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CPCU SOCIETY

Introduction to Capital Market Products for Risk Financing

by Michael W. Elliott, CPCU

Editor's Note: *This is the first in a series of articles in* RMQ *on capital market products for risk financing.*

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The capital markets have financed insurable risk for a long period of time. In the past, the capital markets' involvement was limited to providing capital to insurance (or reinsurance) companies, which have used this capital to underwrite their customers' risks. However, in recent years, the capital markets have developed innovative products that an organization can directly use to finance its insurable risk, bypassing the traditional insurance (and reinsurance) mechanism. These products include insurance-linked securities, insurance derivatives, and contingent capital arrangements. This issue of *RMQ* briefly introduces these new risk financing products, and subsequent issues will describe them in detail.

Insurance-Linked Securities

Insurance-linked securities are debt instruments (usually in the form of bonds) that have insurable risk embedded in them. The investor receives a return higher than it would receive if the insurable risk were not embedded in the security. Any loss to the investor attributed to the embedded insurable risk benefits another organization, which is able to use the proceeds to offset its insurable losses.

Insurance Derivatives

Insurance derivatives are financial contracts that are valued based on the level of insurable losses that occur during a specific time period. An insurance derivative increases in value as specified insurable losses increase and, therefore, the purchaser of the derivative can use this gain to offset its insurable losses. The seller of an insurance derivative accepts insurable risk and receives a commensurate return for doing so. Two major categories of insurance derivatives are swaps and options. Insurance derivatives are traded over the counter and on organized exchanges.

Contingent Capital Arrangements

Contingent capital arrangements are agreements entered into before a loss occurs. They enable an organization to raise cash by selling stock or issuing debt at prearranged terms following a loss that exceeds a certain threshold. The loss can arise from insurable risk, such as property damage from an earthquake. The organization agreeing to provide the contingent capital receives a commitment fee. Contingent capital arrangements include standby credit facilities, contingent surplus note arrangements, and catastrophe equity put options.

The Potential of These New Products

The capital market products for risk financing described above are in their infancy, and their use has been limited. To date, the purpose of most transactions involving these products is to transfer an insurance company's

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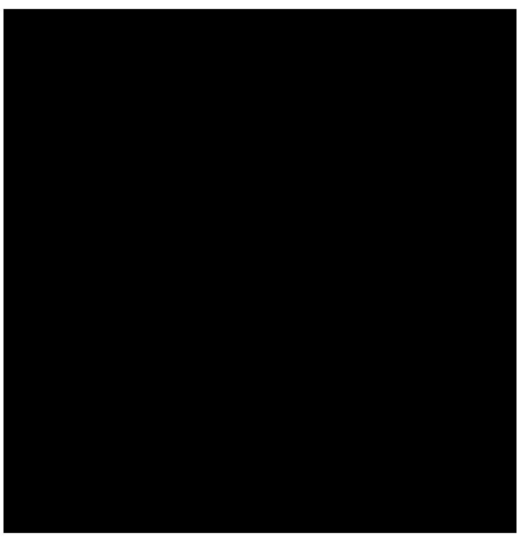
catastrophe risk, mimicking a traditional catastrophe reinsurance transaction. However, the convergence of insurance with other financial services in the general economy is a driving force behind the development of these new products, and many insurance companies, insurance brokers, reinsurance companies (and brokers), investment banks, and other financial institutions are strongly promoting them.

Conceptually, these products can be used to finance any type of insurable risk for any type of organization. They will grow in importance as a source of risk financing if a large number of buyers and sellers develops for them. A well-developed market will reduce the cost and improve the accessibility of these products. If they prove superior to traditional insurance by efficiently deploying risk capital, their use will grow exponentially. ■

Author's Note: *Many of the terms used in this first article on capital market products are not defined and might be new to the readers of* RMQ. *In subsequent issues, I will define these terms and explain how the various concepts apply to the financing of insurable risk. The next issue of* RMQ *will explore insurance-linked securities in detail.*

Thank You, Dr. Head

by D. Ted Flores, CPCU



As most of you know, George L. Head, Ph.D., CPCU, ARM, CSP, CLU, has retired from the American Institute for CPCU and the Insurance Institute of America. Dr. Head is widely recognized as one of the founders of risk management as a professional field of study. During his 30+ year career with the Institutes, he developed and led the Associate in Risk Management Program.

Dr. Head has received many awards for his contributions to insurance literature and risk management education, including the American Risk and Insurance Association's C. Arthur Kulp Award (twice), RIMS' Godell Award, the Philadelphia Chapter of the CPCU Society's Franklin Award, and PRIMA's first Distinguished Service Award.

The Risk Management Section Committee has been privileged to have Dr. Head's participation at its Mid-Year and Annual Meetings. We are grateful for the wisdom and experience he has shared with us over the years. Thank you, Dr. Head!

Michael W. Elliott, CPCU, AIAF, ARC, assistant vice president at the Institutes, has been named director of the ARM program. Mike is also a regular participant at this section's committee meetings.

The Risk Management Section Committee currently has openings for persons interested in furthering the mission of the CPCU Society. If you have an interest in risk management and would like to serve on the committee, please contact the Society or me directly. You may also complete the application included in this newsletter and fax it to John Kelly, CPCU, at (610) 251-2775. ■

Mark Your Calendar for these CPCU Society Events!

May 24, 2000

Financial Services Modernization: Threat or Opportunity

Satellite Broadcast

■

June 1, 2000

Mathematics of Risk Management

Hartford, CT

Connecticut Chapter Workshop

■

June 8-10, 2000

National Leadership Institute

Las Vegas, NV

■

October 22-24, 2000

CPCU 2000: A Time to Lead

San Antonio, TX

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   If nominated, I understand that I'm expected to automatically move into the President-Elect, President, and Immediate Past President offices, which represents a 4-year commitment.

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3. **National Committee/Section Committee Service:**
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As Society service is on a voluntary basis, any expense incurred in attending meetings is the responsibility of the individual involved.

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*If available, please attach a recent photograph of yourself.

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C = Committee Chairman
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☐ Regulatory & Legislative
☐ Reinsurance
☐ Risk Management
☐ Senior Resource
☐ Total Quality (pilot)
☐ Underwriting

Complete reverse side also.

Risk Manager Burnout: Managing the Occupational Risk

by Kevin M. Quinley, CPCU

Kevin M. Quinley, CPCU, ARM, AIC, ARe, AIM, *is senior vice president of risk services for MED-MARC Insurance Company and Hamilton Resources Corporation, Fairfax, VA. He has a B.A. from Wake Forest University and an M.A. from the College of William & Mary. He holds the CPCU designation and specialty designations from the American Insurance Institute in risk management (ARM), in claims (AIC), in reinsurance (ARe) and in management (AIM). A contributing editor of* Claims Magazine, *Kevin co-authored the Insurance Institute's AIC 33 textbook on* Workers Compensation Claims *and* Industrial Low Back Pain *published by the Michie Company. The author of more than 400 published articles and seven books, his articles have appeared in publications including* Business Insurance, The National Underwriter, Risk Management, Occupational Safety & Health, Best's Review, CPCU Journal, Insurance Settlement Journal *and* For the Defense.

Your stomach churns as the boss waves you into his office and closes the door. You're the third manager who's gone one on one with the Big Cheese this morning. He asks you to sit down as he clears his throat and begins.

"As you know, your risk management assistant—Darby—just submitted her resignation. Because company management believes in you, we're not replacing Darby but are reassigning her responsibilities to you and your remaining staff. This may increase your current workload by 20 percent.

"Since your relationships with our key divisions around the country are so strong and we are under orders from the top," he continues, "I'm cutting your travel budget by 50 percent. There may be some slight delays in getting insurance certificates out, but we're confident that you and your risk management staff can handle it.

"Also, the Executive Committee has put its foot down about using temps for those peak times of administrative demands within risk management, so there may be delays you'll have to live with in managing the paperwork.

"Finally, Corporate wants to put you in charge of Employee Benefits. We need your assessment of this cafeteria plan proposal by Thursday at noon. Congratulations.

"Oh, one more thing," the boss says—almost as an afterthought—"did I mention the pay freeze?"

Risk management is a demanding mistress. Like a jealous lover, managing risks can monopolize our time and attention, drive us to drink or divorce, and wreak havoc in our lives unless we find ways to manage stress. Risk management has its own unique stresses and perils. Do you know who your broker will be tomorrow? Will the organization downsize and decide that your are expendable? Will your property insurer reconsider its denial of that large business interruption claim before you have to report to the CEO?

Risk managers live not only with risk, but also with stress. To control the former, they ratchet up the latter. If stress becomes unmanaged, risk managers will face problems in their personal and professional lives.

No risk manager wants—or needs—to be on the wrong side of divorce, alcoholism, or heart attack statistics. Risk managers are skilled at assessing risks elsewhere. To avoid burnout, though, they must be perceptive about their own careers—managing them and pacing themselves to maximize their energy. Here are 14 tips for avoiding burnout.

1. **Watch the fuel gauge.** Risk managers are the decathletes of the insurance business. They must be fast and have the stamina to work long hours. This is only possible if they eat as carefully as disciplined athletes. View food as fuel, not just filler. Remember the Russian proverb, "It's not the horse that draws the cart, but the oats."
2. **Exercise.** Fueling your body is a first step. Keeping the engine in good shape is key. In risk management, those who exercise have an edge over couch potatoes. Regular moderate exercise is sufficient. Twenty minutes of aerobic exercise three times a week is a minimum. Try biking, jogging, walking, swimming or racquetball. Find an activity and establish an enjoyable regimen. You may find that you look forward to it rather than seeing it as drudgery. Find time to exercise, or you'll eventually have to find time for illness.
3. **Take five.** Your body requires a minimum amount of rest, and the mind a minimum amount of dream time. Some risk managers need at least eight hours of nightly shut-eye. Others need less. Skimping on sleep wears you down, compromising the alertness so critical to risk managers' effective decision making. Chronic sleepiness also makes you testy and irritable—qualities ill-suited to managing risks and other people.
4. **Make time for family and friends.** Risk managers spend most of their waking hours working. In the remaining moments, though, make time for family and friends, undistracted by professional

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concerns. Why marry and have kids if you never see your spouse or progeny? No risk managers have ever been quoted on their deathbeds as saying, "I only wish I had spent more time at the office handling insurance renewals." The work will always be there. Your family may not.

Inform family members in advance that you may be preoccupied, if not incommunicado, during peak work times: an office move, a huge renewal, a "crash" preparation period preceding a major audit; or any of the other crises to which risk managers respond. Managing risk is stressful enough without burdening yourself with marital or family turmoil. Discuss these needs with your family beforehand so that your "support crew" will be there for you when you need them.

5. **Make time for yourself.** That ancient RIMS member Socrates said, "The unexamined life is not worth living." Such time includes introspection, meditation, daydreaming—even self-indulgences. This relaxes you, clarifies what's important, and enhances your enjoyment of life. It also reduces the odds that you will begrudge the time you spend working.
6. **Vary your routine.** Routine has pluses—predictability, reliability, and consistency. Routine can also be mind-numbing, however. Avoid getting into a rut. Recharge by altering your routine occasionally. Change your time of arrival, departure or lunch. Vary your commute to work. Go somewhere different for lunch, with a different person. Breathe fresh life into your daily habits.
7. **Expand your horizons.** Remember life before becoming a risk manager? You probably had interests, hobbies, and intellectual pursuits that have been dormant for years. Dust off that guitar, read a novel, see a play, a funny movie, a concert, a basketball game—whatever you enjoy, as long as it's unrelated to risk management.
8. **Plan a realistic work schedule**. Avoid scheduling appointments too close together. Tackle priority and tough work early in the day, when you are normally the most fresh. Allow ample time—extra time if possible—to complete tasks. Reasonable deadlines let you polish and refine. Pace yourself.
9. **Don't procrastinate.** Inherent in risk managers' work are annoying and anxiety-producing tasks—returning phone calls of difficult underwriters or brokers, taking a confrontational position, explaining cost-allocation to a subsidiary, working on a burdensome file under a tight deadline, or giving the boss bad news. Delay in facing these events only worsens the situation: your anxiety increases while the problem festers.
10. **Be prepared.** Use a diary system that tracks deadlines and gives you ample notice well ahead of due dates. Anticipate and comply with boss-imposed deadlines, and set your own timetables in your boss's absence. When you start a new project, think it through.
11. **Review all projects and tasks regularly.** At least every 30 to 90 days, go through all your projects to ensure that each is progressing appropriately, and none has languished. You don't want to discover too late that the time for rendering a key report, responding to a demand or initiating a time-sensitive search for needed coverage has expired.
12. **Seek help when needed.** This includes brainstorming with other risk managers, assigning responsibility for different tasks among colleagues and support staff, using the resources of RIMS—national and the local chapter, and having other staff persons cover for you when you are on vacation or on business travel. Make sure that allocation of tasks is understood so that nothing "falls through the cracks." Seeking help is not a sign of weakness. Being too proud to ask for it is.

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Is Flood Coverage Mandatory for Public Entities? No It Isn't, But Yes It Is

by James R. Mahurin, CPCU

James R. Mahurin, CPCU, ARM, *provides independent risk management and insurance consulting services. Mahurin's consulting practice was started in 1984 and includes work in 11 states. He is a member of the Society of Risk Management Consultants.*

A little known amendment to the Disaster Relief Act of 1974, known as the Stafford Disaster Relief and Emergency Assistance Act, was signed into law on November 23, 1988. The amendment eliminated the "first bite free" provisions previously permitted in federal disaster relief funds available to public and certain nonprofit organizations. Previously, these organizations could receive federal disaster assistance for property located in base flood zones. After receiving payments for flood damages, the entities were required to obtain flood coverage in the future.

The "first bite free" concept ended May 22, 1989. Today a reduction in disaster assistance through the Federal Emergency Management Agency (FEMA) is made for facilities located in the base flood plain, whether or not the applicant has the facility insured. The reduction in assistance is the ***maximum*** amount of flood coverage proceeds the organization would have received if the facility had been fully covered by the National Flood Insurance Program (NFIP). The penalties today are up to $1 million per structure. Further, if an entity has damage and fails to maintain flood coverage in the future, it will receive no relief at the next disaster. This can be tens of millions of dollars.

I have personally struggled for years on public and nonprofit entity accounts to identify all flood zone properties and address the problem in a manner that will avoid the penalties. Using various forms of retention, NFIP coverage, private insurance, or combinations of the three, we have attempted to address this most serious exposure. But I worry constantly that a facility, or facilities, will be omitted and we will be penalized a few million dollars following a disaster. Not a comforting thought at 2 a.m. At several regional and national conferences I have asked what procedures risk managers and insurance brokers were using to clearly identify all base flood zone properties so as to avoid the federal disaster relief penalties. To date, not one person at any of these conferences was aware of the problem, and the audiences included some of the larger public entity providers in the United States. A separate recurring problem is to find NFIP policies on flood zone facilities that have not been increased to reflect the current limits available. Within the past year I found a $100,000 and a $250,000 policy on facilities valued approximately $1 million and $10 million, respectively. It appeared both policies had been written for the maximum limits when the buildings were new, and had not been updated in the interim.

NFIP policies contain coinsurance clauses. A combination of the coinsurance penalty and the FEMA penalty would create an interesting problem. Representatives of FEMA will confirm the application of these penalties and the importance of public and nonprofit entities addressing this issue. In fact, FEMA and NFIP work together. They will help an organization address this problem, or tabulate the amounts of the penalties to be applied. They appear to have been quite busy on the penalty application and less active providing assistance. Federal disaster relief following a flood is critical to the recovery of a community. The FEMA programs provide invaluable assistance at times of great need. Failure to identify and properly insure flood-prone facilities will result in severe penalties that can be avoided. This is a problem that needs to be addressed on every public and nonprofit entity account. And the exposure should not stay hidden from the risk management and insurance community for another 11 years. ■

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13. **Nurture staff relationships.** Risk managers are often only as effective as the people working with them—risk analysts, assistants, transcriptionists, secretaries, and file clerks. Praise good performance promptly, in public if possible. Criticize inadequate performance constructively, and in private. Relate to members of your staff as people, and *not* just on their birthdays.
14. **Take your satisfaction "temperature" periodically.** Evaluate your professional happiness. Annually assess what makes your work fulfilling. List obstacles to that fulfillment. Consider the risks you manage, your workload volume, the people you work with, the quality and depth of your support staff, and your level of professional development compared with what you had originally expected to have attained at this stage of your risk management career. If you think making changes could promote your professional satisfaction, make them. Evaluate your stressors and try to reduce them.

These nostrums are better than chicken soup. They won't hurt, and they may help. Risk management has a personal, individualized component. Risk managers manage the risks of others. Who manages the risk of burnout for the risk manager? The answer is: the risk manager. Like the parable of the cobbler children who went shoeless, risk managers must be able to manage not only external risks to their organization, but their own risk of job fatigue, dissatisfaction, and burnout. At no time have risk managers been called upon to do more. Their "plates" get increasing numbers of tasks heaped upon them. Their task "cups" runneth over. The risk management profession poses unique challenges of stress, which produces its own physical and mental risks. Short of moving out to the country and putting flowers in our hair, there are specific practical ways to avoid burnout and take a fresh look at each day's new challenges. ■

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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