RISK MANAGEMENT FORUM

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Please respond to

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1992 : AN OVERVIEW OF DEVELOPMENTS TOWARDS EC LIBERIZATION

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SLIDE 1

Ladies and Gentlemen

Bonjour
Guten Tag
Good morning

You have heard from my colleagues this morning/about the legislative/and political forces/driving harmonisation in the EC// the wider financial implications/and how each country/is approaching the age of freedom of services.//

I would like to move away/from the changes relating to conventional insurance/and focus on one broad area//that of risk management/including risk financing techniques.// I would like to look at the background;// why I believe there will be developments in this area;// what those developments might be// and the practical implications/for insurance brokers/in meeting their clients changing needs.//

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My reasons for concentrating on risk management are//

1. With apologies to the underwriters/and brokers this morning//I would like to address my remarks/to the risk managers of large organisations/where risk management is fundamental/to the protection of assets/and potential liabilities.//

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2. Your companies will change/through Merger and Acquisition/into even larger units/creating larger risks/and increased opportunities/for risk management and self financing.//

3. The speed of development of risk management techniques/will continue to increase despite/or because of the increased capacity/and competitiveness of conventional markets.//

4. The need to reduce insurance costs,/ensure a measure of stability in premiums/and minimise the problems presented to buyers/by a volatile market.//

A number of eminent speakers at RIMS in Atlanta this year referred to the changes that will take place in risk management techniques and risk financing methods after 1990.

Our Chairman this morning David Ovenden predicted that "there will be a rapid growth in risk management techniques". He went on to say that "the role of the risk manager currently is virtually unknown" in many of the less developed European countries. In the opinion of Eddy Hester of the Zurich, "there is likely to be a significant trend to self insurance and alternative risk financing, particularly on the part of larger companies".

He added that interest in risk analysis and loss control "is likely to increase as a result of greater concentration of risk as industry consolidates in the European Community".

Increasing use of technology and more complex operations will require greater risk management. The European Community directives imposing strict liability for products and pollution together with the trend towards self insurance will lead to a greater awareness of exposures and a desire to take steps to eliminate or reduce risks.

There is therefore scope for the development of risk management techniques in Europe and we can look for changes in the wider EC such as we have experienced in the UK which in turn came to us from North America.

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You will be aware of the processes involved/from risk identification and evaluation/to retention,/avoidance,/reduction,/control/and transfer but to what extent have you received advice from your professional advisors/on how to apply these processes.//Do you agree/that there is room for improvement/not just in assessing your risk/but in reducing your risk/and your cost of risk?//

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Perhaps an easy example/is in the property and business interruption areas/starting with construction of the premises,/handling and storage of materials,/particularly finished goods,/fire protection/and separation.//What is the position on spares for key items of manufacturing plant,/dual sourcing of supplies/and standby computer facilities?//

Have incidents involving injury to employees/been recorded and analysed/to see if there is a common cause that can be reduced?//Have the financial implications of these injuries been analysed?//A similar situation applies to motor vehicles.//

What are the quality control procedures in the manufacturing process,/product description,/instruction for use/and labelling?//

Do you have a disaster plan in being/so that in the event of a serious incident/senior management is aware of the action that needs to be taken/to minimise the financial effect of the incident on sales/and profitability?// Have the insurance implications of acquisition been fully identified,/evaluated/and dealt with?//

A detailed statistical analysis of premiums and claims/over a period of years/particularly in the liability area/provides essential background/to enable risk managers to make informed decisions about their insurance programmes.//

Let us move now/from matters directly related to the basic insurance areas of property/and liability/to a broader area.//

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Health & Safety legislation has had its effect/particularly in the area of major hazards.//The EEC requirements are set out in the Seveso Directive/and put into practice in the UK/under the regulations controlling industrial major accidents and hazards.// Most major European Community members/are also well advanced/in meeting the Seveso requirements.//

Similarly in the area of safety/Section 118A of the Single Europe Act/requires that/"member states shall pay particular attention/to encouraging improvements/especially in the working environment/as regards the health and safety of workers".//

The draft safety framework directive/must be complied with by member states by 31st December 1992.//

Additional directives have also been drafted/or are being drafted/dealing with//

Machinery Safety
Personal Protective Equipment
Heavy Loads
Minimum Workplace Standards
Visual Display Units

Other proposals require a watching brief/such as a draft product safety directive/designed to supplement the products liability directive/and a draft directive on safety in services/providing legal recourse in cases where death or injury/is caused by a service/rather than a product.//

The transport and disposal of hazardous waste/and the major accident hazards of industrial plant/cause great concern to responsible governments and companies.//

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Some examples of major/environmentally damaging events include/

Alaska Oil Spill
Bhopal
Chernobyl
Piper Alpha
Pollution of the Rhine

Public opinion and re-action is such/that industrial companies that mismanage/or fail to manage/their environmental affairs/ can expect it to impact directly/on their sales and profits.//

The European Community/has been active in creating a legislative framework for environmental risk management.// The Council of the European Community/laid out the basis of environmental policy/as long ago as 1973.//Since then there have been approximately 300 EC directives/with an action plan for the period 1987-1992/addressing the key issues of//

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Air Quality
Water Quality
Worker Exposure
Waste Management
Contaminated Land

Industry must be aware of its obligations/and endorse good environmental practice/because the implications of environmental irresponsibility/will be felt increasingly/in the profit and loss account/and on the balance sheet.//

I acknowledge that certain countries in the EC/are more advanced than others/in the application of Risk Management techniques./ Nevertheless/the UK/which is regarded as a sophisticated insurance market/has seen substantial changes in the area of risk management/particularly over the last 5 years/ many of which have come from the United States.// I submit/ that in the medium term/these developments will begin to be seen in the wider European Community/and the legislation I have been referring to,/embraces areas that you/as risk managers/must be able to address.//

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Why have we seen these developments in UK?// Why have needs changed/or why does the client feel/they are not met by conventional insurance?//

Obviously the Health and Safety aspect comes from European and national legislation.// Areas of changing insurance risk come from the growth of industrial units.// Recent examples include/ the merger of Carnaud and Metal Box/GEC Siemens and Plessey/and the discussions between British Aerospace, Thomson and Ferranti.// To supply a domestic market of 320 million consumers/as well as meet competition from the U.S. and Far East/our own manufacturing companies/must achieve a critical mass/that produces goods at the right price/in the best locations/generating good cash flow/to provide working capital/ and fund research and development.//

A situation that can be used as an example/is that in North America/[redacted] there are four companies engaged in the manufacture of farm tractors.// Europe has 50 companies engaged in the manufacture of farm tractors.// What do you think will happen to those 50 companies?//

Many of our industrial companies will therefore grow larger with a consequent increase in risk calling for a modern approach to risk management.

The requirement and expectations of the insurance buyer of a medium sized industrial or commercial concern are different to those of the insurance buyer of a very large industrial or commercial concern.

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This then brings us to another very important question. We need to examine the ability of the conventional insurance market to meet satisfactorily the needs of the major buyer. One purpose of insurance is to have a known cost - the premium - to replace the unknown cost - the claims. We saw in the hard liability market of 1985/86 premium increases of 300 and 400% coupled with severely reduced limits and restrictions in cover. Indeed for some exposures no cover was available at any price in some of our markets.

It was to overcome these particular problems that M & M and others established ACE and XL to fill this gap in the catastrophe liability market.

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As an example of market performance the next two slides show how in a relatively short period of time between 1983 and 1985 underwriting losses increased dramatically in both the U.S. and U.K. This led quickly to the severe hardening in the market and shows why I believe that lack of market stability is an important factor for Risk Managers to take into consideration in planning their medium and long term strategy.

We saw just two weeks ago a general increase in interest rates throughout industrial Europe. Will this encourage insurance companies to underwrite for premium volume to generate investment income? Will that strategy be followed when interest rates fall or will there be a reduction in capacity leading to a hardening market?

The freedom of services legislation increases competition, which is one reason for its existence, competition encourages a volatile market and we know that the premium and capacity cycles are of relatively short duration adding to the problems of the risk manager and insurance buyer.

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My main thrust therefore/in the practical implications of 1992/is to look at the potential development of captive insurance companies/for the reasons of/

1. Increase in the size of industrial companies/leading to increased risk/but greater ability to bear risk themselves.//

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2. The possible volatility of market/with more capacity needing to become more competitive.//

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It is for these reasons/that the medium and long term change I envisage for the very large buyer/is the development of alternative means of financing risk/particularly through a captive insurance company.//I wanted to start this paper/by referring to the basic disciplines of risk management because/when an industrial company starts to share its risk bearing/rather than transfer to the conventional market/it becomes more important/for local management at operating company level/to become involved in the application of these disciplines.//

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The advantages of a captive include/

1. The ability to retain underwriting/and investment profit.

2. Direct access to the professional reinsurance market.

3. The provision of capacity for "uninsurable risks".

4. The ability to stabilise insurance costs and capacity.

5. A facility to fund at group level/losses that would severely impact the results of an individual company.//

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The first step in assessing the feasibility of a captive/is to determine the financial level of self insurance that the company is comfortable with.//Much depends on the philosophy of the company/and its approach to risk/but there are certain financial criteria that can be used to reach a starting point./ This involves computer modelling/to relate the level of self insurance to//

Working Capital
Total Assets
Sales
Cash Flow
Earnings per share

The ultimate decision must rest with the management of the company since they are the ones who determine philosophy and will be aware of factors affecting the financial status of the company which are not necessarily available from published information.

Clearly the claims experience over a period of years needs to be carefully analysed. Historic claims records need to be updated to represent present day values. This claims experience must then be further analysed into

Average Claims	-	Average Historic Claims Experience
High Claims	-	Worst Historic Claims Experience
Catastrophe Claims	-	Worst possible loss in the first year of operation of the captive.

We can then use a financial model to produce anticipated

Underwriting Accounts
Profit and Loss Account
Balance Sheet

If it is decided that a captive insurance company <u>is</u> feasible/ there are various ways for the captive to participate in the parent company's business.//

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Co-Insurance	-	The <u>advantages</u> are that/ underwriting,/claims and documentation/are handled by insurers//
Reinsurance	-	Legislation can prohibit <u>unlicensed</u> insurers/but an approved multinational company/can write the business locally and reinsure to the captive//
Deductible Funding	-	This is usually not economic and <u>can</u> create tax difficulties//

A captive insurance company can become involved in three broad areas of insurance

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Group Related Business – This is self explanatory and the most suitable class of insurance is property including crime and marine. More captives are writing liability insurance but there are obvious problems if this is of a long tail nature

Reinsurance Risk Pooling – Whereby the company participates in a reinsurance pool for other captives on the basis that risk management techniques will be applied resulting in profitable business. There is however always the danger of a major loss

Non Parent Business – We do not recommend this approach because there is loss of control on the risks offered which defeats the primary objective of establishing a captive in the first place.

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The location of a captive is of primary importance/and there has been considerable activity in the European Community in this area.//

Luxembourg	Now has 91 reinsurance captives/taking advantage of the ten year/tax deferment legislation//
Dublin	Decided in 1986/to promote a major international financial services centre/with a tax rate of only 10% until the year 2000/ approved by the European Commission.// Direct and reinsurance companies are allowed./
	Bowring/amongst others/are operating as a captive management company there.//
Denmark	Has a similar situation to Luxembourg/and is attempting to attract non-EC/ Scandinavian business//
Guernsey	Whilst not a full member of the EC/has 170 captives/offers 20% tax on investment income/and tax deferment on long tail business//
Isle of Man	Again not a full member of the EC/but with 64 captives/(20% with European parents/ with zero tax on exempt insurance companies)//

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Currently/74% of the top 100 UK companies own a captive/and of the top 200 Uk companies/64% own a captive.// Whilst there is unlikely to be a significant growth in those numbers/ as a consequence of 1990,/there could be a move to relocate the captive companies/to domiciles within the European Community.//

For the reasons I outlined earlier of/growth in the size of industrial companies/and the need to establish stability in cover and premium/I anticipate growth in the number of captives.// I think this will be particularly true of German companies/who already operate in a sophisticated insurance market/conversant with international practice.//

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Having outlined the reasons for the growth of risk management/ and alternative risk financing/in the European Community/I would like to return to the sub-title/our Chairman this morning/ gave me when we discussed this paper originally.//

The practical implications of 1992 for insurance brokers//

Meeting the needs of their clients/
- How will brokers respond//

Let me explain how Marsh & McLennan Bowring and Bowring London Ltd./have already responded to meet these changes.//

Marsh McLennan Bowring/was established with headquarters in London/to have responsibility for direct insurance broking activities in Europe/as well as the Middle East,/Africa/and Pacific Basin./

Marsh McLennan Bowring is represented in all the member states/with offices 100% owned in eight countries,/affiliate companies in 3/and a correspondent of long standing in 1 country.//

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Bowring London Ltd. is the principal office in the UK / specialising in major multinational accounts / with specialist departments / dealing with the main classes of insurance / property, / casualty and motor. //

In addition / the company has a risk management division / staffed by qualified specialists in

Hazard Analysis
Health and Safety
Property Loss Control
and Risk Financing

Our sister company / Clayton / has 70 scientists in the UK / working on all aspects of the environmental issues / which are becoming more important in our green society. //

In addition / as a worldwide resource / Marsh & McLennan has some 700 engineers / working in the area of risk management. //

We work closely from London / with our colleagues in Europe / to supplement their own resources in these specialist areas / and it can be quicker and easier / to travel to Paris, / Brussels and Frankfurt / than it is to get to Birmingham, / Manchester or Glasgow. //

I have no doubt/that the other major international brokers/are also establishing/or have established/some resources in these fields./

The complex nature of industry,/the impact of national and European legislation,/the concentration on improving the environment/whilst not strictly and directly related to insurance/ are very much an integral part of risk.//Risk managers must become more involved in these areas/and will need access to specialist advisers/in at least some of the disciplines involved.//

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Ladies and gentlemen/the free market of 1990 offers a great challenge/and opportunity/to you as risk managers/and to us as brokers.

Thank you.