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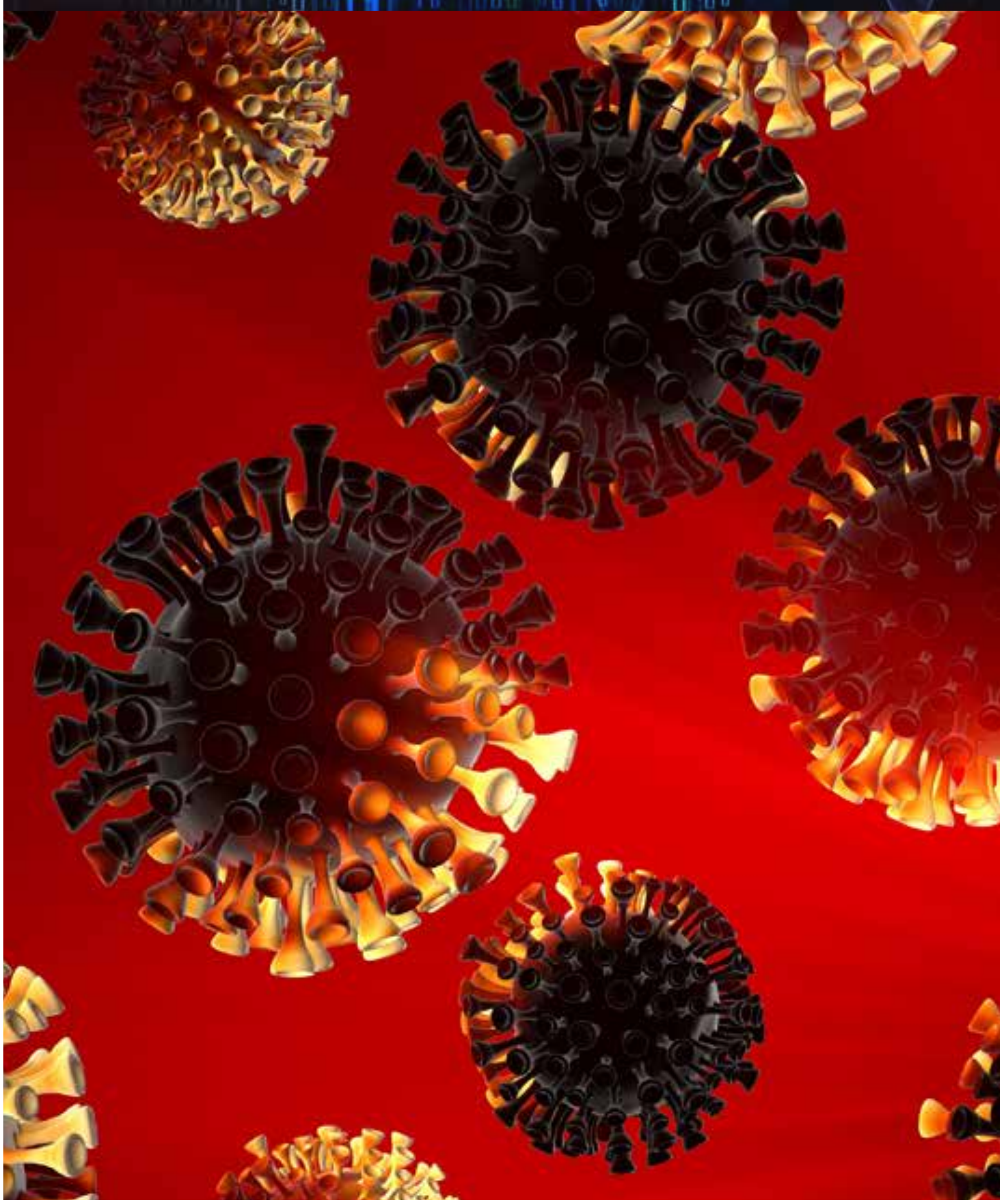

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Entering the Reputation Risk Management and Insurance Marketplace: A Solution for 2020

BY PETER J. GERKEN AND DENISE WILLIAMEE

ABOUT THE AUTHORS

Mr. Gerken, a certified property and casualty underwriter (CPCU), is Steel City Re's Senior Vice President, Risk Transfer Agency and Insurance where he heads broker relations and client development. A Vietnam veteran, Mr. Gerken has been in commercial insurance for some 40 years both on the underwriting as well as the broking sides of the business. Holding an MBA in Management, Mr. Gerken formerly headed the Intellectual Property practice at Marsh.

Ms. Williamee is Steel City Re's Vice President, Corporate Services, where she heads client relations and education for integrated reputation groups. Ms. Williamee, who holds an AAS in Paralegal Studies (cum laude), has broad experience in the legal industry including the courts system, civil litigation, criminal defense and investigations. Previously, Ms. Williamee founded and operated a multi-location, full-service private investigations firm.

ABSTRACT

This article demonstrates how Reputation Risk Insurance, approached on a parametric basis, can profitably counteract the multiple negative effects of the current hardening P&C insurance market while also providing reliably profitable future gains once the current market has stabilized.

INTRODUCTION

In 2008, Former Federal Reserve Chairman Alan Greenspan told students at Georgetown University, "In a market system based upon trust, reputation has significant economic value."[1] In 2020, executives of the most successful companies told PR firm Weber Shandwick that reputation represented on average 85% of their firms' value.[2] In public filings, 90% of S&P 500 companies include reputation as among their material risks. Yet for most firms, the enterprise risk management apparatus–comprising governance, management, controls and insurances–offers little at this time to protect reputation value beyond a compliance-driven acknowledgment of the peril's materiality in regulatory filings.[3]

At the January 2020 Intermediaries and Reinsurance Association (IRUA) meeting in New York, Mr. Gerken suggested that the gap between the materiality of reputation risk and the current paltriness of risk management and risk transfer products afforded risk underwriters a substantial commercial opportunity. This article will outline the reputation insurance marketplace as Steel City Re understands it from both the demand as well as supply side. Entering a new, uncrowded marketplace by its very nature presents considerable potential for profits when there are fiscally sound and credible solutions available. Also, while there are inherent risks in any new product, today's markets create long-term strategic reasons for assuming those risks and embracing the opportunity.

A UNIQUE TIME FOR A UNIQUE SOLUTION

Currently, the traditional Property and Casualty marketplace is going through a cyclical change which we have not seen since the 2001-2004 cycle.[4] Consequences of the hardening market include the following challenges: inflation of pricing by carriers via line of business (from historically soft levels) of 20% or more,[5, 6] coverage terms being tightened, previously available limits being reduced, and attachment points, deductibles, and coinsurance all being tightened. This scenario is occurring uniformly across the industry as the vast majority of carriers on both insurance and reinsurance levels are hardening their underwriting approaches, and while the world is suddenly experiencing a virus pandemic.[7, 8, 9]

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The hardening market has placed relationships between insurers, brokers, and insureds in substantial peril. Insurers no longer have the flexibility to negotiate and insureds are feeling varying degrees of powerlessness and marginalization. In the middle are brokers who, trying to retain long-term relationships with insurers while also maintaining the trust of clients, are dismayed with these tightening terms and premium increases. They, in turn, push back on the underwriters. This is what attendees at IRUA's January meeting heard and what has been echoing across the industry. In this article, we will define reputational risk as the peril of economic harm from angry, disappointed stakeholders, whose expectations are not met.[10] The current situation meets that definition, as insureds whose expectations are not being met are feeling disappointment and anger, and could have long-term impacts.

At the end of this hard market cycle – and at some point it will level out – insurers will face long-term relationship pain unless they take steps now to safeguard trust within both the broking and insured community. We suggest that now is the time and reputation risk management and insurance is the vehicle insurers should consider offering. It is a solution that will address the risk disclosures being described as material in public financial filings, help protect client relationships, and safeguard trust.

QUANTIFYING REPUTATION RISK

Regardless of type of risk one cannot begin to provide solutions unless and until one can begin to quantify it. Part of the process is creating a workable model to describe the solution. As George Box said "all models are wrong, but some are useful." The beginnings of the captive insurance industry are an example. Fred Reiss[11] believed that companies at the time were being charged too much for their property insurance, and he had the idea to invent some new risk vehicles which he began to call "captives." But first he had to assemble data to begin to quantify the risk, even if the numbers were not perfect.

With respect to reputation risk management and insurance solutions utilizing a parametric approach, the first step was identify a reliable repeatable predictor of cash flow stability that, like the spread pricing of a credit default swap or the value of equity, was forward looking. Fortunately, in this era of big data, and using a strategy similar to what Ray Dallio used to create a synthetic futures index to transfer risk for McDonald's[12] Steel City Re was able to identify ample stable data sources of expected cash flows that could serve as proxies for the expectations of all stakeholders.[13] With a bit of experimentation and years of effort, Steel City Re began applying its algorithm to generate a forward-looking index and provide Reputational Value Metrics (RVM) on approximately 5500 public companies effective January 2, 2002.[14] Hedge funds began consuming the data seeking reputation arbitrage, and today, the same algorithm generates a unique indicator of reputational value and volatility for 7800 public companies each week. These measures supply Steel City Re's actuarial data base that powers its enterprise reputation risk management solutions and underpin its parametric approach, with underwriting with Tokio Marine Kiln. At this time, the Reputational Value Metrics comprise in excess of 6.6 million data sets that are sampled for actuarial purposes to generate approximately 134,000 insurance experiences of which approximately 40,000 represent some type of loss event.[15]

REPUTATION INSURANCE MARKET-SUPPLY

The underlying foundation of a company's reputation include ethics, quality, safety, security, sustainability, and innovation.[16, 17] The risk to the value of a company's reputation comes largely from the changed behaviors of angry disappointed stakeholders and the economic consequences arising.[18] Media and social media coverage amplify the crisis, but are not the cause of it.

Still, most reputation insurance products merely provide indemnification for crisis communications expenses that are typically deployed in an effort to quell stakeholder anger in a crisis. Endorsements for varying limits of public relations expenses to be reimbursed post-event are the largest element[19] of the reputation insurance marketplace. These endorsements are attached to numerous policy types of first- and third-party designations. Public relations firms must be retained to address the issue and with limits such as $25,000, $50,000, or perhaps a bit more after which time reimbursements will need to be secured. Currently there are numerous endorsements available from multiple markets.

Stand-alone insurance policies[20] covering crisis communications are also offered. AIG Insurance' Reputation Guard is an example of this stand-alone approach. The flaw of narrowly focusing on crisis communications is that significantly more could be done to mitigate harm before a crisis; not unlike how fire doors and sprinklers are a preferable approach to fire control than blaze suppression, in that sprinklers and fire doors can slow down progression and minimize damage even as a blaze is being suppressed. Within the insurance industry the best-known historic example of risk mitigation were the solutions put together by[21] Hartford Steam Boiler Inspection and Insurance Company (now owned by Munich Re) which engineered the risks to be lower.

Because of a failure to understand the true nature and causes of reputation risk, more elaborate economically feasible solutions, including strategies that foster risk management, have been not forthcoming from markets, with the exception of products offered by Steel City Re, which employs informational and behavioral economic principles[22] to enable actuarial modeling and policy manuscripting.[23]

A broader type of reputation insurance product offered by a few carriers including Allianz[24] and Munich Re,[25] does provide for financial or profit losses and is business interruption oriented, with the carriers looking backwards at actual incurred loss with reimbursement of the insured for that loss on a profit or net income basis. The challenge with non-damage business interruption policies is that the vagaries of manuscripting and post event forensic claims adjusting is a swamp rife with disputes and litigation. Administrative costs devour limits, underwriting profits, and recoveries.

RISK MITIGATION AND MANAGEMENT ARE KEY

As noted above, early products in the marketplace looked at loss that happened and then offered early stage products/endorsements that reimbursed companies for certain expenses that they incurred. As noted, they were post-event. Steel City Re thought that a better approach was to prevent and mitigate the loss but that if it happened it would be happening on a go-forward basis, and that is where parametrics[26] comes into play.

PARAMETRIC SOLUTIONS TO THE RESCUE

Steel City Re saw within the definition of reputation risk--the peril of stakeholders' disappointment and anger when expectations are unmet–an opportunity to define loss through the going forward impairment to cash flows.[27] More specifically, the peril of economic damage was the consequence of changed economically relevant behaviors by stakeholders who have expectations of a firm and include customers, employees, vendors/

suppliers, creditors, equity investors, regulators, and NGO's (Non-governmental Organizations).

When expectations are not met, a chain-reaction of numerous negative actions begins to occur: the emotionally charged disappointment of stakeholders changes their behaviors and impairs cash flows. These cash flow[28] losses can result from customers purchasing less, less frequently and at lower price points. Retention of key employees becomes more difficult, raising human resources expenses. Supplier pricing increases and availability diminishes, leading to higher vendor terms or stocking charges. Creditors may renegotiate credit with lower ceilings and increased interest rates. Investors may sell their stock or otherwise alter their investing habits which create less beneficial P/E ratios. Lastly, regulators will still regulate, but with a heavier hand, driven by a political environment that is more hostile.

For purposes of risk management and insurances, it became Steel City Re's belief that firms would be better off thinking of reputational value as a measure of companies' ability to meet or exceed stakeholder expectations – and that, with risk management taking the lead, marketing should be deployed in conjunction with strong risk management, finance and governance controls to communicate that thinking to stakeholders who will appreciate and value it.[29] Stable cash flows would be the metric of success, and volatility of reputational value would naturally be indicators of risk. The economic model of cash flows, in Steel City Re's thinking, implied a behavioral economic framework for understanding stakeholders.

The runs on banks[30] in the 1930s are a stark example of cash flow instability that if severe may pose an existential risk to a business. It is generally appreciated that Federal Deposit Insurance Corporation[31] (FDIC) mitigated the fear that precipitated the run on banks. What Steel City Re saw in FDIC was the expressive power of insurances to tell a story and strategically signal to stakeholders, from which we inferred that an informational economic model also needed to be part of a solution's design.

The Reputational Value Insurance[32] policy, while actually written by Steel City Re is issued by Tokio Marine Kiln, a Lloyd's syndicate; Steel City Re operates as an advisor, essentially like a managing general agent. This coverage's objectivity and triggers are linked to Reputational Value Metrics. The solution overall could be best compared to Industry Loss Warrants, with which most readers are familiar.

To mitigate moral hazards and hazard gaming, there is a dual trigger of loss in this parametric form:

- A scheduled Enterprise or Board level process fails resulting in an Event with corresponding negative media, and thus is known to the public
- A sustained material drop in the Insured's Reputational Value Metrics.

Also, as parametric products, risk financing and risk transfer solutions are engineered to exploit the power of captives and insure working-layers of risk while benefitting from the lower costs of reinsuring captives at lower frequency/higher severity levels of risk. So, these vehicles,[33] invented by Fred Reiss, have become significant participants in the market. There is however room for major growth in the utilization of captives, and thus a need for reinsurance of these vehicles.

REPUTATION INSURANCE MARKET – DEMAND

There are several indicators of latent and unmet demands that could translate into market saturation at some as yet unknown tipping point. These drivers of demand come from the worlds of regulations, litigation avoidance, and ESG "compliance."[34] For all three major demand scenarios, reputation insurance can tell simple, easy to understand, and completely credible stories about risk management to key stakeholders.

Evincing that the lessons of the bank runs have not been lost over the intervening 90 years, firms in the banking sector have regulatory needs[35] established by the Office of the Comptroller of the Currency to manage reputation along with seven other named perils, recognizing the relationship of reputation and liquidity. Reputation insurance would be recognized by regulators as part of a bank's compliance program, while the expressive aspects of the insurance would speak to the quality of an institution's enterprise risk management infrastructure.

Litigation avoidance is another driver. The Economist Intelligence Unit crowned reputation as the "Risk of Risks"[36] in 2005. Fourteen years later, it's become a personal risk to corporate leadership. Over the intervening years, upwards of 90% of the S&P 500[37] and other public companies began disclosing the materiality of the risk in their annual regulatory filings and corporate reports. Plaintiff attorneys got the memo. In the fiscal year ending June 2019, 25 complaints were filed or amended in federal court that alleged, at least in part, board-level responsibility in connection with corporate reputational damage according to the *Financial Times* specialist, *Agenda Week.* Only six were filed[38] the year prior.

The third driver of demand is the rush to ESG utopia.[39] In September of 2019 the Business Roundtable[40] published a manifesto that for the first-time subordinated investor rights to the general rights of all corporate stakeholders. While this disappointed shareholders, this raised expectations for all other stakeholders; those companies that are signatories to that pronouncement must now meet or exceed those expectations or face both known and unexpected consequences. Reputation risk management evidenced by insurance is a key strategy for reconciling this apparent contradiction.

PUTTING IT ALL TOGETHER

Just as companies and boards need to tell a strategic story to their stakeholders of sound reputation risk management, evidenced by insurance, so must insurers tell a strategic story to brokers and insureds by offering the type of reputation insurance products that will support their needs.

Rather than continuing with damaged relationships, we suggest that a better strategy is for carriers to supplement current offerings with a product that answers a critical Board need on a company's most valuable asset – a product that clients will find attractive, affordable and with viable potential

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for future growth. Reputation risk solutions address a known, disclosed material risk while also acting as a key component in establishing a comprehensive, forward thinking and fiscally responsible cornerstone in reputation risk management. If the risk is material it automatically begs the question of what is being done to mitigate that risk. Transparent dialog both in the media and in financial reports is a key component to the process of mitigating potential stakeholder anger and disappointment – and a convincing narrative requires the kind of third party validation that insurance underwriting provides.

SUMMARY

This is a unique time and it calls for unique measures all made more complicated by the impact of a global health pandemic. The majority value of companies today is intangible, and the most valuable asset of firms is their reputational value. The forces affecting the insurance marketplace today, along with the economic after effects of Coronavirus/COVID-19, there are strong drivers of demand which are only going to become more widespread. Focus on reputation by risk management communities like RIMS and Airmic, and requests for additional capacity by large public companies are also in the mix. In the investment community these days, it is all things ESG, and reputation is a strong second. As the traditional P+C market continues to repair itself, expanding risk offerings in a way that addresses key corporate needs is a great strategic signal. Steel City Re is pleased to assist in these endeavors. ◀

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Vision

To facilitate a vibrant forum that encourages professional and personal development of member company personnel through educational excellence, the exchange of knowledge among industry constituents within the insurance and reinsurance marketplace and recognition for academic excellence for the next generation of reinsurance professionals. We accomplish this vision through focused educational offerings, a robust Scholars program, the publication of the *Journal of Reinsurance,* and an Annual Conference.

Mission Statement

The IRUA is a not-for-profit corporation, organized for the purpose of providing high-quality insurance and reinsurance education, meaningful networking opportunities, and the dissemination of topical publications and information relevant to the reinsurance industry.