

Optimizing Return on Capital Employed on Risk Transfer

A growing number of companies now recognize that risk can create valuable upside in their businesses when it is managed effectively. A company that understands how risk might impact its key performance indicators can move more effectively to seize opportunities and drive business performance. The strategies that companies develop for financing risk are an important part of this process. By simply buying insurance, companies probably miss an opportunity to extract better value from capital in their businesses.

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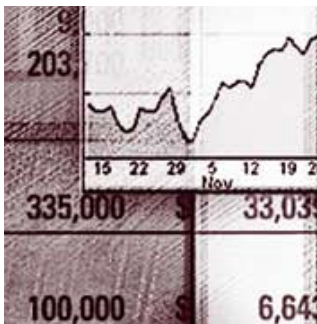
Companies that take a more sophisticated approach to understanding their optimal risk-financing arrangements typically see a sustainable and lower total cost of risk in their businesses. At Marsh, we call the process that underpins this approach Risk Transfer Optimization. This article sets out the rationale for Risk Transfer Optimization and outlines the key stages that successful companies follow to ensure that they are not only providing adequate financial protection against their businesses' exposures, but are also optimizing the cost of capital.

The case for optimizing risk transfer

Risk Transfer Optimization describes the strategic process undertaken by a growing number of firms in order to make balanced and objective decisions around the allocation of capital to risk. Its fundamental principles are:

1. It considers the purchasing of insurance as only one of a number of tactics that can be deployed as part of a broader, often longer-term risk management and financing strategy. Risk Transfer Optimization is about more than the limits and deductibles of an insurance policy, although this often forms part of a company's considerations.
2. It treats insurance and risk financing spend as a form of capital allocation, with the potential to work harder for a company and deliver a higher return when allocated in a more optimal way.
3. Ultimately it describes the matching of a company's buying style with its appetite to take risk, the losses it is likely to sustain, and the cost of capital associated with its various financing options.

A company that previously treated risk transfer as no more than a series of annualized insurance transactions may wish to re-evaluate this position for financial, business and professional reasons.



Financially, the acknowledged volatility of the insurance market means that a company relying solely on insurance to finance its exposures is at the mercy of the broader market cycles and has to be prepared for its insurance costs to fluctuate year-on-year. This issue can be exacerbated when a sudden rise in the number or value of claims has a material impact on the company's future cost of insurance cover.

Some organizations have happily bought the same levels of insurance for years, without considering alternative ways in which their risks can be financed, on or off balance sheet, through an alternative vehicle. Over that time the

cost of purchasing insurance may have become more expensive in relative terms than the cost of capital for retaining the risk – either because of changes to the cost and availability of insurance, changes to the strategy or financial model of the company, or a blend of both. It is only through evaluating and balancing this broader view of the cost components of risk – known as Total Cost of Risk (TCOR) – that companies can begin to understand whether capital is being effectively deployed and value continues to be created from risk-financing decisions.



From a business perspective, a longer-term view of the risk-transfer strategy of a company provides a framework for senior managers to dialogue more openly about risk and the issues that might prevent them from successfully achieving their objectives. The benefits from this can be significant. Insurance coverage can be accurately matched to exposures and loss expectancies. Uninsurable exposures can be identified and assessed, and alternative forms of financing arranged to manage potentially major losses. Areas on which to focus risk improvement or management activity can be identified, with the investment budget determined by or even offset against the potential reduction in losses or savings in risk transfer.

Finally, from a professional perspective, modern-day risk managers have an opportunity to determine and underline the value they are contributing to the firm by closely aligning overall strategy and performance indicators with the criteria they follow for risk and insurance decision making. Risk managers who can unequivocally evidence that the decisions they make are on the basis of business-relevant and objective data stand to minimize costs, reduce volatility and build meaningful and long-term relationships with the executive board, insurance markets and brokers.

The process for optimizing risk transfer

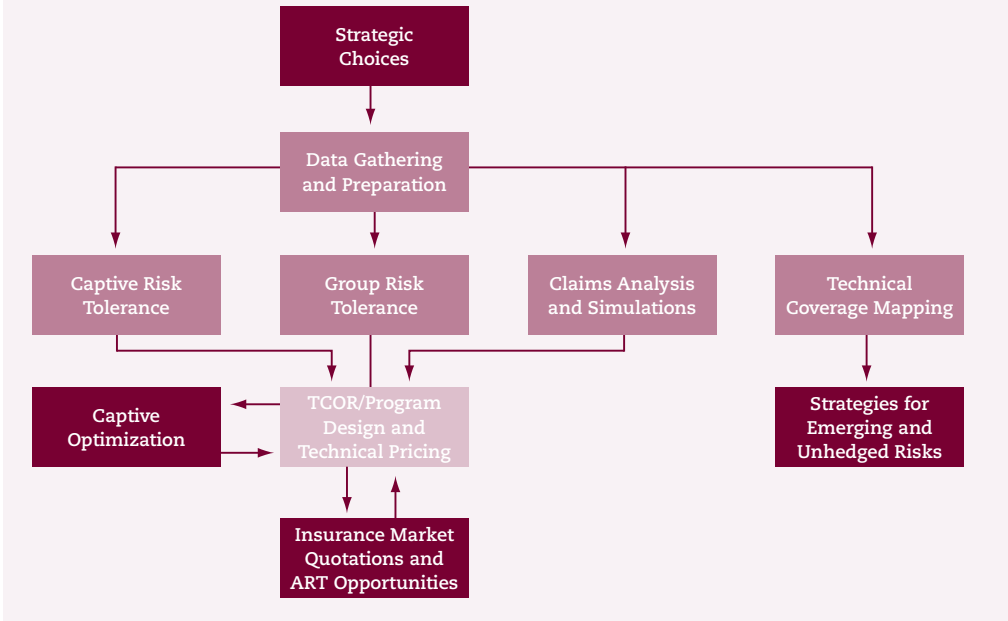
Risk Transfer Optimization can appear to be a complex process, including within it a wider review of all business risks, the adequacy of existing controls, and the optimum use of capital to finance those risks. The component parts are summarized in exhibit 1. However, very often the process is more about coordinating the activities of existing functions and individuals, while overlaying more rigorous financial analysis on which to base management decisions. At Marsh, we recommend that our clients follow a three-step process to ensure that they are making appropriate risk-financing decisions.

Step 1: Understand the strategy and current position of the business

The strategic direction that a company takes and the impact of this strategy on its capital allocation should ultimately underpin the decisions it takes on risk transfer. It is not enough to say that a company with a strong cash flow should, de facto, retain more risk. The company may prefer to invest that capital in new areas or to issue dividends to shareholders. Equally, it could be naturally risk averse and feel more comfortable insuring a greater proportion of its risks than its balance sheet might otherwise suggest. Companies arrive at their “risk appetite” through a variety of measures, from the scientific to gut feel. Whatever the method, it is only when there is a collective view on the role that risk transfer should take that an optimum strategy can be developed.

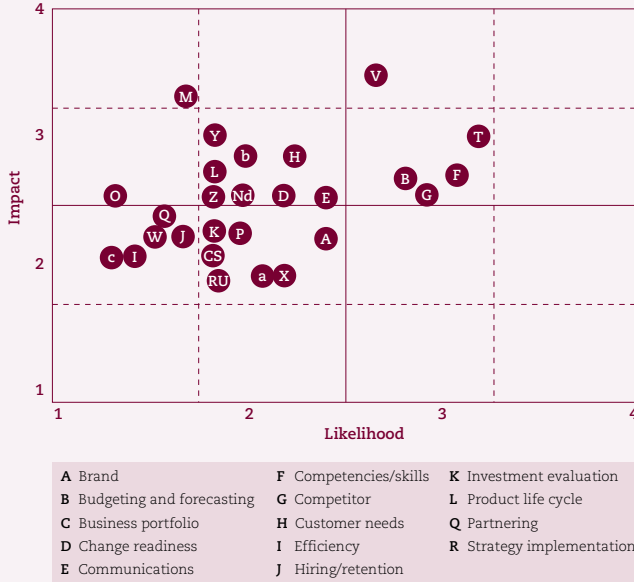
Information is as important as strategy. High-quality information on the company, its risks, and the quality of its risk-management controls will play an influential role in decisions around program structure and investment in risk control. Important information includes the following:

Exhibit 1



- Historic claims experience;
- Existing risk registers;
- Business-continuity plans and programs;
- Corporate-governance programs;
- Benchmarked data from industry peer groups;
- Attitudes to risk from the executive board and senior management group;
- Gaps in required underwriting information; and
- A snapshot of the business risks around the company's operating divisions, sites and locations, often represented in a risk map (see exhibit 2).

Exhibit 2



This stage of the process is about delivering a clearer perspective on emerging/expected losses and risk controls, and in doing so starting to develop quantitative measures that can be used for future financial analysis. Some companies use this stage in the process to review whether their risk-management controls are effective and whether an investment in improvement might positively affect their risk profile and subsequent cost of risk.

Step 2: Analyze and model the data

Turning data into meaningful decision-making tools forms the second, critical stage of the process. The goal of this stage is to identify the optimal structure for the risk-financing program, against which coverage can be overlaid. This stage is focused not only on identifying optimum insurance arrangements, but also on determining the amount and type of risk that can be retained by the company. Typical considerations in this step include the following:

- Technically reviewing current coverage, limits and exclusions to stress test the adequacy of existing insurance arrangements against the risks identified in step 1.
- Calculating risk tolerance. This step helps companies determine their materiality threshold and transfer “strike points.” A variety of indicators can be used to help companies understand their willingness to pay for losses out of their own liquid reserves, which include credit ratings, materiality thresholds, benchmarked retention levels by industry or “rules of thumb.”
- Using the analysis on risks, existing insurances and optimal retention levels to develop actuarial models – sometimes called integrated loss models – to design and stress test various program structures. The objective of this step is to identify the lowest total cost of risk, allowing for self-insured volatility. The accuracy of this process can be limited by factors such as long-tail claims or large unidentified future exposures, and companies use sophisticated risk-modeling techniques, such as Monte Carlo Simulation, to help compensate for these variances in losses.
- Analysis of alternative risk-financing options, including captive insurance companies. Some companies may decide to set up a captive insurance company to self-finance some of their risk, with further analysis required to determine which classes to participate in, how to structure the captive, and where it should be domiciled.

Step 3: Design and place risk-financing solutions

Selecting potential insurance markets is a strategic decision in its own right, and should be governed as much by performance considerations such as program



administration, serving and security rating, as it is pricing. Underwriting submissions should contain detailed and relevant data on the extent of the risks, the performance of controls and their correlation with losses, and the commitment of the business to improving its risk profile. The insurance placement will be complemented by the structure of alternative risk-financing and transfer solutions to ensure the overall return on capital invested in risk is optimized for the company.

Case in point – FTSE 250 company reduces cost of risk by millions of dollars

A FTSE 250 company recently appointed Marsh to carry out a review of the appropriateness of its insurance program and its overall approach to buying insurance. There were a number of reasons why the company thought it the right time to carry out this review, which included increased requirements to demonstrate corporate governance and a major restructure within the business.

The starting place for the review was to undertake a risk assessment with business leaders across the company in order to build a risk register. Using this information, the client was able to compare its perceived exposures to its actual insurance cover. Having calculated its risk tolerance, we were able to help the company design the optimum risk-transfer program and negotiate renewed coverage with the insurance markets.

This exercise ended up saving the company millions of dollars in its total cost of risk.

Summary

For most companies, a Risk Transfer Optimization exercise should not represent a marked change to many of their existing processes. The more significant change will be the

linking of these activities under one consistent strategy. Far from this process representing additional bureaucracy, it should help streamline the way in which a company finances risk, creating further efficiencies.

The culture, behaviors and attitudes that senior managers demonstrate toward risk management and insurance buying will be a major contributor to the success of an integrated approach. Sometimes it will be worth running short executive workshops at the outset to help business leadership understand how business risk management and insurance fit together, and the benefits that can be achieved from having a robust approach to optimizing capital allocation.

The process of Risk Transfer Optimization is increasingly evolving the way in which companies approach risk financing. The net result of this should be sustained financial and business benefits, and opportunities for risk managers to shine.

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