RMQ

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CPCU SOCIETY

Contingent Capital Arrangements

by Michael W. Elliott, CPCU, AIAF

Editor's notes: *The last issue of* RMQ *highlighted the role of insurance options in transferring insurable risk and compared them to insurance policies. This article continues the discussion of capital market products for risk financing by describing contingent capital arrangements, which can be used to raise cash in the event of a loss.*

This article is an excerpt from a monograph published by the Insurance Institute of America (IIA) titled Capital Market Products for Risk Financing. *Michael W. Elliott, CPCU, AIAF, authored the monograph while employed by the IIA.*

A contingent capital arrangement is an agreement entered into before any losses occur and enables an organization to raise cash by selling stock or issuing debt at prearranged terms following a loss that exceeds a certain threshold. The organization pays a capital commitment fee to the party that agrees in advance to purchase debt or equity following a loss.

With a contingent capital arrangement, the organization does not transfer its risk of loss to investors. Instead, after a loss occurs, it receives a capital injection in the form of debt or equity to help it pay for the loss. Because the terms of the capital injection are preagreed to, the organization generally receives more favorable terms than it would receive if it were to raise capital after a large loss, when it is likely to be in a weakened financial condition.

Contingent capital can be provided through a standby credit facility, a contingent surplus notes arrangement, or the purchase of catastrophe equity put options. Each is explained below.

Standby Credit Facility

A **standby credit facility** is an arrangement whereby a bank or another financial institution agrees to provide a loan to an organization in the event of a loss. The credit is prearranged so that the terms, such as the interest rate and principal repayment schedule, are known in advance of a loss. In exchange for this credit commitment, the organization taking out the line of credit pays a commitment fee.

Contingent Surplus Notes

In the United States, statutory accounting rules allow insurance companies to issue **surplus notes**, which are notes sold to investors that are counted as policyholders' surplus rather than as a liability on an insurer's statutory balance sheet. A benefit of surplus notes is that they increase an insurer's assets without increasing its liabilities. (Regular debt increases both assets and liabilities.) Although surplus notes have many of the characteristics of debt, their treatment as equity (policyholders' surplus) on an insurer's statutory balance sheet allows an insurer to increase its capacity to write business.

Contingent surplus notes are prearranged so that an insurer, at its option, can immediately obtain funds by issuing surplus notes at a preagreed-to rate of interest. An insurer can use the funds to bolster its surplus following a loss.

Contingent surplus notes are made available to an insurer through a trust, known as a **contingent surplus note (CSN) trust.** The trust receives funds from investors and places them in liquid investments, such as U.S. Treasury securities. In exchange, the investors receive trust notes from the CSN trust. For a specified period of time, the insurer, at its option, can receive the cash value of the investments in the trust in exchange for surplus notes that it issues to the trust. Therefore, the insurer has a standby source of cash that it can use to help itself recover from large losses.

As compensation, investors in the CSN trust receive a return higher than that available from other liquid investments of comparable maturity because the investors (1) provide standby funds to the insurer and (2) take the credit risk involved with any surplus notes that are issued. The cost to the insurer for the option to issue surplus notes is equal to the difference between what the investors receive and the return on liquid securities purchased by the CSN trust.

If it exercises its right to issue the surplus notes, the insurer must repay interest and principal to the CSN trust over time so that funds are available to provide interest and principal repayments on the trust notes to the investors. Figure 1 illustrates the relationships among the investors (capital providers), the trust, and insurers for contingent surplus notes.

A major benefit of contingent surplus notes is that funds are available to the insurer at a preagreed-to rate of interest after a loss. Without this arrangement, after a large loss the insurer might find it difficult to issue surplus notes on favorable terms.

Continued on page 2

Contingent Capital Arrangements

Continued from page 1

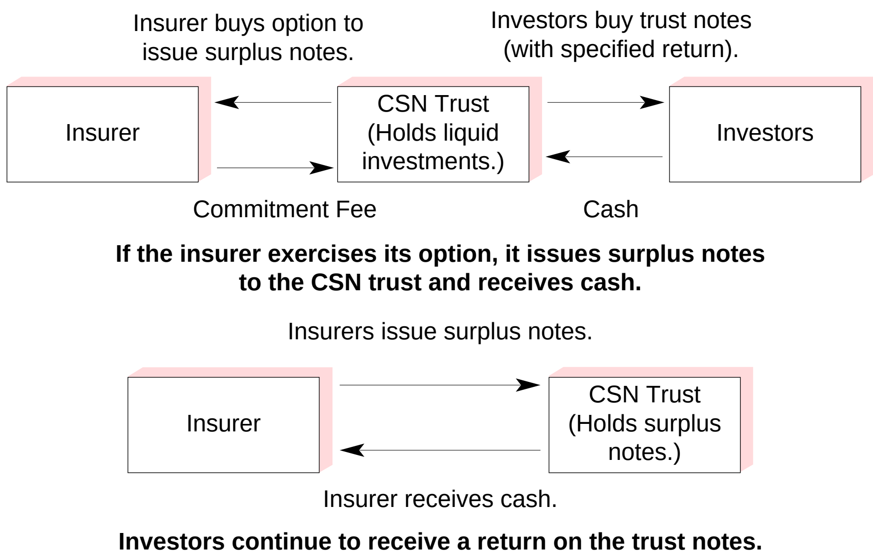

Figure 1
Contingent Surplus Note Arrangement

Michael W. Elliott, CPCU, AIAF, *works in Philadelphia as a senior vice president of MMC Enterprise Risk, an operating entity of Marsh & McLennan Companies.*

Catastrophe Equity Put Options

Catastrophe equity put options (also called catastrophe equity puts) are another way for an insurer or noninsurance organization to raise funds in the event of a catastrophic loss. As previously mentioned, a put option is a right to sell an asset at a predetermined price. A **catastrophe equity put option** is a right to sell equity (stock) at a predetermined price in the event of a catastrophic loss. The purchaser of a catastrophe equity put option pays a commitment fee to the seller, which agrees to purchase the equity at a preagreed-to price in the event of a catastrophic loss, as defined in the put agreement.

Figure 2 illustrates the relationship between an insurance or a noninsurance organization (the buyer) and an investor (the seller) in a catastrophe equity put.

A major advantage of catastrophe equity puts is that they make equity funds available at a preagreed-to price when an organization needs them the most: immediately following a catastrophe. If an organization suffers a loss of capital due to a catastrophe, its stock price is likely to fall, lowering the amount it would receive for newly issued stock. Catastrophe equity puts provide instant equity at a predetermined price to help an organization regain its capital following a catastrophe.

A disadvantage of catastrophe equity puts is that they dilute ownership in the organization following a loss. The amount of equity increases when the put option is exercised, thereby reducing the existing shareholders' percentage of ownership.

Conclusion

This article explained the mechanics of various types of contingent capital arrangements. Insurance companies are the main users of these techniques. However, under certain circumstances, a noninsurance organization might find that a standby credit facility or a catastrophe equity put is an effective technique for financing its losses. ■

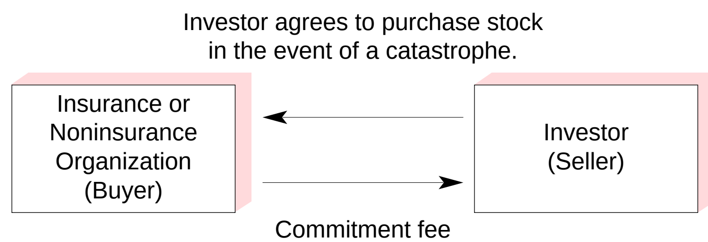

Figure 2
Catastrophe Equity Put Arrangement

CPCU SOCIETY
SYMPOSIUM

Optimizing Mergers & Acquisitions

The Roles of Insurance and Risk Management

October 24, 2001
Seattle, Washington

A half-day symposium—Presented by the CPCU Society
Developed by the Risk Management Section

DATE/LOCATION

October 24, 2001

Sheraton Seattle Hotel & Towers
(East Ballroom)
1400 Sixth Avenue
Seattle, WA 98101

(206) 621-9000

SYMPOSIUM SPEAKERS

David O. Van Delinder, CPCU (Moderator)
Independent Insurance Agents of Texas

Myla D. Bobrow
Remediation Financial, Inc.

Millicent W. Workman, CPCU, CPIW
Mueller Industries, Inc.

Stephen Packard
Accenture

Tom N. Zacharopoulos
Marsh USA Inc.

AGENDA

7:00 a.m.	*Registration and Continental Breakfast*
8:00	How Mergers and Acquisitions Take Place
	Due Diligence and the Risk Manager
	Case Study: an interactive exercize
	Refreshment Break
	Results of Case Study
	Adjusting Existing Insurance Program and Utilizing New M&A Insurance Products
12:00 Noon	*Adjournment*

CPCU SOCIETY SYMPOSIUM

Optimizing Mergers & Acquisitions

WHAT'S IT ABOUT?

Mergers and acquisitions are happening at an alarming rate. Your company, or that of your client, could be next on the list! Learn how you can utilize insurance and risk management functions during a merger or acquisition to produce optimal results for everyone involved.

WHO'S IT FOR?

This symposium was designed for insurance and risk management and other professionals who need to protect their organizations and to advise their clients about extremely important risk management issues arising out of mergers and acquisitions.

WHAT YOU'LL LEARN

Sources of information, business valuation, representations and warranties, and new solutions for environmental issues will be explored from the perspective of the buyer and seller. In addition, panel members will share their concepts for optimization through their analysis of a case study on an actual merger/acquisition.

CONTINUING EDUCATION CREDITS

This symposium is filed for the following credits:

- CPD—4
- CE credits—4

Registration fee includes one CE certificate. Additional certificates are available as follows:

$4 each . . . . .CPCU member *and* CPD Qualified
$8 each . . . . .CPCU member *not* CPD Qualified
$12 each . . . . .Nonmember

ABOUT THE CPCU SOCIETY

The CPCU Society is a community of credentialed insurance professionals who promote excellence through ethical behavior and continuing education. The Society's 30,000 members hold the Chartered Property Casualty Underwriter (CPCU®) designation, which requires passing 10 rigorous undergraduate and graduate level examinations, meeting experience requirements, and agreeing to be bound by a strict code of professional ethics. The CPCU designation is conferred by the American Institute for CPCU.

REGISTRATION INFORMATION

Fee: **$90 for CPCUs and New Designees with Full Annual Meeting registration ($110 after 10/05/01)**

$110 for Wednesday workshop only ($130 after 10/05/01)

$110 for Guests and Nonmembers with Full Annual Meeting registration ($130 after 10/05/01)

$130 for Guests and Nonmembers for Wednesday workshop only ($150 after 10/05/01)

- ***Registration Fee***
  The registration fee includes one CE certificate, all handout material, and refreshment breaks.
- ***Cancellations***
  Your registration fee less $20 will be refunded if notification is received at the Society two weeks prior to the program. After that date, registrations are transferable, upon request, to other programs for one year following this workshop. A non-refundable processing fee of $20 will be deducted from all refunds and requests for workshop changes.
- ***Tax Deductions***
  Tax deductions for educational expenses are permitted in accordance with current U.S. Treasury regulations.
- ***For More Information***
  Contact John Kelly, CPCU, the Society's continuing education coordinating manager, at (610) 251-2773.
- ***For Hotel Information***
  Call the Member Resource Center at 800-932-2728, Option 4.

REGISTRATION FORM

YES. Please register me for the *"Optimizing Mergers & Acquisitions"* symposium on October 24, 2001, in Seattle, WA. (M&A102401).

NAME (Mr./Ms.) ____________ COMPANY ____________

STREET ____________ CITY/STATE/ZIP ____________

PHONE ____________ FAX ____________

NAME ON BADGE ____________ E-MAIL ____________

Please pay registration fee in advance.
The registration fee includes one CE certificate, all handout material, and refreshment breaks. Hotel accommodations are not included.

CPCUs and New Designees (w/ Full registration): $90 ($110*) ....$ ________
Wednesday Workshop Only: $110 ($130*) ....$ ________
Guests and Nomembers (w/ Full registration): $110 ($130*) ....$ ________
Guests and Nomembers (Wednesday Only): $130 ($150*)........................$ ________
TOTAL ....$ ________

*See Registration Information for pricing after October 5, 2001.

☐ Check enclosed payable to: CPCU Society
☐ Charge my credit card.
☐ MasterCard ☐ Visa ☐ American Express

EXPIRATION DATE ____________

ACCT. NO. ____________

NAME AS IT APPEARS ON CARD ____________

SIGNATURE (REQUIRED) ____________

Send registration to: CPCU Society, 720 Providence Road, PO Box 3009, Malvern, PA 19355-0709 Phone: (800) 932-CPCU Fax: (610) 251-2780

Meet the Members of the Risk Management Section Committee

Cheryl L. Topham-Coffee, CPCU, AIM

Cheryl L. Topham-Coffee, CPCU, AIM, has joined the Risk Management Section of the CPCU Society. Cheryl is the Principal of CT-C Consulting, an independent consulting firm that specializes in the evaluation and enhancement of property and casualty and HMO claim management processes; claim financial evaluation; benchmarking of claim processes; claim management program design; and optimization of claim-processing functions. Cheryl has a B.A. in english from Indiana University, has attended John Marshall Law School, and has an Associate in Management designation in addition to her CPCU designation.

On her own, "I really enjoy my work, and I also try to make time to stay involved in community activities, such as the Tax Assistance Program, participation in the arts, and other civic activities." Cheryl's hobbies include collecting art and books, biking, and travel.

Cheryl has been active in the CPCU Society's Chicago Chapter since achieving her CPCU designation, serving as a board member and officer of the chapter. This will be her first year serving on the Risk Management Section Committee. It is her hope that participation in the national Risk Management Section Committee will allow her to contribute to the growth and activities of the Society, support her continuing professional development through formal educational opportunities and informal opportunities to network with insurance colleagues, as well as providing an opportunity for her to help strengthen the professional image of insurance professionals at a time when a changing business climate is challenging the insurance community. ■

Join us in Seattle, WA!

The Risk Management Section has developed these educational seminars to be held during and after the CPCU Society's 57th Annual Meeting and Seminars in Seattle, WA, October 21-23, 2001.

An Awakening Giant—Asian Markets—India, China, Japan

Monday, October 22—3:15 to 5:15 p.m.

Dramatic change is underway in India, China, Japan, and greater Asia, in response to unprecedented political, cultural, and economic forces at work in these lands. Several authorities will come together to describe events in Asia that have global significance and will ultimately affect the world economy—including our industry. You don't want to miss the insights this panel will share or the opportunity to ask them your own questions.
Developed by the International Insurance and Risk Management Sections.

Optimizing Mergers & Acquisitions—The Roles of Insurance and Risk Management

Wednesday, October 24—8 a.m. to noon (Optional post-meeting workshop)

Mergers and acquisitions are happening at an alarming rate—could your company, or that of your clients', become next on the list? Learn how insurance and risk management functions can be utilized during a merger or acquisition to produce optimal results for everyone involved.

Sources of information, business valuation, representations and warranties, and new solutions for environmental issues will be explored from the perspective of the buyer and seller. In addition, panel members will share their concepts for optimization through their analysis of a case study on an actual merger/acquisition. *Filed for 4 CE credits.*

Call (800) 932-2728, select option 4, for Annual Meeting registration information or visit www.cpcusociety.org to download a copy of the registration form.

How To Build a Rewarding Risk Management Practice

by Haig G. Neville, CPCU, CLU

Editor's note: *The editors inadvertently failed to include the customary author biography for Haig G. Neville, with his article entitled "Are You Insured Against Year 2000 Computer Problems?" and published in our December 1998 issue of the* RMQ. *We apologize to Haig Neville for this omission and include it here.*

Insurance is a competitive business. Agents complain that unless they can offer the lowest price, their chance of landing an account is slim. What happened to the value of service, competent counsel, caring, and expertise?

The most satisfying agent activities are providing clients with professional advice and recommending insurance solutions to protect their assets. Unfortunately, working as an agent is no longer a rewarding business. Insurance has become a commodity, packaged and marketed so competitively with one-size-fit-all policies that the need for a value-added professional agent has diminished. Many agents still strive to offer customized service, only to lose out to the low-priced direct writer or the web-based mass marketer.

Customizing an insurance program for a prospect takes time and skill. Under the present compensation system, an agent who designs an appropriate program hopes to recover his or her investment over several years of serving the account. But more often than not, the agent finds that he or she simply has set up specifications for a competitor to underprice. This is not a satisfactory way to do business.

There is a simple solution to this problem. With it comes financial reward, recognition and feelings of professionalism, fulfillment, and self-esteem to which most practitioners aspire. It is called fee-based risk management.

How To Become a Fee-Based Consultant

A well-trained agent is a professional. He or she should be compensated like a professional—namely, at an hourly rate or by the project.

Consider the effort that goes into an ordinary account like a dry-cleaning establishment generating $60,000 to $70,000 in annual premiums. First, the agent arranges to meet the owners. Then he interviews them, inspects the premises, completes a risk exposure questionnaire, and secures copies of existing insurance policies and loss runs for analysis. To this point, he's expended about five or six hours.

He reviews and analyzes the documents, then prepares a written report containing recommendations and preliminary cost indications. He presents the report to the prospects in a second interview. By now, the agent has spent 10 or more hours on the account.

If the prospect accepts the recommendations, the agent submits applications to insurance companies, often with a narrative elaborating on the business. He may gather promotional literature, photographs, and news clips to include with the submission.

When the agent receives the quotations, he presents them in a third meeting and attempts to close the sale. If the agent succeeds, he earns about $5,000 in commission for 20 hours of time expended. That works out to a gross rate of about $250 per hour, which is what a professional agent should earn. However, service on the account has only just begun. During the course of the policy term, another 20 hours of uncompensated time likely will be expended on the account.

And what if the agent fails to make the sale? The entire effort is wasted.

There is a better way. Why not request a $2,500 retainer for evaluating a prospect's exposures and recommending treatment options, with a $2,500 balance due upon completion? If the agent does the work skillfully, the client will obtain $5,000 worth of value-added coverage or annual savings. Both parties win—and that is a common result in fee-based risk management practices.

Haig G. Neville, CPCU, CLU, *is a risk management specialist, who, in addition to the CPCU and CLU designations, also holds the diploma in risk management.*

For several years, he has served as a consultant to major oil companies, insurance companies, banks, cities, educational institutions, utilities and industrial organizations and as the risk manager to the State of Michigan.

Neville is a frequent lecturer at association seminars, including the CPCU Society and RIMS and also conducts CPCU and risk management classes for the American Institute for Chartered Property Casualty Underwriters.

How To Get Started

The first thing an agent should do to establish such a practice is enroll in a risk management course and attain a degree or designation. The subject matter of these courses is invaluable. Next, study every text published on the topic and voraciously read all the risk management journals. Then, speak on the subject, teach and mentor your peers, develop an informational brochure for presentation at business meetings, and arrange to publish your speeches.

Get endorsements from satisfied clients. Arrange press interviews for them to praise your services. Write your own stories but let the press edit them any way they want. Order reprints of every article published and insert them in your newsletter.

What To Expect

Even as this process unfolds, additional clients should be clamoring for your services. You will begin to service larger accounts, even some that have full-time risk managers, especially if you have expertise in specialized matters like D&O, employment practices, pollution, or computer risks.

Practicing risk management is not as complex as it appears. It is merely the common-sense application of a professional body of knowledge. It is what most professional agents do and aspire to do without recognition or compensation. Most insurance problems are simple, but businesses often are reluctant to ask their agents for solutions because they fear that they will be burdened with additional insurance. Sometimes clients have questions about self-insurance, captives, and alternate risk financing. In responding to these questions, agents may solve clients' problems while simultaneously putting their commissions at risk without obtaining offsetting compensation.

It is different when functioning as an insurance consultant. The perceived objectivity of the client/consultant relationship creates a greater freedom of interaction, and the consultant's credibility is highly regarded. Respect comes from many sources: from clients, underwriters, and agents with whom the consultant deals. All of this results in more satisfactory outcomes in insurance-related transactions.

Although insurance is an important product, much of it is marketed by poorly trained and ill-informed salespersons. Few agents enjoy the rewards and recognition that they deserve for their professionalism. As a fee-based risk management consultant, you can find fulfillment and never again have to battle with an underwriter/trainee. ■

In this issue . . .

Risk Management Section Quarterly is published four times a year by and for the members of the CPCU Society's Risk Management Section.

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