurance was all Maurice said he wanted, and there is nothing ethically wrong with providing a customer with what he wants.

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Maurice's Pieces

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A Win-Win Solution?

Maybe there was a way Tina could meet her duties both to Maurice (making sure he spends his premium dollars most cost-effectively, getting the biggest risk management "bang for the buck") and to the Alpha Agency (increasing its—and Tina's—long-term income from commissions). After pondering a while, Tina came up with this set of proposals:

- Encourage Maurice to get enough term life insurance, either through the Alpha Agency or some other source.
- Convince Maurice to increase the amount and breadth of the property damage insurance on his jewelry inventory.
- Check regularly with Maurice, perhaps every three months, to see how Maurice is feeling about his coverages. For instance, if his confidence as an airline passenger is growing and he no longer has panic attacks, Tina can keep the current policies. However, if Maurice is still panicked about his coverage and believes he needs flight insurance, then sell him some flight insurance. After all, in such a case—at least for Maurice—flight insurance would not be just an overpriced financial indemnity. For Maurice and his psyche, flight insurance might well be a cure-all—probably well worth its cost, regardless of its questionable risk management value.

Ethically, and as a profit-seeking business strategy, what do you think of Tina's plan for serving Maurice? Please share your thoughts with me at head@cpcuiia.org. ■

Don't Miss Your Risk Management Section's Seminar at the 2007 Annual Meeting and Seminars in Honolulu

Sustaining Profitability through Enterprise Risk Management and Enterprise Performance Management

September 10, 2007 • 10:45 a.m. – 12:45 p.m.

As insurers seek to improve enterprise performance, Enterprise Risk Management (ERM) is gaining momentum. Insurers are leveraging Enterprise Performance Management (EPM) and Enterprise Risk Management (ERM) strategies, technologies, applications, and data in this effort.

Both EPM and ERM can incorporate external political, economic, social, and technological factors—such as regulatory changes, interest rates, demographic shifts, and global warming—into their strategic and tactical planning model assumptions. This seminar will review an ERM framework and its components; risk management exposures with a focus on emerging sustainability risks; and best practices use of EPM & ERM technologies and applications. And since ERM is a global topic, the program will include a discussion of its evolution in Europe, from the banking industry's Basel Accord to Solvency II for insurance, and its effect in the United States. An ERM case study encapsulating all of the above will be presented.

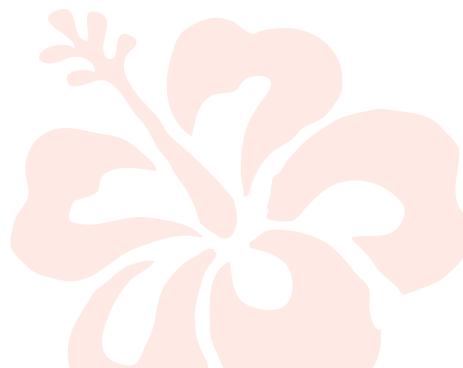
Speakers

Dan R. Anderson, Ph.D., CPCU
University of Wisconsin-Madison

Richard G. Berthelsen, J.D., CPCU
AICPCU

Patricia L. Saporito, CPCU
Business Objects Americas

Chris Suchar, FCAS, MAAA
DFA Capital Management Inc.



Register today at www.cpcusociety.org.

Beyond Financial Services

ERM Still Hasn't Been Adopted by Most Other Industries

by Michael J. Moody, ARM

Michael J. Moody, ARM, is the managing director of Strategic Risk Financing, Inc. (SuRF), an independent consulting firm that was established to actively promote the concept of enterprise risk management by providing current, objective information about the concept, the structures being used, and the players involved.

Editor's note: This article originally appeared in the March, 2007 issue of *Rough Notes Magazine*. It is reprinted here with its permission.

Author's Introduction: Movement Forward on the ERM Front: Today, there is little question that ERM is moving forward, however, some industry sectors are getting into it much quicker than others. Certainly the financial services sector is on the fast track of ERM adoption. While there are a number of reasons for this rapid pace, one of the key drivers is the rating agencies.

Obviously, all insurance companies are concerned about their ratings. In fact, ratings are one of the key competitive advantages all insurers ascribe to. Standard & Poor's (S&P) was one of the first rating agencies to publish its own ERM standards. And for the past six months it has been using ERM as one of its eight factors in determining an overall rating. According to S&P, several insurers, including Munich Re, have attained a higher rating, due in large part to their ERM program. Conversely, S&P notes that several reinsurers have also been downgraded due to substandard ERM programs. The point is clear: early adopters were able to maintain a competitive advantage by implementing an ERM program. But now, those that lag in ERM implementation are clearly at a competitive disadvantage.

Other rating agencies have also begun to develop their own ERM criteria and have also indicated that they will begin using ERM factors as part of an overall

rating determination. At this point, there is little doubt that the financial service industry is well aware of the benefits of ERM. However, the bigger question is when will the remainder of the business sectors begin to commit to ERM. The following article may provide some insight into that topic.

Over the past three or four years, enterprise risk management (ERM) has been the buzz in the risk management community. Its holistic view of risk management has resonated within corporate America. Having the ability to analyze risks from a 360-degree vantage point has been found to have significant benefits for corporations and their stakeholders. Now, with additional emphasis being placed on ERM by rating agencies and stock analysts, interest in the concept is growing. And with the introduction of the COSO (Conference of Sponsoring Organizations of the Treadway Commission) Enterprise Risk Management Framework, an effective implementation plan has been established.

But despite all of these positive developments, it appears that it is only the financial services industry that is moving towards ERM in a meaningful way. Both banks and insurance companies have been adopting ERM strategies in a major way over the past few years. And in survey after survey, non-financial industry participants note problems with accepting an ERM format. What is the problem for non-financial service industries?

Easier Said than Done

"There are a variety of reasons why banks and insurers are rushing to adopt ERM," says Fred Travis, associate senior consultant for Shelter Island Risk Services, "and most Fortune 500 companies have not." He points out that for financial service firms "money is their product," and this has some

distinct advantages from an enterprise risk management standpoint. He notes that their stock and trade are primarily bookkeeping entries, and even this is "facilitated by regulatory agencies and formal markets using standardized methods."

Manufacturers, on the other hand, have production, distribution, and regulatory exposures that vary considerably from industry to industry, each with its own unique set of exposures and risks. Travis, who is the past director of corporate safety and risk management for Anheuser-Busch Companies, Inc., in St. Louis, Missouri, notes that typically the major risks for financial firms are counterparty credit, aggregation, business continuity, and system failures. Further, he says, these risks are quite similar from one institution to another. If a bank, for example, were destroyed by fire, it would typically have "an alternative site established where the same people may be able to go to work almost immediately." However, if the same fire occurred at a production facility, an alternative operation, if available at all, would be generally at a geographically distant site.

Additionally, Travis points out that "robust risk tracking and evaluation systems have been extensively developed for financial service firms." The same is not true for most manufacturing industries. Operational systems, he notes, for non-financial service firms "are often thin or non-existent." Financial firms also lend themselves to standardization since their risk management personnel have similar backgrounds and qualifications. As a result, ERM training can also be standardized to a large extent. However, the risk management skills required for manufacturing operations vary greatly from one industry to another and typically require specific experience and training.

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Beyond Financial Services

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Moving Forward

Despite the lack of standardization, ERM is beginning to show up at some forward-looking manufacturing and non-financial service organizations. Travis says that anyone contemplating starting an ERM program should consider several key issues. He points out that "systems and information are critical for ERM." Accordingly, he suggests, "You need a good understanding of your company's universe of systems before you embark on an ERM journey." Travis recommends that "you work closely with your organization's CIO in developing an overview of all of the company's operational and financial systems."

Additionally, the CIO should assign someone from the IT department to assist in understanding all the department's systems. An inventory of each major corporate department—human resources, finance and accounting, and procurement—will be critical to the analysis. Travis says another critical department is risk management and the risk management information system and related components. Any data deficiencies found should be noted and resolved before proceeding.

Other key areas that should be reviewed in advance of an ERM effort are the business continuity and recovery plans. Travis says that while ERM is not a necessary step in the creation of these two important areas, they should be established well in advance of tackling an ERM implementation program.

A thoughtful review of the risk management program is also a good idea according to Travis. "Is ERM a logical next step in the progression of risk management at your company?" asks Travis. "Or do you have a lot of unfinished projects?" He notes that if the company is in the middle of finding a new TPA, for example, "it is probably not the right time to start ERM."

Practical Steps

Travis says that there are some practical steps that a company can take if it is beginning to consider implementing an ERM program:

- Find a champion—It is critical to identify a C-level executive who is enthusiastic about ERM. He or she must be "willing to work at getting ERM high-level consideration," Travis points out. He goes on to say that "if no one is willing, ERM is not going to get the attention to succeed."
- Identify compelling reasons—Develop an outline of why ERM is critical to your organization. "A generic list of pros and cons will not suffice," Travis says. "It must be tailored to the issues that are specific to your company, geography, products, and markets." Here again, "if you cannot come up with a compelling list of reasons, then implementing ERM will not be a priority."
- Take your lead from COSO—Review the COSO ERM Framework and see how it can apply to your company. The COSO Framework, notes Travis, "provides a standard outline and process for implementing ERM." He also points out that while it is very general and will require a lot of tailoring to an individual organization's ERM needs, it is far superior to "reinventing the wheel."
- Develop timelines—Incorporation of detailed plans and timelines is essential for the proper development of ERM. Travis suggests that you "list all of the steps leading up to a fully functioning ERM system." Once this list is completed you will need to break it down into phases. While this whole step is important, Travis says the key piece of the puzzle here is the project outcomes: "What will ERM look like when fully implemented?" It is important that you can articulate this aspect of the program. "What are the deliverables and measurable benefits to the organization?"

• Draft a risk map—This is typically the first step in the ERM process and includes a formal, detailed risk identification and assessment process. Travis points out, "If you don't know what your risks are, you can't manage them," but he also says that a key challenge is to find common measures to evaluate risk in terms of severity and frequency/probability.

- Information for the risk map will need to come from primary data sources such as historical loss data, policy checklists, as well as questionnaires and interviews with corporate executives. Secondary sources such as financial statements, business plans, and procedure manuals can also help.
- In addition, Travis says it is important to consider the organization's plans for growth, potential new products, and services, and "what would cause the firm to go out of business." Basically, he points out, "What keeps management up at night?" But Travis says it should be only the key risks facing the company. "Mapping every risk is a task never to be completed." And it should be remembered that the risk map is the first step in the ERM process, but it is not the only step. "Be sure to place risk assessment in the context of an overall ERM strategy; otherwise, you may never have the opportunity to implement any more steps," Travis observes.

Conclusion

Enterprise risk management has become a standard operating procedure for many financial services firms but not so much for other industry segments. Travis has highlighted a number of reasons for this lagging development. He points out that one underutilized resource has been the COSO ERM Framework. When the Framework was originally released, the authors made it clear that it was merely a starting point, and they indicated that it would be up to individual trade associations to develop specific criteria for their industries' unique exposures

and risk. To date there has been little movement from the individual industry trade associations, and it would appear that this is hampering ERM development.

Mr. Travis has offered a number of suggestions as to how to get ERM implemented at a non-financial service organization. And while all of the suggestions warrant consideration, it's

the comment regarding the COSO ERM Framework that should be considered. He points out that the Framework is a very under utilized resource. However, as he noted in the article, COSO's original intent was to advance the Framework and allow individual industry groups and associations the opportunity to fine-tune the document.

The time is at hand for individual industry groups to accept responsibility for this task and advance specific ERM criteria for their industry. Failing to advance their own specific ERM guidelines will open the door to other unrelated groups formulating these critical documents. ■

Take Risk Management and Compliance to the Next Level

by Vincent A. Oliva

■ **Vincent A. Oliva** is a managing vice president in Gartner Research, with responsibility for Global Financial Services Industry Research, including our Banking, Investment Services, and Insurance Industry Advisory Services.

Prior to joining Gartner, Oliva co-founded Capital Protection Insurance Services, an underwriting management firm dealing in alternative risk financing and reinsurance. He also spent 16 years at Marsh & McLennan in New York City, as managing director with responsibility for the financial services and middle market practices. Oliva also spent nine years at Irving Trust Company in the risk management area.

Oliva received a B.B.A. degree in insurance and risk management from The College of Insurance, is listed in *Who's Who in Finance and Industry*, *Who's Who in Insurance*, and is a past trustee of the College of Insurance.

Oliva has addressed many groups, including the EDP Auditors Association, Risk and Insurance Management Society, New York Real Estate Board, American Society for Health Care Risk Management, and several technology user groups.

A seemingly never-ending wave of new compliance directives is perplexing insurance companies around the world, sowing confusion among insurers about how they should respond.

These new requirements include Solvency II in Europe, new regulations for annuities in the United States (by the National Association of Securities Dealers), and the National Provider Identifier (NPI) and Medicare Part D mandates, affecting healthcare payers in the United States.

And, if that wasn't already enough to cope with, U.S. insurers face the onerous task of complying with ongoing legislative and regulatory requirements such as Sarbanes-Oxley and other alphabet-soup mandates including HIPAA (the Health Insurance Portability and Accountability Act) and the USA Patriot Act.

Silo Approach to Risk Management Muddies Transparency

The aim behind these mandates is, of course, greater transparency, fueled by the spate of corporate accounting scandals in the early 2000s and the insidiousness of global terrorism. Investors and regulators

are seeking greater transparency into company operations and increased accountability from senior management. However, most financial services firms take a piecemeal approach within their individual business units to managing risk and compliance activities.

Information that is captured and maintained in separate silos impedes the timely access to data essential to make critical operational decisions. And it hinders detection of potential risk events early enough to prevent them. Silo structures also inhibit the sharing of knowledge related to best practices, and create redundant and incompatible data, which complicates technology decisions.

Although the silo approach may appear, at first glance, to be cost-efficient, there are long-term risks associated with this disjointed approach that actually increase the costs because it deters exploiting common data across all business and support functions. This inhibition increases enterprise risk by impairing operational and financial performance.

Risk management structures designed solely to meet regulatory requirements are ineffective. A different approach is necessary.

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Take Risk Management and Compliance to the Next Level

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Take an Enterprise Approach to Risk Management

The appropriate corrective course of action for insurers is to adopt an enterprise approach to risk management. Here's why:

- Insurers benefit from developing an effective and enduring risk and compliance technical architecture. Knowledge gained in the architecture project identifies the company's internal business environment and provides a decision-making blueprint of future initiatives.
- Previous technology investments can readily be exploited. Much of the data and a lot of the foundational technology are shared by various enterprise data initiatives including risk management, compliance, corporate performance management (CPM), and customer relationship management (CRM).
- Operational risk metrics can be tightly integrated with overall enterprise performance measurement to develop key risk indicators that map against performance goals and risk limits. This also provides early-warning signals, and engenders timely and detailed company-wide data reporting.
- The vast range of information to know your customer and to ensure the control required by regulatory mandates illustrates the inseparable connection among risk management, compliance, CPM, and CRM.

Building on a common data warehouse, for example, removes redundancy and more easily integrates these initiatives. Interconnectivity is key to achieving the overarching benefits of enterprise risk management (ERM)—capital allocation, risk-adjusted performance management, aggregation of risk measured against established levels of risk tolerance, and product pricing.

Insurers Should Take the Lead and Embrace ERM

Because the insurance industry is founded on the need to manage risk, one would expect insurers to be way ahead of other companies in initiating enterprise risk management. However, that's not so. For example, few insurers have hired or appointed chief risk officers (CROs), and few are instituting strategies and technologies to manage risk on a companywide basis.

ERM is a competitive strategy that must exceed mere compliance. An ERM initiative should explicitly align to insurers' capital allocation and growth goals. Critical success factors for insurers will include the following:

- identifying, measuring, monitoring, mitigating, and financing all aspects of risk
- instituting procedures for handling risk
- computing and allocating capital based on risk tolerances

Gartner urges insurers to make ERM a higher priority. We believe that companies that welcome risk management and take it to the enterprise level will gain a competitive advantage—especially if they tie ERM to the allocation of capital to business and geographical units.

We also urge insurers to step up their hiring of CROs. Such executives will claim a high profile in their companies. CROs in insurers that are dead serious about the risk management process will report to the office of the CEO or the board of directors, and wield that clout effectively. ■

Midwest Current Events and Contingency Planning

by Brian Jilek, CPCU, ChFC, ARM, AIAF

Brian Jilek, CPCU, ChFC, ARM, AIAF, got his risk management start in business continuity. Jilek is an American Red Cross (ARC) Disaster Services Instructor, and co-founder of the Central IL Chapter of the non-profit Association of Contingency Planners (ACP). He is also a limited lines producer (state of Illinois)/independent associate for Pre-Paid Legal Services Inc.

As I sit in meetings and someone mentions “business continuity,” too often it seems people want to jump to “the smoking hole” event—that somehow a comet has fallen from the sky and rendered some beautiful business campus to just that, a “smoking hole.” Unfortunately, I think this type of “jumping ahead” to that fallacy engenders a dismissal of prudent risk mitigation strategies. People think “smoking hole” and in the next thought they think “that can’t happen to me” and it’s back to the operational crisis du jour, a refocus on their accounting report that doesn’t balance.

It’s been an interesting winter in the midwest, to say the least. Since the writing of my last article, the “when” has come to pass, and more than once. Several incidents have occurred, impacting the community as a whole and gathering our collective local and regional attention . . .

- the rain on November 30 that became the “deep freeze” ice of December 1
- the St. Valentine’s Day Blizzard that dumped and drifted quite a bit of snow on February 13 and 14
- the town power outage with the Prospect sub-station problems on February 22

Our roadways got snarled, our travel plans stymied when the first two events happened. Our commercial buildings were shut down on the last. With each event, we saw more likely, more probable



events transpire than events like the “smoking hole.”

In each case here over the last few months in the midwest, even though there were widespread office closings in the region, event cancellations, etc., certain business activities still needed to take place in spite of the roads, drifts, and darkness. The financial markets were still open in New York and the global world. The banking system was still open and the Fed expecting transactions. Field offices or other affiliated businesses or service providers outside the immediately affected areas were open and operational. Customers in today’s day and age have their pick of businesses providing goods and services, and expect broad access (telephone, mail, e-mail, Internet) at the time of their choosing. With the business of insurance, there’s the added customer need of having their insurance contracts fulfilled and then indemnified in a timely fashion, the promises made by the insurance company kept, in what may be their most trying and difficult circumstances.

It could even be argued that the December and February incidents were the smallest glimpse of what life could be like in a pandemic. After all, businesses’ buildings were still available—standing, intact, functional for those who could reach them. Businesses’ technology platforms were intact and operational,

waiting for users. Businesses’ *people* were affected as people could not reach the buildings or perhaps even the technology. The absence of people impacted the work that could be done, but in the winter storms of 2006 and early 2007, this absence was restricted to a very small window—a day, or two days, at most perhaps three days. Imagine that loss of staff on a protracted, lengthy absence . . . enter the reality of what a pandemic will look like.

I find that as a professional planner, I don’t appreciate the older models of planning for specific scenarios (a “tornado plan,” a “flood plan,” etc.) as much as I appreciate the newer models of planning for resources (or the absence thereof—high-level resources like buildings/facilities, people, technology, or some more detailed level of each resource, such as a specific technology platform in Internet connectivity). With the old model, if we’d planned for a tornado hitting, or a fire in a building, and say a chemical spill and mandatory evacuation happened, now perhaps we haven’t addressed with theory the reality we are facing. In the new model, there isn’t a constraint of “I think this could happen to us, and here’s my flowchart . . . oh wait, we didn’t plan/train/drill/exercise for this!”

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Midwest Current Events and Contingency Planning

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Enter contingency planning, or navigating around the issues affecting operations—the production of products and services when there are impacts to resources. Just the exercise of contingency planning, the thought processes of thinking through resource needs, criticality and importance associated with each organizational process, and strategic ways of still producing products and services adds resiliency to organizations. Indeed a well-done study of the business and its resources for contingency purposes can also provide operational and tactical value in uncovering inefficiencies and mapping through bottlenecks and weaknesses within each business.

The planning process builds on theory, but there's no replacement in theory for the wisdom of experience. The last several months have provided real-time, real-world experience on the theories in execution. However, it's only if we adequately capture the lessons we learn as we learn them, and then act on them to improve ourselves, our processes, our plans, our assumptions and strategies, are we better prepared for the next blizzard or power outage.

Here's where the collective value of professional networking comes into play, with organizations like the Association of Contingency Planners (ACP; www.acp-international.com).

- Meet other people facing similar, or even different, issues.
- Discuss the theories.
- Share the realities and experiences.
- Build on an aggregated “lessons learned.”
- Collaborate and enhance resiliency in individuals, organizations, and communities!

Certainly those of us in the midwest who dealt with these events can be thankful the snows are melting, spring seems to be on its way, power is restored and lights are lighting, but we cannot afford to be so thankful we forget the experiences and return to our “normal” days. I know for me, each of the bullets above is still an open activity “in progress”—still lingering, much like that orphan mound of snow in the obscure corner of the mall parking lot. ■

New Challenges Require Insurance Agent Owners to Implement Strategic Advisory Boards

by Andrew J. Barile, CPCU



■ Andrew J. Barile, CPCU, has more than 40 years of experience in the property and casualty insurance distribution business. He has owned, operated, and consulted to retail brokers, surplus lines brokers, MGAs, insurance companies, reinsurance intermediaries, and reinsurers. He was instrumental in co-founding the first publicly held Bermuda reinsurance company, and putting Bermuda into the capital-raising world in 1978. Barile has written several books, and many articles that have appeared in *The National Underwriter*, *Insurance Advocate*, *Florida Insurance News*, *Business Insurance*, *Forbes Magazine*, and *The Insurance Journal*. Interviews have appeared in *New York Times*, *The Wall Street Journal*, *Best's Review*, and *Rough Notes Magazine*.

As the owner of an insurance agency, there is no legal requirement that you have a Board of Directors. Unlike owning an insurance company, which requires a Board of Directors, insurance agent owners do not have boards. But in these interesting times, the owner of an insurance agency should look at forming a Strategic Advisory Board.

What Is a Strategic Advisory Board?

A Strategic Advisory Board is a group of carefully selected insurance experience advisors who can assist the agent owner in making the right important decisions for the agency. Unlike a traditional Board of Directors, a Strategic Advisory Board is comprised of members who have knowledge and expertise in specific areas of the insurance industry. The goal of the Strategic Advisory Board is to reduce the amount of anxiety equated with confronting unexpected situations, and to provide solid, trustworthy business advice to ensure successful and profitable agency planning and execution. By adding substantial value, their cost does not become a burden for the agent owner. Generally, a Strategic Advisory Board meets on a quarterly basis, allowing for members to keep abreast of the significant issues affecting the insurance agency.

Basic Competencies of a Strategic Advisory Board

Ideally, your Board should be comprised of a minimum of four members with expertise and knowledge in the following broad areas:

1. Agency Growth

- a. insurance product development for new programs
- b. employment agreements for agency producers
- c. forming the agent-owned captive insurance company

- d. managing and implementation of a risk retention group for a group of insureds

2. Carrier Relationships

- a. negotiating existing insurance carrier agency agreements
- b. finding new insurance company markets
- c. interviewing underwriters for your managing general agency

3. Mergers and Acquisitions

- a. unsolicited offers to buy your agency
- b. accessing capital to grow your agency
- c. selling your agency to private equity firms

4. Legal and Tax Advice

- a. selecting an insurance litigation law firm
- b. negotiating reinsurance structures to increase agency commissions

Here are examples of how your Strategic Advisory Board comes into play in the real insurance world.

1. Agency Growth

a. Insurance Product Development for New Programs

Your managing general agency has been given a new opportunity by a new "A"-rated carrier owned by a large Bermuda reinsurer, who wants to come into California to write general liability on the California contractors, and compete with the various risk retention groups operating in the market. Your strategic advisory director is given the assignment to develop the rates, coverages, and forms that will enable your managing general agency to compete in the market, and in addition, build a complete retail

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New Challenges Require Insurance Agent Owners to Implement Strategic Advisory Boards

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insurance broker distribution plan for the state of California. What an opportunity to add additional value to your managing general agency.

b. Employment Agreements for Agency Producers

In your agency, you have approached a competing producer trying to persuade her to leave her present position and join your fast-growing retail agency. There is one big hurdle; she has a very strict "non-compete agreement" that has to be circumvented. How can you do this? So you turn to the expertise in your Strategic Advisory Board, and work with it to come to a solution on hiring the producer, without the problems of a non-compete agreement can give you. There are many different types of non-compete agreements with respect to retailers, wholesalers, and even managing general agents.

c. Forming the Agent-Owned Captive Insurance Company

Your retail insurance agency has been writing errors and omissions on real estate appraisers with a consistently 25 percent loss ratio, and you want to recapture some of the underwriting profit into your own agent owned captive insurance company. You require a complete feasibility study, and want to raise the capital for the captive insurance company through a private placement memorandum (PPM). The technical task of structuring the feasibility study for the agent owned captive can be delegated to the Strategic Advisory Board. Should you use Arizona or Vermont, or even Hawaii as your domestic domicile? Do you want to own a Cayman Island agency captive, or Barbados? What are the advantages and disadvantages



of each domicile, or shore and offshore? The strategic advisory director has all the answers to let you proceed with this concept to enhance value.

d. Managing and Implementation of a Risk Retention Group for a Group of Insureds

As the owner of a fast-growing wholesaler, you discover a need to provide general liability for roofing contractors, or medical practice for a group of doctors, and want to provide a unique insurance product for these exposures. There are more than 200 risk retention groups operating within the United States providing insurance capacity in various areas of the business. The product designs, capital implementation, and reinsurance structure for risk retention groups can be assigned to the Strategic Advisory Board. Once again, you are outsourcing your need and will obtain the necessary expertise to implement a risk retention group that your agency will manage. Build

agency value with the fee income generated by the risk retention group.

2. Carrier Relationships

a. Negotiating Existing Insurance Carrier Agency Agreements

Your retail insurance agency in Florida has just received the "bad" news that your largest carrier is leaving Florida because of reinsurance costs and insurance product pricing. As the owner of the agency, you turn to your Strategic Advisory Board to come up with a solution to delay the carrier's withdrawal from the state. In fact, the strategic director would be aware of the carrier withdrawal before it makes the decision to withdraw. Experienced strategic directors know all the signs because they have experienced this before in their younger years. Delaying the withdrawal is commission dollars saved, and value added.

b. Finding New Insurance Company Markets

The owner of the wholesale agency has put aside a specific budget for searching for new carriers and even investing in initial public offerings (IPOs) of newly formed insurance holding companies. The strategic advisory director can help in identifying new insurance carriers that have just received their A-minus rating, and looking to build a new distribution system. This expertise is not with the owner of the agency, whether it be retailer, wholesaler, or managing general agency. Having access to the members of the Society of Financial Insurance Stock Analysts always helps the strategic advisory director. The dedication to search out newly formed insurance companies, is an expertise, starting with knowing

state insurance department officials. Your strategic advisory director can find new carriers better than you, the owner of the agency.

c. Interviewing Underwriters for Your Managing General Agency

The objectivity of the strategic advisory director makes him suitable for the decision-making process in new hires for your managing general agency. MGA owners can turn to the director for one last interview before decision-making time. Once again, value being added by the Board.

3. Mergers and Acquisitions

a. Unsolicited Offers to Buy Your Agency

The unsolicited offer by a bank to buy your managing general agency or wholesaler, or even retailer should be the sign for you to seek financial representation. Dealing with organizations that have made numerous agency acquisitions puts you, the agency owner, at a complete disadvantage. The world of "letters of intent," due diligence, pro-forma financials makes you the agency owner a novice. Turning to your strategic advisory director, who has been around long enough to know what your asking price should be, is really an advantage. It is always an emotional time, and the thought of selling your agency needs careful consideration.

b. Accessing Capital to Grow Your Agency

For your geographical expansion of your wholesaler, you require additional capital for this expenditure. The Strategic Advisory Board has approved the expansion expenditure, and now turns to who is going to provide the financing. Strategic advisory directors have access to expansion

capital. Many agent owners need to put their financials in order to complete the process of acquiring expansion capital at economical terms. The entire proposal to obtain expansion capital must be done professionally, and is another area where strategic advisory directors make a significant contribution.

c. Selling Your Agency to Private Equity Firms

Recent events have caused a stir in the traditional insurance industry whereby cash rich private equity firms have paid substantial premiums over book value to obtain retail insurance brokers, wholesale insurance brokers, and yes, even managing general agents. Owners are smiling all the way to the bank, as rates start coming down in insurance making the former profit margins difficult to come by. The strategic advisory director, with merger and acquisition experience, can be put to the test by the agent owner. Hedge funds, like private equity firms, have very little actual insurance industry experience. Therefore, the strategic advisory director makes a good go-between to facilitate a transaction that meets both sides' approval.

4. Legal and Tax Advice

a. Selecting an Insurance Litigation Law Firm

The number of lawsuits between agents and insurance companies has dramatically increased over the past five years. Agent owners need to access insurance litigation law firms, utilizing their strategic advisory director. Interviewing law firms for litigation purposes requires a different type of expertise that agent owners do not have.

b. Negotiating Reinsurance Structures to Increase Agency Commissions

Owners of managing general agencies need to understand how capacity is structured behind the insurance companies they represent. Various types of reinsurance agreements can be negotiated, which ultimately increase the MGA's commission under the MGA contract. Understanding the various characteristics of treaty reinsurance agreements is required. The strategic advisory director should have reinsurance expertise.

Conclusions

Your Strategic Advisory Board will only be as good as you, the agent owner, wants it to be. It will be your responsibility to keep your Board informed of situations that affect your agency.

When it comes to appointing members to your Strategic Advisory Board, there are several qualities you, the agent owner, will want to look for. Ask yourself the following questions:

1. Is this person knowledgeable about this area of expertise in relation to the insurance industry?
2. Complete confidentiality, can this person be trusted with complete confidentiality?

Remember that your Strategic Advisory Board is there to assist you in making the right decisions for the future of your agency. ■

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