The Evolution of Risk Management

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The Coca-Cola Company

AMCHAM Insurance Committee Breakfast
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Agenda – The Evolution of Risk Management

- Insurance Basics
- Stand Alone Programs – “JustBuying Insurance”
- Deductibles and Retentions
- Global Programs
- Alternative Risk Financing
  - Captives
  - Integrated Insurance Programs
- Enterprise Risk Management

The Search to Add Value
Insurance Basics
What Is Insurance?

Insurance: Amortization of Losses Over Time
Composition of Insurance Premiums

1. Projected Losses

2. Insurance Company Administration Fee and Profit (Policy Issuance, Claims Handling, Brokerage)

3. Funding for Catastrophic Event
Loss Ratios

Loss Ratio = Total Losses / Total Premiums

Examples:

<table>
<thead>
<tr>
<th>Total Losses</th>
<th>kr 600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Premiums</td>
<td>kr 500,000</td>
</tr>
<tr>
<td><strong>Loss Ratio</strong></td>
<td><strong>120%</strong></td>
</tr>
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<table>
<thead>
<tr>
<th>Total Losses</th>
<th>kr 200,000</th>
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<tbody>
<tr>
<td>Total Premiums</td>
<td>kr 500,000</td>
</tr>
<tr>
<td><strong>Loss Ratio</strong></td>
<td><strong>40%</strong></td>
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What’s happening in the insurance market today?
U. S. Cost of Risk: 1990 – 2003*

* Cost of Risk includes insurance premiums, retained losses, and administrative expenses.

Source: 2003 RIMS Benchmark Survey; Insurance Information Institute
Trends in Danish Insurance

- **PD/BI Insurance**
  - Annual rate increases of 20-40% over past 3 years (more for large claim policies).
  - Coverage and sublimits reduced.

- **Liability Insurance**
  - Only major change in coverage is exclusion of terrorism.
  - Increases in premiums (trend expected to continue in 2005.)
  - Personal injury compensation increased substantially ⇒ premiums increased accordingly
  - Claims experience also showing expected increase.

- **Workers Compensation**
  - Law adjustment entailed substantial increase in number of claims.
  - Most insurers have announced proposed increases of 50%.
Stand Alone Programs
“Just Buying Insurance”

Pay a premium – Transfer all risk

Property  Auto  General Liability  Directors & Officers Liability

$$$$$
Add Deductibles and Retentions

Opportunity for Savings: LOSS PREVENTION

SIR = SELF-INSURED RETENTION
Benefits of Deductibles/Retentions

- Reduce the purchase of insurance
- Retain reasonably predictable losses
- Segregate and scrutinize expenses
- Instill awareness and involvement in claims management and loss prevention functions

- Lowers overall insurance costs
- Allows you to hold onto premium dollars as long as possible
Global Programs
Multi-National’s Require Insurance in each Country

- Japan
- U.S.A.
- Denmark
- France
What is a Global Program?
“Acts like a blanket”

Local Coverage

Global Coverage

Global Programs provide DIC/DIL
Global Program Policy Issuance

Risk Transfer to Insurers

Fronting Policies Minimum Coverage

Global Insurance Company

UK • USA • Japan • Mexico

Headquarters Denmark Master Policy DIC/DIL
Merits of Global Programs

- Leverages your buying power
- Financial Security of Insurer
- Stability of Program = Stable Program Costs
- Broad Scope of Coverages
- Continued Compliance with Local Legal Requirements
- Reductions in Frictional Costs
- Ease of Administration
Alternative Risk Financing
Captives
What is a Captive?

An insurance company that primarily insures the risks of its owner.

Examples:

Pure – single owner

Group – owned by the policyholders

Rent-a-Captive – for companies who may not be large enough to form a captive or just do not want to own a captive.
Captive Concept

Risk Transfer to Insurers

Self-Insured Retention Pooled at the Captives

Fronting Policies No Risk Transfer

Insurance Companies

Insurance Companies

Insurance Companies

Reinsurance Captive Retentions

Denmark

USA

Japan

Mexico

Premium

Claims
Benefits of a Captive

- Greater control of your insurance program
- Unbundling of claims management services
- Facilitates greater focus on prevention of losses
- Reduced insurer fronting fees – direct writing captive
- Future flexibility of coverage
- Cash pooling mechanism
Captive Statistics

Number of Captive Formations & Liquidations 1993 to 2003 E

- Hard market fueling captive formation.
- Corporate collapses and captive consolidations fueled the upward trend in captive liquidations in 2002.

Source: AM Best, Advisen
Alternative Risk Financing
Integrated Programs
Risk Financing Strategy - Catalysts For Change

- Policy Form - Market Driven
- Administratively Inefficient
- Inherent Market Price Volatility
- Short-term Focus
- Constant Coverage Ambiguity
Integrated Risk Financing Trends

- Multi-Line
- Multi-Year
- Stop Loss
- Basket Aggregate
- Double Trigger Coverage
- Finite Risk
- Variable Deductibles
Integrated Risk Financing

Illustrative Design

Per occurrence/Term aggregate
Multiple lines/ Multiple year program

Blanket Limits

Statutory

Stop Loss

Term Aggregate

Commodity
Interest Rate
F/X
Marine
Property
E&L
Fidelity
Fiduciary
D&O
B Side Only
E&O
AL
GL
WC

SIR/Captive
Risk Transfer
Stand Alone Risk Transfer
Integrated Risk Advantages & Benefits

- Ease administrative burdens
- Eliminates the need to renegotiate multiple insurance programs each year
- Multi-year, multi-line approach potentially reduces costs
- Gain price stability
- Mid-sized corporations good candidates

In today’s market, capacity is limited.
So, How Do You Do It?
Structuring A Multi-Line, Multi-Year Integrated Risk Program

- Perform Initial Risk Assessment
- Examine Corporate Risk Bearing Capacity
- Analyze the Economics of Integrated Approach
- Gain Senior Management Support
- Design and Structure with Best Features of Integrated Risk Options
- Implementation Plan
KO Program - Objectives

- Create value through
  - lower risk transfer costs
  - administrative efficiencies
  - leverage the system buying power

- Provide long-term stability

- Provide a platform for continuing development

Focus total organization on managing risk.
KO - A Time Line

**Conceptual**
- Jul 96: Receive Broker Proposal
- Sep 96: Strategic Planning Session
- Oct 96: Get Buy-In From Sr. Mgmt.
- Nov 96: Negotiate Details of Structure
- Dec 96: Submission to Markets
- Mar 97: Fronting Carrier Working Session
- Apr 97: Finalize & Bind Coverage
- Aug 97: Consortium Partnership Meeting
- Jan 98: Policy Finalization

**Details**

**Communication**

**Project Management**
Enterprise Risk Management
ERM
What is Risk?

- Risks are uncertain events or conditions that can keep you from achieving your strategic objectives.
- Risks arise from many sources and can have multiple effects.
- Some risks affect all businesses, other are business-specific.
- Risks most often arise in times of change.

Risk can be both positive and negative.
Positive and Negative Risk

Expected

\[ y \]

\[ x \]
**Impact of the New View of Risk**

<table>
<thead>
<tr>
<th>Old Paradigm</th>
<th>New Paradigm</th>
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<tbody>
<tr>
<td>Historically focused</td>
<td>Strategic</td>
</tr>
<tr>
<td>Ad hoc activity</td>
<td>Continuous activity</td>
</tr>
<tr>
<td>Accounting, treasury and internal audit</td>
<td>All of management</td>
</tr>
<tr>
<td>Silo Approach</td>
<td>Focused and coordinated (holistic)</td>
</tr>
<tr>
<td>Financial risk</td>
<td>Business risks</td>
</tr>
<tr>
<td>Inspect, detect, react</td>
<td>Anticipate, prevent, monitor</td>
</tr>
<tr>
<td>Focus on people</td>
<td>Focus on processes and people</td>
</tr>
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The Economist Intelligence Unit, Managing Business Risk, p.10
What is driving the changes?

- Investor interest
- Sarbanes-Oxley
- Turnbull Report
- A way to add value to our companies
The directors should, at least annually, conduct a review of the effectiveness of the group’s system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.

Provision D.2.1

The Turnbull Report
ERM is a rigorous and coordinated approach to assessing and responding to all risks that affect the achievement of an organization’s strategic and financial objectives. This includes both upside and downside risks.

Tillinghast-Towers Perrin

ERM: Trends and Emerging Practices
COSO believes ERM

- Is a process,
- Is effected by people (an entity's board of directors, management and other personnel)
- Is applied in strategy setting
- Is applied across the enterprise
- Is designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite
- Provides reasonable assurance to an entity’s management and board
- Is geared to the achievement of objectives


Authored by PricewaterhouseCoopers LLP
COSO Dimensions of ERM

Objectives
Levels
Components

- Internal Environment
- Objective Setting
- Event Identification
- Risk Assessment
- Risk Response
- Control Activities
- Information and Communication
- Monitoring
Components of ERM

- Internal environment
- Objective setting
- Event identification
- Risk assessment
- Risk response
- Control activities
- Information and communication
- Monitoring
Silos may manage risk well.
Challenge of ERM

ERM TOOLS AND PROCESSES

- Treasury
- Quality
- Internal Audit
- Environment
- Financial Reporting
- Human Resources
- Information Technology
- Security
- Risk Management
Benefits of Enterprise Risk Management

- Align risk appetite and strategy
- Link growth, risk, and return
- Enhance risk response decisions
- Minimize operational surprises and losses
- Identify and manage cross-enterprise risks
- Provide integrated responses to multiple risks
- Seize opportunities
- Rationalize capital

Increase the value of the organization
Where is your company in this Continuum?