

# RISK & INSURANCE®

## Innovation: Shackled Souls

*It's hard to innovate when your hands are tied by rules, compromise and the difficulty of accurately setting aside reserves for future*

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Forgive insurance company executives for feeling hamstrung. During the best of times, even the most experienced managers are grappling with a conspiracy of professional contradictions, both profound and mundane. At times it's a wonder they still insist on showing up at work every morning.

Take loss reserving, for example.

How many an insurance exec has gone to his or her CFO to explain a \$5 million loss for which there's not enough capital in reserve? How many has gone to his or her CEO to explain why \$5 million worth of capital was allocated to a loss that never occurred?

How much latitude is there to innovate when your hands are tied because you don't know what the future will hold?

"We don't know what the nature of the change will be," says Ken Rado, risk manager for Jersey City, N.J.-based Insurance Services Office, a data and analytics vendor to the insurance and risk management industries.

Long ago, Rado recalls, a former boss cautioned him about investing in companies whose business it was to set aside contingency reserves on the grounds that "nobody gets reserving right." Rado stands by that dictum today.

The best insurance managers try to look several years into the future to get a sense of where the losses might come from and turn to software and computer models to help them.

Yet even for the brightest minds developing advanced loss reserving

techniques, finding how much to set aside for future losses remains devilishly frustrating. Loss reserving experts, after all, are being asked to fund an uncertainty.

Take, for example, the insurer who stashed away \$100,000 for commercial auto claims in 2001. Three years later, in 2004, a jury sympathetic to the plaintiff, who happens to be a war veteran, finds in favor of the veteran to the tune of \$1 million in the wake of an accident.

"In the interim, the country went to war, and that couldn't be foreseen in 2001," says Rado.

Loss reserving is a balancing act the industry has yet to master. Carriers that put aside too much in reserve run the risk of making inefficient use of corporate capital. "If the size of the reserve is too large, there's a big potential for problems," says Mark Jablonowski, a vice president with Conning Research & Consulting Inc. Managers who don't put aside enough run the risk of coming up short if a claim is unexpectedly large.

Setting aside the proper amount of reserves, let alone finding new, innovative ways to measure how much to put aside, isn't easy.

How are insurers supposed to know how much to reserve for claims from risks ranging from nanotechnologies to genetically modified crops to noroviruses?

With loss reserving having developed into such a finely tuned balancing act, the question is whether there's any room at all for innovation.

The answer is not much, according to several insurance experts interviewed for this article.

Loss reserving, adds David M. Siesko, former chief claims officer of Zurich Corporate Global, is an art and a science.

"It's the claims department's responsibility to evaluate a loss and place a dollar on the loss for what they think it's worth," he says. "Then our actuary friends have an opportunity to take historical data and add their incurred-but-not-reported items to that. Then they have the total loss projection."

Unfortunately, Siesko says, carriers very often fall short when it comes to seamless execution. Who can remember the last time the vice president of claims and the chief actuary sat down for an honest tête-à-tête in the corporate cafeteria on loss reserving strategies and innovative ways to calculate loss reserves?

## Appeasing A Threesome

Commercial buyers never close alone. There's always a carrier involved in any deal and almost always a broker. Closing a deal requires three lights, not one, turning green at the same time.

Lance Ewing, vice president of risk management for Las Vegas-based Harrah's Entertainment Inc., prefers the cooks-in-the-kitchen analogy. "Three cooks in the kitchen and they always have to create the same soufflé, but we all have different cookbooks," he says.

Before renewing a policy to cover the exposures associated with a multibillion-dollar corporation with 85,000 employees and far-flung holdings in the gambling and resort industries,

Ewing has to come to agreement with his primary brokers at Willis and Beecher Carlson.

A risk manager who pushes for a policy considered too cutting edge or innovative is likely to be reined in by his corporate higher-ups or the underwriter. Similarly, commission-based brokers with every incentive to craft forward-thinking policies and close a deal won't get their way unless buyers and underwriters sign off.

"There's always somebody that says, 'We'll give you coverage,' and then there's always somebody saying, 'Well, we have to control it,'" says Andrew Barile, president and CEO of Andrew Barile Consulting Corp.

And so the parties find themselves caught between the need to find new ways to cover risks, and the necessity for control.

It might help if the three parties found the time for a "full-blown meeting of the minds," yet that doesn't happen as often as one might think, says Ewing.

Every broker has a story about deals that fell apart. Sometimes buyers are to blame. "We in risk management don't know what we want," admits Ewing. "We lean on our partners with our broker saying here are our ideas. Then you've got the carrier out there dancing to its own music."

But how can commercial buyers be a driving force for innovation if they don't have a clear idea of where they want to go?

How can they truly innovate when so many deals, particularly the large complex ones, are the result of compromise and negotiation?

These are not unfair questions, and perhaps it's no accident that many initiatives considered by the industry to be innovative spring from sources other than buyers.

Ewing, for example, points to Joseph Plumeri, CEO of the London-based broker Willis Group, as a catalyst

for innovation in altering the terms of the buyer-broker relationship. "He's out on the edge and on the precipice."

"In the real estate business, it's the brokers who are trying to work with their clients and carriers to craft the coverage so that clients can meet a loan covenant required of their banks in the case of a dirty bomb exploding in New York City, for example," adds Jack Hampton, KPMG Professor of Business at St. Peter's College in Jersey City, N.J.

Buyers, particularly within the Fortune 500, are more familiar with the risk exposures of their corporations than the broker or the underwriter. In a perfect world buyers, backed by the resources of the corporation, should be the dominant party during any negotiation, Barile says.

"Innovation should come from a risk manager who says we need a policy to cover hurricane insurance without a flood exclusion, without a 72-hour clause," he says.

Yet that doesn't happen nearly enough. In a keynote address to carriers and brokers 15 years ago, Wayne Salen, risk manager for Labor Finders Inc., a Palm Beach Gardens, Fla.-based staffing firm, recalls telling his audience that the industry was its own worst enemy.

The inertia among buyers, brokers and underwriters with regard to policy innovation, policy issuance and claims turnaround was legion.

"We're the only industry that appears to say, 'Oh well, that's the status quo,'" he recalls telling the audience.

Salen understands that unlike toy manufacturers of plastic bobble heads, for example, the insurance industry is unique and its products and services are "not easily summarized." "It's more comparable to the legal industry, like contract law," he says. "They don't move fast either."

Even when buyers, brokers and underwriters agree on an innovative strategy to cover a risk, executing quickly

isn't always at the top of the agenda.

Real innovation in this kind of environment is hard work, says Kevin H. Kelley, chairman and CEO of Boston-based Lexington Insurance Co. "You can have great ideas, but you must build the right box around the exposure and then price it accordingly," he says. And then you've got to get everyone to agree.

## The Regulators

It was never easy for risk and insurance managers to innovate with 50 different rulemakers looking over their shoulders, and in the wake of new federal transparency laws, the number of rules with which risk managers have to deal is increasing.

With no reprieve in sight, the latest batch of rules is expected to further constrict the amount of wiggle room they have, at least in admitted markets.

"Today it's worse than ever because the regulatory process gets right into restructuring innovation," says Barile. "In the insurance company world today, they are battling with ratings organizations."

Price controls, in the form of fee schedules, make it difficult for carriers to raise premiums to cover personal and small commercial risks. In workers' compensation, the rate schedules dictate what carriers have to reimburse for workers injured on the job.

Carriers complain that they're hamstrung because they are not allowed to charge what the market will bear, and that prevents them from developing and selling products and services that accurately reflect the risk exposure.

Absurd examples abound: Truck drivers with abysmal records and covered by commercial inland marine policies are hit with minuscule premium increases; small businesses in strip malls built smack in the path of hurricanes are covered by generic property contracts that don't reflect the real danger of such a location.

In the workers' comp arena, carriers

find they are forced to continue paying a claim that might have been closed years before were it not for restrictive mandates of state-based workers' comp systems.

Adopting optional federal charter regulations, which have been under discussion for years, could loosen the shackles a bit. Fewer rules would lead to more innovation, adds Mike Dover, vice president of syndicated research with the Toronto-based consulting firm New Paradigm.

But are state insurance regulators and the laws they are required to enforce really to blame for hand cuffing industry initiatives?

To some extent, they are, says Jablonowski, a former risk manager with United Technologies. "Regulation is a little bit stodgy in this business," he says.

Many regulators, says Jablonowski, are using terms and vocabulary developed more than 60 years ago when the McCarran-Ferguson Act of 1945 allowed individual states to continue regulating insurers. As a result, the industry often finds itself staring at what he calls a "weird dichotomy."

"You're in the jet age but all of a sudden you put your visor on to look at Schedule P," he says.

Thus, the changes that have come about tend to be incremental, says the business professor Hampton, a former executive director of the Risk and Insurance Management Society Inc.

Absent an optional federal charter or other superceding federal law giving carriers more flexibility in the marketplace, buyers, brokers and their carriers had better learn to innovate within the confines of state rate-making bodies.

Because risks are local--a Coca-Cola bottling factory in Georgia, for example, isn't exposed to the same risks as a bottling plant in Wisconsin--regulating the management of these risks will likely maintain a local flavor, regardless of

whether it spurs innovation.

When it comes to regulation, the industry wants it both ways, says James Bisker, global insurance industry leader for IBM.

Carriers and brokers find it convenient to blame regulators for stifling innovation, while at the same time using regulation to protect their interests and maintain the status quo.

"The very things they complain about are the things they hide behind--50 state regulators, the European Union and insolvency--they tend to complain at the same time that they are taking advantage of it themselves," says Bisker.