

ROUTE TO:

Risk Transfer? **Maybe, Maybe Not**

By Robert N. Hughes, CPCU, ARM

While there are arguments among insurance professionals about the nature of risk, a large contingent adheres to the proposition that “risk” equals “uncertainty.” (One of the principal ramifications of this interpretation is the idea that as frequency increases, risk decreases and, accordingly, so does the need for insurance. Therefore, according to the proponents of this theory, once the frequency of occurrences reaches the level of complete predictability, there is no longer any risk, and the exposure is not a proper subject for insurance.)

Now that you’ve learned (or been reminded of) this parenthetical lesson, forget it. I’m not talking about that aspect of risk in this article. I am talking about the ultimate purpose of insurance and how it is being thwarted today by many influences prevalent in insurance company finance, underwriting and claims handling. An understanding that “risk” equates to “uncertainty” will, however, be helpful in understanding my point.

Let’s go back to the ultimate purpose of insurance. My SMU mentor, Professor Frank Young, taught me that insurance may be defined as “A social device by means of which the chance of large, catastrophic losses is replaced by the payment of small ascertainable losses.”

“Taking the view that risk = uncertainty, then insurance can be seen as a method of reducing the uncertainty of the policyholder.”

We also learned that insurance is a contractual transaction in which the policyholder’s risk of loss is transferred to a professional risk bearer (the insurer). Taking the view that risk = uncertainty, then insurance can be seen as a method of reducing the uncertainty of the policyholder. By paying an affordable cost-certain (the premium), the policyholder eliminates or reduces the chance of an uncertain and often unaffordable cost.

The question then arises, “Does it work?” Well, for most individuals and small businesses, the answer is yes. In spite of anecdotal evidence of insurance companies’ bad-

faith claims handling, my experience has been that, for the most part, individuals and small commercial entities get their claims paid in a fair and timely manner. Even in catastrophes such as the recent hurricane in Florida, at the end of the day most insureds will have their claims settled fairly and, considering the huge numbers of claims to be settled, in a reasonable amount of time.

On the other hand, if you examine the same question regarding claims presented by large commercial enterprises you will see a much different landscape. In many cases, larger policyholders are now finding that, rather than reducing or eliminating uncertainty, their purchase of insurance has served only to add an additional element of risk ... whether or not their claim will be paid in accordance with their expectations. Such uncertainty arises from a number of different influences, including the following.

Some Can’t Pay

First let’s talk about the financial ability of the insurer to pay a large claim. There is hardly a significant commercial enterprise standing today that does not have one

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FROM NEAR AND FAR



According to Insurance Services Office, Inc., catastrophe claims for the second quarter of 2004 will be the lowest in four years. Insured property claims are estimated to be about \$1.65 billion arising from six catastrophic events, compared to the four events that accounted for \$5.1 billion during the second quarter of 2003. ISO defines a catastrophe as an event that causes more than \$25 million in insured property losses.



London – The slips used at Lloyd's of London for the placement of binding authority must comply with London Market Principles as of January 2005. The use of a standard slip should allow for a certainty of contract wording at the time of placement.



Amarillo – A hailstorm that struck the Texas panhandle city of Amarillo in June caused insured losses of more than \$175 million. The Insurance Council of Texas said that the storm resulted in about 32,000 claims that averaged about \$5,000 each. The storm ranks as the sixth most costly in Texas history.



According to an article published in *Insurance Day*, Tropical Storm Risk in London warns that there is an 86% probability of an above-average Atlantic hurricane season. TSR is an insurance industry-backed consortium based at Benfield's Hazard Research Centre. The report also states that "It is 90% certain that landfalling storms and damage will be higher between 2004 and 2007 than it has been in the last four years."

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or more claims outstanding against insolvent carriers or carriers that, although currently solvent on paper, have balance sheets that are of significant concern. The names of these companies are legion ... Home, Highlands, Reliance, Midland, Texas Employers, and Mission, to name just a few of the better-known ones. Even Lloyd's itself must appear on the list, since, in order to avoid total collapse of the market, all of its pre-1992 claims were assigned to a newly formed reinsurer called Equitas. Equitas was funded with a finite amount of money, and although the funds appear to be well managed, there is the distinct possibility that, in the end, there will be no more funds to pay still-outstanding losses. If that happens, Equitas has the legal right to bill the

Lloyd's members who participated as names on the syndicates for the short-fall. That would likely create an uproar of majestic proportions that could have a far-reaching effect in the world's insurance market.

One of the singularly most vexing and difficult problems in insurance and risk management is the determination of a particular insurer's ability to pay claims that become manifest sometime after the expiration of the policy. As we have seen in the plethora of insurance company failures, both foreign and domestic, that have occurred in the past three decades, the company's financial structure is often already in flames before anyone smells the smoke. One of the most reliable observers of insurance company finances is A.M. Best Company. Its ratings, however,

are of necessity based upon results that are at least months, if not years, old. For instance, the financial information contained in the 2004 A.M. Best books, which are published in the summer of every year, is 2003 year-end data.

So if you purchase, say, commercial general liability insurance from a company that is insolvent by the time you have a claim, have you reduced uncertainty? Of course you haven't. I cannot tell you how many occasions in which insureds would have been better off - i.e., would have been more financially certain - had they not purchased a particular policy at all. This situation usually occurs when the policyholder has been forced to sue an insurer to perfect coverage, spending millions on legal costs only to find in the end that the insurer is deemed insolvent.

Some Do Nothing

Another problem that seems to be increasingly encountered by large insureds is, for want of a better word, "stonewalling" by their insurers. Since 1990, I have been involved as an expert in more than 200 cases in which one or more of the policyholders' insurers have simply refused to respond in any way to the submission of a claim. They do not reply to loss notices. They do not investigate. They do not defend, even under a reservation of rights. And, of course, they do not pay. Their attitude appears to be, "If you get anything out of us, you're going to have to sue." Cases like these often take years and millions of dollars to resolve.

Interestingly, the delay in the

(Risk Transfer, continued opposite)

(**Risk Transfer**, cont'd. from opposite)

resolution of the claim may, at least for some insurers, be the method in their madness. Consider this ... suppose the average return on invested funds for insurers has been 6 percent over the past 15 years. Consider further an insurer that has ignored or denied a potential \$5 million claim and forced the insured to sue. The insurer would likely post a reserve of \$5 million plus expenses in the year in which the claim is reported, taking a perfectly legal deduction against taxable income.

Further assume it takes ten years (not an unusual amount of time) to achieve resolution of the claim through adjudication or settlement. By the end of that time, the claim will have been almost completely funded by investment income, and the expenses most likely will have been covered by the tax deduction. Therefore, insurance companies that choose to act in bad faith, as I have just described, have, in effect, simply reversed the risk-transfer procedure. They have the money and the policyholder does not. Even worse, through the addition of legal costs incurred by the insured in the process, they may have actually created a situation in which the policyholder would have been better off having never purchased the coverage.

Some Change the Rules After the Fact

Finally, at least for now, we have a large group of insurers who actually respond to their insured, sometimes even undertaking to defend them, but then offer a long litany of excuses (called "affirmative defenses") as to why the claim is not covered. I've already covered a number of these excuses in previous articles, but for now I want to concentrate on what, for want of a better term, we will call

"post-event underwriting." You might also call it the "oh, we never intended to cover that" syndrome.

First, a quick review ... insurance transfers risk from the insured to the insurance company, right? Risk = uncertainty, right? The most uncertain of all is the "unknown risk," i.e., the risk that no one knows exists at the time of the negotiation of the policy, right? Well, some insurers are now taking the position that the policyholder had a duty to disclose a

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potential for loss from an exposure no one knew existed when the policy was purchased. The most prevalent example involves environmental cases. Insurers, in some cases, have taken the position that the policyholder should have informed them that certain disposal circumstances existed, even though at the time the policy was sold, the disposals were completely in accordance with the law and the substances were not thought of as highly toxic. A good example is the case of Intel, which placed rather small amounts of degreasing waste containing TCE in a tank on its premises. The TCE permeated the bottom of the concrete tank and contaminated the groundwater. The

disposal method was in accordance with the recommendations of the American Insurance Association, as published in its Chemical Hazards Bulletins. TCE was thought of as the perfect replacement for carbon tetrachloride. Nevertheless, when presented with the property damage liability claim, the insurer took the position that the failure to disclose the disposal of TCE was a material misrepresentation on the part of Intel, and it denied coverage. There are other examples too numerous to mention.

So does this mean that corporations that purchase insurance are not really transferring risk at all? In some cases, yes it does. What it really means is corporations that purchase insurance without thoroughly analyzing their insurers' ability to pay are asking for trouble. Further, they are also asking for trouble if they don't take a long look at their insurers' history of defending (or not defending) their corporate clients and paying (or not paying) their claims.

My economics professor taught us that the value of a product or service can be determined only when it is used. One of the most distinctive aspects of insurance is that policyholders purchase the service with the hope that they never have to use it. Only when a claim arises can policyholders discover whether they have, through the payment of their premiums, transferred risk to a capable and dependable partner or, in contrast, spent a lot of money on a worthless piece of paper. RIIA

Robert N. Hughes is founder, chairman of the board, and chief executive officer of Robert Hughes Associates, Inc.

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