RISK MANAGEMENT IN THE DECADE OF THE 1990'S

by P. Richard Hackenburg

I recently had the opportunity to read a presentation given by my chairman, Robert J. Buckley, to the Economic Institute for Pittsburgh Secondary Teachers of Social Studies. He relayed the following story:

An economist was asked to talk about the recession. She tacked up a big sheet of white paper. Then she made a black spot on the paper. She asked a man in the front row what he saw. The man replied, "A black spot."

The speaker asked every person the same question, and each replied, "A black spot."

Then, with calm and deliberate emphasis, the speaker said: "Yes, there is a little black spot, but none of you mentioned the <u>large white sheet of paper</u>. And <u>that's</u> my speech."

If we were confronted with that situation, we would liken that black spot to our current problems of financing the risks of the companies we represent, and the problems facing us in obtaining adequate insurance at reasonable prices. But, in fact, it is the white sheet that represents the social, political, and economic problems and opportunities that impact our abilities to perform effectively and efficiently. For these factors are the forces that will shape our future. I am here to talk about the large white sheet.

One takes great risks in playing the role of a prophet. Perhaps that is why the authors of <u>Future Shock</u> and <u>Megatrends</u>--Alvin Toffler and John Naisbitt--have made so much money. These gentlemen would probably dislike being called prophets, yet they became convinced that much truth lies in the old saying, "the bigger the risk; the bigger the reward." I am now going to disregard that old adage--"never risk a lot for a little." I am about to risk a lot.

The great physicist, Neils Bohr, once said, "It is impossible to forecast anything except the future." My high school history teacher also stated, "Should you ever be so foolish as to try to predict the future, you had best plant your feet firmly in the past and then stretch with all your heart and put your head in the clouds."

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Man by his very nature is a communal creature. Weak physically when compared to God's other creatures, man is endowed by God with the capacity to think, to reason, to make choices, to love, and to hate. Man's need to exercise these characteristics led to the formation of society, as man sought to structure an environment in which he could practice his uniqueness in relative security.

A body of laws was developed early and continues to develop today. These laws governing behavior were at first intuitive and unwritten, gradually becoming, over the millennia, the sophisticated rules by which societies and governments today interact. Every person in this room understands what happens when society fails to abide by these rules.

Thus man, by nature, is an insecure creature, suspicious of others. It is this negative motivation that has created both society's great achievements and some of society's worst moments. It is also the motivation that has created man's desire to know and understand risk, to evaluate its consequences, and to reduce it to acceptable levels wherever possible.

Risk, or uncertainty as to loss, if you will, is not bad by definition. Most endeavors contain an element of risk. The risk of failure often is the motivation for success; it also becomes the guardian against undertaking foolhardy adventures.

Society tends to advance more rapidly or slowly depending on the degree of risk taken, hand in hand with the prudent evaluation and minimization of risk where possible. Society can, on the other hand, destroy itself if concern over risk is ignored and no risk (i.e., nuclear war) is deemed significant to preclude action. By the same token, a society that becomes so adverse to taking risk will lose its entrepreneurial vitality, cease to dream, and ultimately perish.

We are today at a crossroads. One can look to the tremendous changes that have occurred in just the first five years of the 1980's and compare them to the Industrial Revolution. Startling--yes!!!--but even more unnerving is the fact that while 19th century man did not comprehend all of the dynamics of change that he was creating, he knew that the quality of life for himself and his children was improving. To be sure, he suffered doubt, and perhaps yearned for the familiar "good old days' when life was simple. Yet his confidence that there was something better for his children drove him to measure the risk, accept it, and move ahead.

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Can we say the same today? Unlike 100 years ago, we have the ability to destroy planet Earth, either rapidly by the bomb, or slowly through the contamination of the environment. Today, can we say that we continue to have confidence in our systems of laws and of governments? Today, can society truly measure the characteristics of risks, and once measured, does society have the ability to control these risks? Have we come to believe in the futility of risk control and decided that risk avoidance is the only answer? Perhaps our ability to instantly communicate and relay data and information has created a perception that no individual can conquer the risks. Stated another way--"paralysis by analysis"--with a loss of reliance on man's intuitive powers and understanding.

The differences between 1985 and 1885 are easy to catalogue:

* Rapidity and degree of change
* Instantaneous communications
* Volume of data and information
* Computerization
* Breakdown of confidence in systems
* Move toward risk adversity.

They are not, however, easy to understand. Coupled with the age old, unresolved problems of hunger, the "have's versus the have-not's," and man's basic mistrust, is it any wonder that during the week of June 17, 1985:

* TWA Flight 847 from Athens was hijacked and 39 persons were held captive in Beirut for 17 days after one murder
* A death bomb exploded in Frankfort's airport
* Bombs killed and maimed hundreds in Lebanon
* People were systematically machine gunned to death in El Salvador
* A bomb snuffed out over 300 lives in flight from Canada to India
* A bomb killed several people at Tokyo's airport and could have destroyed many more had it detonated in flight.

One week in June!!!

I have spent these few moments attempting to highlight the problems we face. We can only solve problems if we willingly identify and come to understand the parameters presented by these problems. Then and only then are solutions possible.

I am by nature positively motivated and I firmly believe we can find solutions. Some of the factors contributing to the magnitude of our problems are also the "seeds," if you will, for solutions.

Time dictates that I center my discussion around economic issues impacting our discipline, and that is what I intend to do.

How many times have we heard it said that the world is becoming smaller? We all know this to be a fact. I will use the term "globalization" to characterize this phenomenon.

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At my company, we view the world as our marketplace. We make decisions and produce products that will have utilitarian benefits not only in North America, but in Europe, South America, the Far East, and elsewhere. We have come to believe that global needs are similar and the company that globalizes and meets those needs on an openly competitive basis will survive, grow, and prosper.

Globalization stimulates innovation in both products and services and binds societies together in cooperative ventures, despite inherent national differences and prerogatives.

Globalization fosters improved communications and sharing of information for the common good. It provides, through competition, for the more efficient allocation of capital to produce goods and services. Globalization is a major key to solving a number of the economic problems of emerging countries and lesser developed economies.

Most of us have some awareness of the interdependency of the world's economies. This was graphically illustrated by the world energy crisis in the mid-seventies. More recently, we have become aware of the impact on the world economy of the debtor nations' problems and the influence this has on the world's financial institutions and monetary rates.

All in this room understand the impact that the inflated U.S. dollar had on trade and trade balances early this year. We are even more keenly aware of the impact that the strong dollar has had on world insurance capacity. The strong dollar impacted amounts of insurance that could be underwritten against shrinking capital bases of world reinsurance and retrocessionnaire markets, already eroded by three years of disastrous underwriting results.

Almost daily we hear of company mergers. This "urge to merge" is not just fostered by vertical or horizontal integration in particular industries, but is fostered by the changing world environment. Basic industrial production has shifted to emerging third world countries, with the mature economies moving toward the high tech and service sectors in order to effectively compete on a globalized basis.

In our financially-based discipline of risk management, we have become familiar with the term "convergence" or the integration of various financial products and services. We are aware of the pressures to employ scarce capital in areas that produce the highest return. Those pressures are moving banks into non-bank related service areas. We see insurance companies merging and offering non-insurance-based services such as securities and investment management. Sears, Roebuck and American Express, for example, are either buying into or starting enterprises in investment banking, securities trading, insurance, real estate, etc. And picture, if you will, the day that a communications company, such as AT&T, which has already faced a merger of markets with IBM, either acquires or coordinates with one or more of the computer giants, the banking industry, the securities industry, the real estate industry and the insurance industry to deliver financial services in a complete package right into the office or home.

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Remember, AT&T is already wired into most homes and offices in the world. Imagine sitting in front of your television set and being able to view, analyze, and select alternative financial services, and transfer funds to pay for them. Industrial companies are also viewing this trend and rapidly entering the financial services marketplace as well.

If all of these changes are taking place, and I assure you they are, it is more understandable why globalization is important and why nations must act responsibly relative to free and open market access and competition. Protectionism defeats growth; it preserves a few for a short period, but ultimately leads to stagnation and greater and greater upheavals.

One might reasonably ask at this point if success will only be achieved through sheer size. Let me hasten to say that this is not the case. The entrepreneurial spirit will enjoy a resurgence in the next 10 years as new ideas, backed by fresh capital, are used to concentrate on efficient production techniques and research to develop new goods and services.

Products will no longer just be manufactured by super large companies in super large factories. Through the use of computer-based data systems, information and procedures will be available to even the smallest of companies. These companies will be able to react to market trends and compete effectively even with the large companies who themselves will decentralize into smaller units to increase productivity and use their resources more efficiently.

The impact that all of these changes will have on risk management may or may not be readily apparent. Let's look into our crystal ball.

A year or so ago Felix Kloman, who will also speak at this conference, was assigned the same topic I have today. I was tempted to copy his paper, with or without permission, and consider the job done.

Ultimately, I decided this would not be wise, as Felix delivered his paper in London, and many of you would recognize it. Also, Felix's conclusions were used by CIGNA in a Delphi study and being copied once is enough.

Felix related how, in 1971, he predicted that risk management would break away from its dependency on the insurance industry. He allowed that by 1984 this had not happened and did not appear likely to happen. He then went on to say that the mere desire on his part for this to happen would not, in fact, guarantee its occurrence.

I would suggest to you, and to Felix, that this break is now in fact starting to happen; not because Felix wanted it or because you and I may want it, but because the insurance industry, whether or not it wants it or is willing to admit it, may need the break to survive. The degree of this break is worth forecasting, as are its reasons.

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The insurance industry has historically been cyclical in nature and market driven in its operations. By no means is this bad. In fact, until the last ten years "the market" has served industry and the consumer well.

We have, however, faced a series of events in the last ten years that were unprecedented.

First, major portions of our societies have come to expect or believe they are entitled to redress for every loss or risk assumed in life, no matter how small. The advent of government social security systems in the western world may have been just the trigger for this theory of entitlement, but the growth beyond original intent is unquestionable.

Second, we have come to realize that we can no longer expect to live a quality life if we continue to pollute the environment and destroy our natural resources. A concerted effort is underway to change our production processes to stop this pollution in the future. But even more important is the effort to correct the damage already done. The salient questions here are how fast can this clean-up be accomplished and who will pay for it. Does industry shoulder the burden, or does the consumer or taxpayer who ultimately received the benefit of industry's products, shoulder the burden?

Third, society has become very litigious, particularly in North America which represents 50% of the world consumption of insurance. Too many lawyers chasing too few clients for contingency fees have certainly added to the problem. But again, society has come to expect "no risk" in their daily lives, and when confronted with risks and losses, they demand not only payment for losses but monetary gains in the form of punitive damages.

Courts have been too willing to agree, and have altered the civil justice system to the point where analysis of risk in producing a product is difficult at best and, in some cases, impossible. Yet demand still exists for new products and services, the impact of which, in the pharmaceutical industry, for example, will not be known for twenty years.

Insurers, faced with this situation have, and incorrectly in my opinion, simply surrendered and have started to devise insurance contracts that do not insure. They seem to indicate that to do otherwise, subjects them to the courts which misconstrue the contract language and bastardize the intent of the parties to the contract. In this context, one would question whether any industry is insurable. And one could also come to the conclusion that taking risks and hence advancing society is no longer a responsible activity.

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Hence, the insurance industry is in more trouble than just its past three years of poor underwriting results would measure. At a time when rates are up and the chance for returning to profitability looks reasonable, underwriters are ceasing to write business. At a time when business should be put on the books, the artificial limitations of surplus to premium restrictions seem to be arbitrary and self restricting. At a time when reinsurers seem to be getting reasonable changes imposed on the direct markets, they also commence to make unreasonable demands. What does all of this mean? Perhaps the insurance industry lacks quality management or, at the least, not enough good management.

Lastly, the drive to achieve quarter-to-quarter profits has left the insurance industry in a position where its ability to handle catastrophic losses is certainly in doubt. Further, I know in my country, the Federal Government is considering the imposition of a tax structure that would make setting aside catastrophe reserves unattractive.

We are, therefore, confronted with:

1. Insurer management that is abdicating its risk taking role.

2. A lack of skilled underwriters.

3. The inability to define and rate risks.

4. The inability of insurers to assume risk due to premium to surplus ratio restrictions.

5. An insurance and financial services delivery system that is going through a revolutionary change.

6. The inability of business to obtain necessary services, either through the mechanism of insurance or on an unbundled basis, and

7. Consumers of products and services who are not willing to recognize that it is they who will ultimately pay for frivolous and unjustified claims.

This leads me to conclude that what the insurance industry is facing is an irrevocable loss of market share. It is part of the problem, not part of the solution.

Solutions are not simplistic and one dimensional. I would like to suggest that risk management alone would solve some of these problems. I cannot, however, be an underwriter who simply "lazer" excludes the long-term latent disease exposure from the contract, and then goes home, having satisfied myself that I have saved millions.

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Part of the solution is, as I have said, underway with the growth and dissemination of data and knowledge on a broad-based scale. Part of the solution rests with legislative reform in the area of tort liability; and a more pragmatic approach to the hundred billion U.S. dollar plus clean up of the environment. Part of the solution comes with the battle to make our government and social systems solvent by putting them back on the track of helping people instead of bankrupting them. Finally, part of the solution comes from business and industry picking up the gauntlet and accepting the responsibility for controlling and financing risks and equitably passing those costs on to the consumer. This is where risk management enters the picture.

In the last five years, risk managers have concentrated on acquiring the financial skills necessary to fund loss. Strong motivation to acquire these skills was provided by the hard market of the mid-seventies and will serve risk managers well in the current hard market.

Attention has been paid to the impact of funds flow, both before and after tax, pre- and post-loss financing techniques, and a variety of self insurance and captive insurance company schemes.

At the same time, the risk manager was learning the necessity of gaining control over his risk data and computerizing that data as the only viable way to manipulate large quantities of information in order to determine the lowest net cost of alternative financing schemes.

With these new found skills the risk manager must turn his attention and newly acquired computer skills back to the basic concepts of risk management.

Specifically, the next ten years will require the risk manager to once again be most concerned with the identification and analysis of risk and its impact on his organization. Less use of insurance as a transfer technique will exist. The risk manager, working closely with management at the most senior levels, will have to concentrate on controlling and minimizing risk.

The risk manager position will be a senior level position within the organization and the risk manager, more so than today, will require a broadly based education, not only in finance, but in the humanities, sciences, and law. To be certain, a complete knowledge of finance will be mandatory, but unless a generalist background is obtained, the risk manager will find difficult times ahead.

With the aid of the computer, the risk manager will find an important role in the planning process of the organization. Input will be sought, not only for short term and contingency plans, but also within the context of the organization's strategic planning efforts.

Through this ability to capitalize on computerized risk data bases, the risk manager will also become an active participant in formulating business decisions relating to speculative areas in lieu of concentrating solely in the pure risk arena.

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With the advent of risk control and minimization regaining top priority in the risk management process, we are assured that there will be no slowdown in the development of financing schemes. For the unwillingness or inability of the insurance industry to respond to modern technology dictates that industry will have to self fund much of its own losses as the historic transfer mechanisms breakdown for long-tail liability exposures.

More cooperative risk pooling ventures will arise and will be less subject to the cyclicality of the insurance industry due primarily to improved managerial capability. Captive insurance companies will continue to play an important role in funding static losses that can be actuarially projected to the 95% confidence level.

But storm clouds loom on the horizon for non-predictable risks of a catastrophic nature. New entrants into the risk funding business, such as banks, are risk adverse by definition. Like the insurance industry, they do not have the tools to measure, for example, the impact of an earthquake occurring in California. Setting aside reasonable reserves is also a critical part of this problem. Perhaps, as a last resort, governments, on behalf of society as a whole, will be called upon to step in. The precedent is clearly there, but is a poor second choice to private enterprise. Ten years may be too short a time to determine how to cope with the magnitude of this dilemma. Undoubtedly, this will be debated for years to come.

Having approached the role of government, it is clear that risk managers in the next ten years must be politically far more active. Risk management may well be more greatly impacted by events in the capitols of our countries than by the events in the capital markets.

The ability of risk managers to influence proposed legislation, bring reality to funding environmental clean-up, effectively urge de-regulation of financial services, and promote tax and accounting equity for alternative risk funding and captive insurance schemes, will have tremendous impact in the next ten years.

To accomplish this gain in influence and power, and yes, power is the right word, risk managers will have to strengthen their networking with each other on a global basis. Trade associations, such as RIMS and AEAI, and the International Federation, will play an increasing role in gaining that power. So will conferences of the kind we are having today.

Risk managers in the 1990's will have to become great communicators to assist others in understanding risks, their impact on an organization, how they may be controlled and how residual, non-quantifiable risks may be financed properly. Perhaps when risk managers are no longer shackled with the "jingo" of insurance terms, we will be better prepared to relate in general management terms.

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In conclusion, I believe that if we maintain our entrepreneurial spirit, lose our fear of accepting risk on a prudent and knowledgeable basis, and plan our action with global vision, we will succeed.

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