The Specialist ESSL

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Message from the Chair — Wicked Problems

by Mark C. Brockmeier, CPCU, ARe

Mark C. Brockmeier, CPCU, ARe, is chair of the CPCU Society's Excess/Surplus/Specialty Lines Interest Group. He is a senior principal for SAP's Value Engineering Group, assisting insurance companies worldwide in building business cases for strategic investments in process and technology tools. Brockmeier has more than 20 years' experience in the insurance industry, and has worked for insurers, reinsurers, TPAs and self-insurers prior to his current position. He received his CPCU designation in 1993, and is a graduate of Boston University's master's of insurance management program.

As I write this column, the Dow Jones Industrial Average (DJIA) has just closed below 9,000 for the first time since 2002, and is now at 35 percent less than its October 2007 apex. The problems we are facing in the economy today have a number of characteristics that are truly vexing:

- There is no concrete definition of the current economic problem. It's multifaceted in credit markets, home mortgage rates, housing values, credit default swaps (CDS), and complex hedge arrangements of dubious value that suffer under "mark to market" accounting regulations. What we can say is: It's bad, and for right now, it's credit-related.
- Why can't it be defined? The current economic crisis can be solved any number of ways, and the solution set is hard to define because there is no end to the number of things that can be applied to parts of the problem. That fix, however, may trigger a consequence which may trigger another fix. There is no real end to the cause-effect-cause-cure-effect-cause cycle. I'm no actuary, but if there were five cures for each of the five problems stated above, the combinations would be in the thousands. Unfortunately, real-life decisions have only one critical path — the one taken by the Federal Reserve and other authorities.
- There's no way to tell whether the proposed fixes will work or not. There is no precedent or modeling capable of predicting the outcome because of the number of unique, interrelated and multinational variables. Despite unprecedented action in a coordinated rate-cut of 50 basis points by every major central bank worldwide, the Dow still fell 650 points within a day. Do you think central bankers anticipated that? Did it work? Well, they certainly can't rescind it easily. Only time will tell.
- Because the outcome can't be modeled and the consequences of action are so profound, we only have one shot at solving the problem. In macroeconomics, there is no trial

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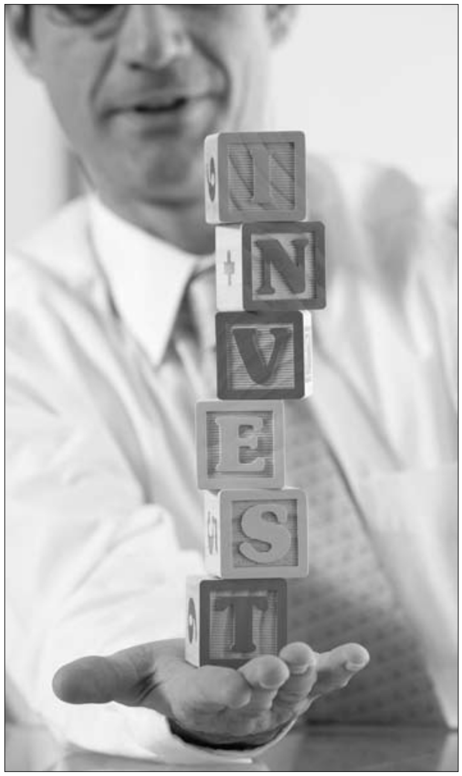
> and error once you pull the trigger on a $700 billion credit line. Every attempt counts and will cause another symptom to strengthen, weaken or become solved.

It sounds like a daunting task, doesn't it? And who could be assigned to solve these kinds of problems? Well, there is a name for these problems. They are called "wicked" problems (not just because I'm from Boston), and the name is rather apropos. And a group of E/S/SL professionals discussed these issues at the Excess/Surplus/Specialty Lines Interest Group Breakfast at the CPCU Society's 2008 Annual Meeting and Seminars.

The current crisis doesn't have a solution which is true/false/good/bad, but we can all agree that we'd rather they not be here. That's why the problems are called wicked — they seem to cast a pall over those who try to define and tackle them, weaving a spell of cause and effect that defies easy resolution.

We challenged the breakfast group to think about how new frontiers of excess and specialty lines might behave like the mortgage crisis. Did insurers and banks anticipate that they were writing wicked coverages when they began to guarantee the CDS contracts that are now the subject of worldwide contagion? How can we identify, sooner rather than later, whether a specific line of coverage will become wicked? What are some examples from your experiences that seem to mimic these kinds of coverages, and how does your management frame them out and evaluate them?

In my humble opinion, there is a cure for wickedness, and it can only be applied prospectively. It has to do with business in general, not just insurance, and is at the heart of our CPCU credo. We have an affirmative duty in our jobs that is summed up in one phrase — *Do the Right Thing*. I am forever grateful to Spike Lee for bringing this tenet into the social conscience of Americans because it's very easy. As an underwriter or insurance company executive, when you have an idea, make sure it's legal and ethical. Ask the lawyers. Search your heart. Both *should* tell you quite quickly what the obstacles are to that idea. Try and solve the problem. But if there are still moral and legal hurdles, move on.



One of the problems in the current crisis may be that some managers knew they had a problem, and knew they were building a worldwide Ponzi scheme that was doomed to fail. But through their own greed and avarice, they ignored their conscience, hired armies of lawyers and lobbyists to keep the regulators at bay and convince politicians that free markets are self-regulating. Each senior, middle and junior executive knew the implications. And they did it anyway, just to get rich.

Therein lies the lesson. Hold yourself to the highest standard possible. Walk away from bad ideas, and don't hire an army of people who will find a way to do it anyway. In the end, there is enough wickedness in the world without us, as consummate insurance professionals, piling on to enrich our own pockets while damaging financial markets in the way the bankers and avaricious executives have behaved. The ones damaged, ultimately, are our friends, neighbors, co-workers, parents and children, and all the people who will lose savings, jobs, retirement funds, houses and families over the actions of a few.

The thought I would leave you with is this: Please innovate, create and build the next worldwide insurer. We need more of those. But do it in a way that you know, each of you in your heart, is sustainable, moral, ethical and legal. If you can meet those parameters, I can almost guarantee profitability as well. Maybe in the future we can define problems as "good" by remembering the lessons of wickedness and never again repeating them.

This is a year which has turned out to be very wicked indeed, and which will forever be more than just Halloween or a melting witch from *The Wizard of Oz*. A world which is ever more complex in business models requires us to become conversant in new syntax and the lexicon of financiers. But in the interim let's not forget our moral compass as CPCUs.

My prediction for 2009? No, Toto, we are definitely not in Kansas anymore. That's all I can say with any certainty. I wish you the best of fall and a fruitful renewal season. ■

Editor's Corner

by Dennis R. Childs, CPCU, ARM, AMIM, ARe, ASLI, MSIM

Dennis R. Childs, CPCU, ARM, AMIM, ARe, ASLI, MSIM, is specialty product underwriting manager for Liberty Mutual Agency Markets. He received the CPCU designation in 1986. Childs has more than 35 years' experience in the underwriting and marketing of commercial lines products, including specialty products, with the last eight years specializing in inland marine. Childs is immediate past president of the CPCU Society's Cincinnati Chapter, and has been published in the *CPCU eJournal.*

Hello, everyone, and welcome to our fall edition. We hope you are enjoying the cooler weather. We have some interesting articles in this edition that are right on point in addressing some of the market conditions the industry is currently facing.

Andrew Barile, CPCU, addresses how to determine market conditions in his article, "Strategies for Insurance Agency Owners to Determine the Signs of a 'Soft' Insurance Pricing Market." **Larry R. Peterson, CPCU, AFSB,** addresses the manner of ethics in the soft market in his thoughtful essay, "The Importance of Being Ernest." Providing a slight change of pace, our chair, **Mark C. Brockmeier, CPCU, ARe,** deals with "wicked" problems in his article.

Lastly, yours truly has a few words on the "green building" phenomenon and what it means to the insurance industry in the article, "How Green Is My Insurance Sales Opportunity?"

We hope these articles provide some insight into how to cope (and survive) difficult market conditions. ■

Just When You Thought Your Data Was Secure

by Celeste Allen, CPCU, CLU, ChFC, FLMI

Celeste Allen, CPCU, CLU, ChFC, FLMI, is a manager for State Farm, and serves as the editor of *Cutting Edge.*

Editor's note: This article first appeared in the September 2008 issue of *Cutting Edge,* the newsletter of the CPCU Society's Information Technology Interest Group.

I'm sure the vast majority of you subscribe to some sort of security service and have gone to great lengths to encrypt access to, and key data on, your machines. *The New York Times*, in a February 2008 article, reported that a research group at Princeton University, consisting of five graduate students and three independent security consultants, discovered a means to capture encrypted information stored on computer hard disks. After reviewing a technical paper by a Stanford group addressing the persistence of data in memory, the Princeton group decided to assess the vulnerability of encrypted data.

There is a longstanding assumption that when the electrical power of a computer is shut off, data temporarily held on dynamic random-access memory (DRAM) chips, which includes data-scrambling algorithms, disappears. The Princeton group chilled the chips using an inexpensive can of air and discovered that information is retained and easily read. Retention of this information for several hours was achieved using liquid nitrogen (–196 degrees C). Special pattern-recognition software, developed by the group, and special utilities within Windows, Macintosh and Linux operating systems were used.

Per John Markoff, the article's author, both Microsoft and Apple ship their operating systems with encryption files turned off and leave it to the customer to turn on this feature. OK, get thee to thy computer to turn this on! Dismay not, as the retention techniques could not be carried out remotely and additional hardware security can be obtained by purchasing secure cards or a special USB hardware key. The research group could not access encrypted data when advanced modes of security were in place.

The research findings reveal vulnerability in "trusted computing" hardware, which is an industry standard approach and assumed to be a means to increase the security on modern personal computers. This newfound vulnerability, although frightening, poses an opportunity to assess how to further strengthen security on our hard drives. Keep current on threats to your computer hardware and invest in appropriate measures to keep your data secure. ■

References

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Strategies for Insurance Agency Owners to Determine the Signs of a 'Soft' Insurance Pricing Market

by Andrew J. Barile, CPCU

Andrew J. Barile, CPCU, has more than 40 years' experience in the property-casualty insurance agency industry as a wholesaler/MGA executive. He has extensive experience assisting insurance agents in finding insurance company markets, helping corporations establish offshore insurance companies, and identifying specialty niche insurance programs for agents. Barile has written several books, including the textbook entitled, *The Captive Insurance Company, An Emerging Profit Center*. His many articles have appeared in leading publications such as *The New York Times, The Wall Street Journal, Forbes, Business Insurance* and *Rough Notes.*

Editor's note: This article first appeared on Producersweb.com in April 2008, and is reprinted with the authority of Producersweb.com.

It has always been said that the ultimate risk taker in the insurance risk distribution system is the retrocessionaire, the reinsurer of the reinsurance company. These types of reinsurers provide capacity for the reinsurance companies. Lloyd's Syndicates had always been a major reinsurer of reinsurance companies.

Recently, Bermudian reinsurer Bridge Re, which is wholly owned by investment bank Dresdner Kleinwort, has closed its three-year $182 million Puma Capital Retrocession Catastrophe Sidecar to New Business, after one year of operation, stating that "conditions are not acceptable for assuming retrocession cat re business." Insurance agent owners should be aware that the insurance carriers they represent could purchase four ultimate net-loss products.

- Worldwide first event cover.
- U.S. and Canada first event cover.
- Worldwide first event cover excluding U.S.
- Worldwide second event cover.

Insurance agent owners should ask their insurance company representatives what covers they are buying. Bridge Re had offered yearly renewals of the retrocession contracts.

This is an important sign that rates will continue to be "soft" for 2008 and 2009. Besides over-capacity in the retrocession market and the withdrawal of Bridge Re, what other signs are there for agent/producer owners?

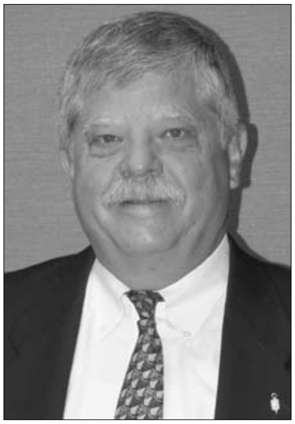
Here is a simple checklist for the insurance agent owner:

- Weaker than anticipated gross premiums written growth during the 2007 fourth quarter.
- Performance of the property/casualty stocks has been disappointing year to date.
- State insurance departments not granting double-digit rate increases.

My 45-year-old crystal ball shows the remainder of 2008, and all of 2009, to remain at competitive pricing for the insurance industry. ■

The Importance of Being Earnest

by Larry R. Peterson, CPCU, AFSB



Larry R. Peterson, CPCU, AFSB, is a vice president of Tennant Special Risk LLC in Norcross, Ga. He is past president of the CPCU Society's Atlanta Chapter, and has been a CPCU program course leader for many years

With apologies to Mr. Wilde, please.

In the modestly responsible position I occupy at Tennant Special Risk LLC, I've come to believe that there are those out there whose motivations are somewhat less than earnest. Another famous writer, Mr. Webster, opines that "earnest" has to do with the serious nature of intentions. Had I been at Mr. Wilde's side when he was creating his timeless masterpiece, I might have suggested that perhaps another definition might include some reference to integrity, honesty, purity of heart and stuff like that. He likely would have pointed out that he dealt with these attributes elsewhere in the book and what did I know anyway? Some of the rest of this will be like preaching to the choir, but bear with me, please.

Tennant Special Risk is a program manager, writing CGL coverage for trade (artisan) contractors in most states around the country. As a program manager, our business originates from wholesale brokerage firms. (I am pleased to say that we do business with the very best in the business, too!) They, in turn, are doing business with retail insurance agencies, and just like me will likely never meet the insured for whom we negotiate coverage. This is where Oscar Wilde and Daniel Webster enter the picture — and the whole subject of "earnest."

Here's a surprise for you naive underwriters out there: some people misrepresent the truth and lie to us in the application process. The earnest intention they have is to sell us something and present it in the best possible light, even if that light is slightly shaded toward the yellow. Like the customers of Tennant Special Risk, my audience is in the excess and surplus lines business, so we're already dealing with risks that the so-called standard carriers can't handle for whatever reason — like writing software for the emergency shutdown computer at a nuclear power plant or changing lightbulbs on runways. What do we see instead? A computer programmer writing software for power conservation or an electrician retrofitting low-energy lightbulbs for commercial customers. And this is exactly the reason why program managers and other contract underwriters order inspection reports after binding a risk. We don't tell the inspection company what we were told about the risk. We ask them to go see it and tell us what they find.

I'm stretching a point here with these two examples, when really the more mundane approach to "being earnest" is merely to shave the projected revenue or payroll because of (a) a minimum and deposit premium consideration, (b) trying to keep the amount of the check the insured will have to write as small as possible, or (c) a bunch of other really terrific reasons. Or how about this? Preparing a supplemental application that shows that sales and payroll for each of the last five years has been exactly the same, year in, year out. We see this because underwriters are stupid people — everybody knows that — but there's another example of being earnest. They're serious in their intentions about not wasting their time getting accurate information.

Another popular, and deliberate, approach to the underwriter is whiting out last year's date and penciling in the current time period. Because underwriters are less than intelligent, we never notice that either. How about one more? Ever see a submission that had a cover note that read something like, "Here's a copy of last year's application. We write this account in our contract unit and are sending this to you to block you as a market for our competition."

> ***… we operate by a code of ethics that requires my personal definition of "the importance of being earnest.***

Lest some of you think I'm picking on the production side of the industry only, let me say that being earnest occurs on the underwriting side as well. I recently bid on a residential roofing contractor, only to have the "snot beat out of my pricing" by a competitor. I was furnished with a copy of the other underwriter's quote, which clearly showed that he had rated the exposure as a grading contractor. I was sorely tempted to respond by re-rating it as a florist shop.

To those of you who are not CPCUs, and that's probably very few who read this, we operate by a code of ethics that requires my personal definition of "the importance of being earnest." We're going to react to an application honestly and with full intentions of providing the coverage that

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The Importance of Being Earnest

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the insured needs and wants — or as close to it as we can come. We are going to price it fairly and be able to sleep at night knowing we did the best we could do. By practicing this approach, we strive to improve the reputation of the insurance industry as a whole and bring credit to our employers. (They might even make a buck or two because of our work.)

The market is hard enough to compete in as it is, with more underwriters concerned about the top line, market share, territory penetration and shrinking average premiums. It's a lesson that we never seem to learn, and go from hard market to soft and back again, always with the same results. If we are to do a good job and feel confident at the end of the day, it will be because we know that we asked the right questions, we challenged odd-looking answers on applications, and we understood the nature of the risks we dealt with that day. We quoted, or declined, for the right reasons, and we did it earnestly. We did our best to help, and practiced the altruism we swore we would when we took the CPCU oath.

■ ***Taking the high road, or losing your temper, is not a viable solution to the problem.***

Reacting as we should does not, in and of itself, address the problems noted earlier. What do we do about the applications that stretch the imagination? What do we tell the broker whose only interest in sending an ACORD 125 is to block you as a potential market for their competitor? Taking the high road, or losing your temper, is not a viable solution to the problem. Education is. We must let the producer know that the turnip truck we fell off of was a long time ago and we've learned a few things since then. Instead of telling them their application is full of contradicting, confusing or inaccurate information, we let them know that we are interested in forging a partnership with them that results in the production of good, solid and competitive business.

As a funny coincidence, the insured just happens to benefit from this as well because the producer and the underwriter have agreed on the exposures faced by the insured and tackled them responsibly. Let the producers who are only interested in a sale go someplace else. They can always find an underwriter that will rate the roofer as a grading contractor. Sooner or later those people get sorted out by themselves anyway when their files are audited. We can also send copies of the inspection reports to the producer, noting any conflicting information and getting answers about it. We can trust each other. Who among us does not work harder for people we trust?

What else should we do? Expanding on that idea of knowing exactly what the insured does, how about designing an insurance contract that serves the needs? How about explaining why the 11/85 version of the CG 20 10 is not in the insured's best interests? (Personally, I'd have the insured sign off on a statement that he knows exactly what might happen by providing that form to an additional insured.) If we're writing that residential roofing contractor, does it make sense to tell him we're going to attach an endorsement that excludes water damage? If we're looking at a waterproofing contractor, does it make sense to recommend the insured accept a claims-made form?

For those that subcontract a high percentage of their work, can we recommend a contract that has an exclusion for the work done by subs? The proof of the pudding is when the contract is tested by a claim situation. Nobody would buy insurance if there was no possible chance of loss, but when the time comes, is that when they learn that the check they wrote wasn't for the right product? Talk about an "earnest" moment!

As underwriters, producers and retail agents, we have a responsibility to the insured, no matter what. The process works best when all persons involved have the best interests of the insured at heart and respond that way. We learn what the need is, and then address it, rate it fairly and provide the product that does the job as best we can.

For most of you, all of this was common sense and nothing you didn't know already. You also know of the people and the circumstances I described earlier. This was written for them. Pass it on. ■

How Green Is My Insurance Sales Opportunity?

by Dennis R. Childs, CPCU, ARM, AMIM, ARe, ASLI, MSIM

Author's note: Special thanks to **Douglas J. Holtz, CPCU, CIC, CSP, CRM,** for his extensive research on this topic.

What is all of this about "greening" of America and what does it mean to our industry? In its most basic form, the term "green building" simply means a structure that is designed and built to be environmentally responsible. The technical definition of "green building" is a building that has been certified as "green" by the USGBC (United States Green Building Council). The USGBC certifies buildings based upon sustainability of the site; water efficiency, energy and atmosphere; materials and resources; indoor environmental quality; and innovation in design.

There are various levels of certification, ranging from Certified to Platinum, depending on the level of environmental considerations in the construction of the building. Examples of green buildings would be larger office buildings, municipal buildings, senior living facilities, libraries, etc. You will also hear the term "LEED." This refers to the rating system used by the USGBC. LEED stands for "Leadership in Energy and Environmental Design." Another catch phrase connected with green buildings is "sustainability." Sustainability refers to consideration of the use of resources and building materials that can be replaced or renewed, and thus are not depleting current resources. It's all about reusing existing resources and reducing our "carbon footprint."

Why Go Green?

Green not only refers to the environment but also to saving money. The USGBC estimates that an upfront investment of 2 percent in building design can result in energy saving of 20 percent over the life of the project. Other benefits include:

- Increased asset value.
- Reduced operating cost.
- Favorable impression by the community.
- Comfort of inhabitants.
- Less infrastructure demands.
- Improved quality of life.

What opportunities may exist in the market?

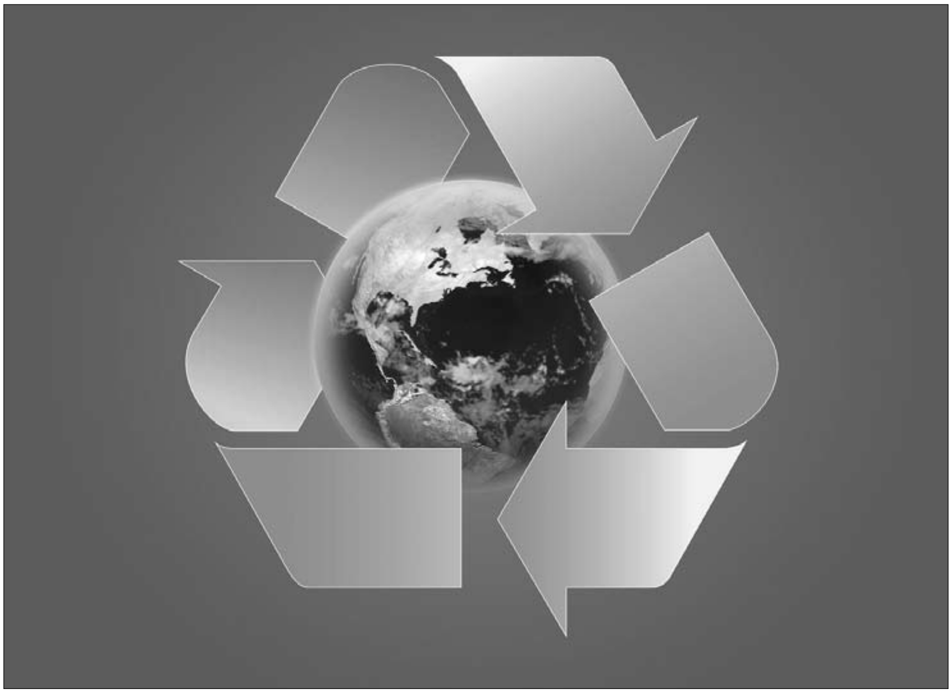
It is estimated by the USGBC that there will be 100,000 green projects by 2010. A number of cities and states are giving tax credits for green construction, and more states and cities are in the process of establishing tax credits. Building green is attractive to building owners and contractors as a means of differentiation from the competition and a way to save money and increase revenues. "Going green" does not appear to be a fad. A number of insurance carriers, including Liberty Mutual, Travelers, ACE USA, Fireman's Fund and Nationwide Mutual (note this is not an exhaustive list), have recognized the potential market and have rushed to supply green insurance products to the industry; others are no doubt working to develop environmental products as well.

What Are the Exposures?

Current standard commercial lines forms may not address the coverage needs of green buildings. For example, in the case of a loss, the insured would have to get the building recertified as green, which involves additional expense for becoming green compliant. There will likely be additional recycling expenses (as opposed to disposing of debris) involved in green building construction. The building may have to be flushed out in the event of a loss to add new filtration systems to certify as green. Alternative water and power systems may need to be purchased until the permanent power and water systems are certified green, and, of course, the additional expenses involved in rebuilding or repairing buildings to green standards may not be adequately covered.

Summary

The increased interest in sustaining the environment has affected us all in many ways, and this increased emphasis in environmental responsibility presents an opportunity for the CPCU community to better serve the public by developing products and services that are responsive to this growing need. ■



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