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RISK MANAGEMENT FORUM 1991

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INTERVENTIONS

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1 The future of international industrial insurance

It will no longer be possible for the insurance industry to offset the losses suffered by industrial insurance against the profit from personal lines or other classes of business, the reasons being tougher competition and falling profit margins in personal lines business within the EC. Industrial portfolios will have to be self-sufficient. This means that, if the loss burden can not be reduced by means of loss control, it will be necessary to apply higher deductibles and premiums or turn increasingly to alternative methods of dealing with risk.

The possibilities of minimising losses with justifiable economic expenditure have by no means been entirely exhausted. The public is more receptive to aspects of safety after large losses and catastrophes have been analysed in the media and not rarely this develops in the direction of a genuine hostility towards the industry. At the same time the government implements more and more safety regulations, leading to a distinct danger that the economy becomes entangled in red tape. Industry will have to take a more active role in public discussion to dispel misconceptions of risk-free prosperity or the accepted "remaining risk element".

The growing complexity of the risk situation of major international industrial firms places considerable demands on the know-how of the industrial insurer. There are relatively few major insurers and reinsurers with the specialised know-how that is called for.

Captives will play an increasing role evolving from tax and financing vehicles to significant risk carriers.

Medium-sized and small industrial enterprises will continue in future to be served by a large number of predominantly national insurance companies, provided these succeed in acquiring the know-how needed in risk analysis and loss control.

Within the EC, cross-border activity and intensified international competition of insurance in industrial business will be based more on the freedom of settlement than on the freedom of services. It is not possible to conduct industrial business from a distance; the insurer to be physically present close to the client.

The relation between insurers and their industrial clients will intensify even more. This is in the interest of both parties and helps to overcome capacity bottlenecks. It is also assumed and hoped that the relationship will acquire a more permanent footing. Qualified brokers and reinsurers will be included in these contacts. Chopping and changing insurers at frequent intervals is detrimental to industrial companies in view of the time needed for a new insurer to become acquainted with a complex industrial risk before he can be of any use to the company in discussing risks.

Competition among industrial insurers will therefore primarily take place in the service sector. There are hardly likely to be the radical differences in the risk premium sector that occasionally occurred in the past.

The limits of insurability cannot be extended by applying conventional insurance techniques alone but by additional methods of risk financing, insurance and reinsurance covers running for fixed periods of several years and clearly defined limitation of the liability in terms of amount and duration. Insurance will have to see to it that the limits of insurability do not come too much under the strain of intense competition (entrepreneurial risk in the narrow sense, political risk).

The disastrous state of U.S. Liability insurance will not change overnight. It has no place in the economic future of a developed industrial nation; it hinders innovation and curbs the readiness of enterprises, the professions and individuals to take risk. What is more, it is asocial and leads to a problematic redistribution of income.

Although liability in Europe is increasingly moving in the direction of strict liability and higher awards are being made in the name of "social" justice, there need hardly be any fear that other particularly dubious elements of the U.S. liability system (punitive damages, contingency fees, lay judges who determine the liability amount and the award) will be adopted here.

The growing stringency of liability laws in Europe is also in keeping with a definite social pattern and increasingly poses problems for the economy. More often such legal developments are unrealistic since they fail to acknowledge where the funds are coming from to finance the consequences.

In complex industrial insurance in particular, it is true to say that, no matter how refined its methods are, reinsurance is unable to rectify conceptional errors made at the root in direct insurance (this also applies to captives). Industrial companies, brokers, insurers and reinsurers will need to cooperate more closely in the sector of industrial risks.

Limits of the traditional insurance markets or alternative risk financing products

I do not intend to present you with any patent solutions but concentrate instead on the current position as I feel that this basis could indicate the approach to be taken and initiate innovation in risk financing.

In industrial insurance (Property, Business Interruption, Liability) carriers have been hit in the past few years by a growing number of large and catastrophic losses and rising losses have been suffered in that sector. These were in addition to heavy burdens from natural catastrophes which have gnawed their way into the insurance industry's reserves.

To a certain extent, the poor results in industrial insurance and - more so - in reinsurance are the consequence of excessive competition among insurers causing the premium level to slump, rendering impossible the indispensable formation of catastrophe reserves. Urgent adjustments are called for. Only if premiums keep pace with rising losses and increasing loss potential, will insurance be able to comply with industry's requirement for higher capacity.

The traditional mechanism of distributing risk in insurance (insurance, coinsurance, reinsurance, retrocession) no longer meets current requirements in all respects. Although it has brought about the necessary breakdown of large risks, it repeatedly gives rise to irritations and serious difficulties, which include inadequate risk information on the part of certain links in the risk chain, lack of clarity as to the material and temporal scope of cover, delays in the payment of premiums and losses and solvency problems, particularly in the case of the final links in the chain. Here too, adjustments aimed at more transparency and professionalism are needed and are underway.

It is also apparent that too much is being expected of conventional insurance technique, particularly with regard to a number of industrial risks that are difficult to quantify. The mutual dependence of economic, technical, social, legal and political developments has reached a level of dynamism at which the effect it has on loss experience is very difficult to predict. This is particularly acute in the case of industrial liability. Such risks include, for example:

- product and work performance guarantees
- environmental risks (in particular old loss burdens)
- product liability risks (especially in the U.S.)
- product recall risks.

but also certain professional liability risks (D & O) and political risk in export credit insurance.

Here we have quite obviously reached the limits of insurability. These limits are gradual within quite a substantial bandspread and can be pushed back with the aid of progressive methods of risk analysis and appropriate risk control measures. With this in mind, industrial insurers and reinsurers are in the process of augmenting further their know-how in cooperation with industry. Capacity problems mainly arise when industry requires very high capacity in risk sectors where the prerequisites are insufficiently met, if at all.

Industrial insurers have been able to satisfy a large part of industry's cover requirements by combining traditional insurance on the basis of professional risk analysis and risk control measures with other elements of risk financing. Today large scale industry bears itself a substantial portion of the risks formerly transferred to insurance and reinsurance. This is in addition to the specific branch-related - and clearly uninsurable - entrepreneurial risk and is effected by means of self insurance, captives and risk pooling arrangements.

While insurance reaches the limits of insurability in industrial business, the limits of transferability of risks become apparent for industry. When the liability of industry is extended by new environmental impairment laws - as in the case of Germany - to include existing burdens from the past and the insurance industry is unable to provide any cover for the reasons I mentioned earlier, this does indeed raise the question as to where industry is to find the funds needed to cover very large risks that cannot be determined as regards extent and time. The high costs incurred in connection with the clean-up of waste deposit sites in the United States do not bode well for the situation in Europe.

Consequently there is an entire series of loss situations which overtax both insurance and industry. It is neither ethically justified nor economically possible to expect them to bear past environmental burdens.

So far technical progress has brought industrialised countries prosperity and a high living standard and the fruits are being consumed by our generation. For quite some time due attention has not always been given to risks and safety aspects during phases of turbulent progress. This was not only through negligence or thoughtlessness, but mostly through the lack of research findings and safety and liability standards which might have helped to restrain a development not sufficiently under control in terms of security. In this respect today's generation has lost its innocence and is condemned to finding solutions. What is needed is a sense of responsibility involving all circles of national economies and societies and spanning generations. Investments in environmental protection are often not susceptible to short-term profitability analysis. We are being called on to pay the price for the prosperity we have hitherto enjoyed "on credit".

"We" in this case is not meant as current industry or insurance alone. All who profit from a high standard of living - the public, the state, the tax payer - have to contribute to solving this collective, generation-spanning problem. Insurance and industry must, however, also raise their voice to prevent increasingly stringent norms from being implemented, when their economic consequences have not been thoroughly considered.

The situation in the United States plainly demonstrates the fatal consequences of outdated legal norms and court practices which, moreover, interest groups abuse to their own advantage. Contrary to our hopes and expectations there have hardly been any noticeable signs of improvement, although the paralysis of the readiness to take risk and be innovative has taken on alarming proportions in American industry and in many liberal professions. The only glimmer of hope on the horizon is the courageous stance taken by Vice President Quayle a few weeks ago. Addressing the American Bar Association, he grabbed the bull by the horns and called for reforms.

Industry and insurance are sitting in the same boat. The more intensively they tackle the problems in close collaboration and engage the authorities, technology, the general public and the media in their risk dialogue, the better their prospects of success will be. Competitive interests will have to take a back seat to those of the entire economy and society, as the significance of the solution transcends borders and generations.

5 What roles do insurance and industry play with regard to the postulates of the affluent society

Industry and insurance, both major exponents of private economy, are equally susceptible to compelling social trends predominantly visible in highly industrialised social market economies. In this connection we are a target in the demands repeatedly heard for more security, quality of

life, protection of the environment and care in handling natural resources.

The extensive efforts of industry and industrial insurers in the sector of loss control present a perfect answer to these postulates, but they do not suffice. We have to talk more openly about them.

Grave problems arise for both sectors of the economy whenever such demands are made in a blinkered, boundless, unrealistic and one-sided fashion and lead to hysteria or even hostility towards the economy. This danger exists and is fostered when today's litigation-happy society is made more aware of it, for example when media reporting shows only one side. Such a development would end in the distorted image of a society split into two groups: on one side we have the group of producers, the economy, the companies which see to it that elaborate products and services are available and which are expected to be innovative, which safeguard full employment and enhance prosperity as well as bear full responsibility for errors. On the other we have the organised consumers, the general public which enjoy low prices, security, progress and prosperity and hold the economy liable for any restriction of its quality of life.

This distorted image is of course exaggerated. It would appear to me, however, to be necessary that industry and insurance pursue a common policy of moderation and realism in the public discussion of these issues in the media and also with regard to science and the authorities. This would involve the following topics, for example:

- the illusion of a risk-free society
- what does acceptable remaining risk mean?
- economic limits of loss control in the enterprise
- repercussion of state loss control and liability norms (e.g. strict liability) on prices and services, on employment, prosperity and growth.

I am well aware that this risk dialogue will be fraught with difficulty. The topics are complex and are not popular in that they could demonstrate to the legislator and the public the consequences of excessive safety-mindedness and the limits to growth and prosperity, topics which are gladly pushed to one side. The connections can also be termed more provocatively. If the call for safety and loss control, supported by safety and liability norms lose that degree of moderation, the outcome would be undue pressure on the economy leading to negative consequences for employment, innovation, growth and prosperity.

According to "Managing Environmental Affairs", investment analysts predict a rise in environmental management systems expenditure in Western Europe from 60 billion ecu to 180 billion ecu over the next decade. Although 90% of European companies support their countries' environmental standards, they have serious reservations regarding:

- their high complexity
- their extremely high cost
- the still differing standards from country to country
- the overlapping and sometimes conflicting rules governing the same waste

and regarding the fact that scientific and technical evidence is too frequently subordinated to political "hype".

A risk dialogue should be borne on the basis of a common philosophy of industry and insurance. The prerequisites could be created by closer contacts between the two during which the basic issues of handling risk from an underwriting, financial and social point of view could be discussed with absolute openness and joint action initiated.