The National Underwriter Company
Supplement to

the
TOOLS & TECHNIQUES of
RISK MANAGEMENT & INSURANCE

STEPHAN R. LEIMBERG
DONALD J. RIGGIN
ALBERT J. HOWARD
JAMES W. KALLMAN
DONALD L. SCHMIDT

Supplement Authors
James Kallman and Patricia M. Arnold
2009
James W. Kallman holds a doctoral degree in risk management and insurance from the University of Wisconsin, a masters of Science degree in business from the University of Wisconsin, and a Bachelor of Science degree in finance from the University of Minnesota. In addition, he has earned the Associate in Risk Management (ARM) designation.

Kallman is a professor at the International School of Management, St. Edwards University, and Kaplan University. He teaches graduate and undergraduate courses in enterprise risk management, risk control, financial management, property and liability insurance, financial management of insurers, financial risk management, and the psychology of risk.

Kallman also teaches professional education courses in financial management and risk management for the Risk and Insurance Management Society’s risk fellow and professional development programs as well as the Insurance Institute of America’ ARM courses. His seminars have been presented internationally to organizations including A.M. Best, Aon, Marsh, General Reinsurance, GNP-Mexico, the Insurance Education Institute, and the U.S. Department of Commerce.

Prior to teaching, Kallman was an insurance agency owner, bringing more than twelve years of business experience to his academic research and teaching. He has served as the coordinator of graduate studies, graduate student advisor, and school liaison for RIMS national and chapter activities. His global presentations have been in Bermuda, Canada, China, Mexico, Puerto Rico, and Paris.

His work has earned several academic honors including two Spencer Educational Foundation grants, the State Farm Companies Foundation Doctoral Dissertation Award in Insurance, and a pilot project research grant from the Center to Protect Workers’ Rights, the research arm of the Building & Construction Trades Department, AFL-CIO, as well as several teaching awards, including ARIA’s Lester B. Strickler innovation in insurance award.

Kallman is the Owner of KCS, an international enterprise risk management consulting firm, providing advice on implementing enterprise risk management programs in organizations. He also serves on various boards including the International School of Management, University of Minnesota Carlson School of Management Enterprise Risk Management advisory board, and LifeWatch Corporation.

Patricia M. Arnold is on the faculty at the University of Texas at Austin, and holds two professional designations—Chartered Property Casualty Underwriter (CPCU) and Associate in Loss Control Management (ALCM). She received her BA from the University of Texas in 1970. In addition to two courses at the undergraduate level, she teaches a professional-level Certified Financial Planner (CFP®) course.

She has held leadership positions in two CPCU chapters—in the Central Texas Chapter of the CPCU Society (chapter president and chapter Diversity Initiative chair), and in Central Illinois (All Industry Day Committee chair, among others). She holds a Risk and Insurance Management Society (RIMS) membership and has assisted the Central Texas Chapter in hosting speakers on such subjects as ERM, “green building” hopes and hazards, cyber liabilities, and Texas legislative updates.

Arnold’s publications include Deregulation, Pricing, and Availability Issues in the Texas Homeowners’ Insurance Market, with Patrick Brockett, PhD, for the Texas Public Policy Foundation (Dec. 2004), and a number of articles for the CPCU Journal.

She has served the University of Texas as McCombs School of Business member of the ad hoc sustainability committee, as faculty advisor of the TechConnects student volunteer organization, and is involved in Net Impact activities.
Arnold has over 30 years experience in the insurance and risk management industry, as an underwriter, field underwriter, safety representative, Texas-certified trainer and consultant. She worked for The State Farm Insurance Companies, including work in their headquarters teaching complex coverage issues and insurance contracts in personal and commercial lines.

Her areas of special interest are catastrophe risk financing, products liability and outsourcing, contracts and risk transfer, and the dynamics of public policy development and enterprise risk management.
TABLE OF CONTENTS

INTRODUCTION .................................................................................................................................4
KEY TERMS, MODIFICATIONS, AND UPDATES ..................................................................................6

Techniques of Risk Management & Insurance
Chapter 1: Introduction to Traditional Risk Management .................................................................7
Chapter 2: Enterprise Risk Management ............................................................................................10
Chapter 3: Risk Assessment: Identification .........................................................................................13
Chapter 4: Risk Assessment: Quantification .........................................................................................15
Chapter 5: Overview of Risk Treatment Alternatives .........................................................................17
Chapter 6: Noninsurance Transfer of Risk ..........................................................................................19
Chapter 7: Insurance as a Risk Transfer Mechanism ..........................................................................20
Chapter 8: Overview of Alternative Risk Transfer Techniques .........................................................21
Chapter 9: Global Risk Management ..................................................................................................22
Chapter 10: Loss Control Techniques ................................................................................................23
Chapter 11: Emergency Response Planning .........................................................................................24
Chapter 12: Business Continuity Planning ............................................................................................25
Chapter 13: CLAIMS MANAGEMENT .................................................................................................26
Chapter 14: MONITORING CLAIMS FOR FINANCIAL ACCURACY ....................................................27
Chapter 15: INSURANCE COMPANIES AND RISK MANAGEMENT ..................................................28
Chapter 16: WORKING WITH AN AGENT OR BROKER ....................................................................29

Tools of Risk Management & Insurance
Chapter 17: COMMERCIAL GENERAL LIABILITY INSURANCE .........................................................30
Chapter 18: THE WORKERS’ COMPENSATION SYSTEM ....................................................................31
Chapter 19: COMMERCIAL PROPERTY INSURANCE ......................................................................34
Chapter 20: DIRECTORS’ AND OFFICERS’ LIABILITY INSURANCE ...............................................36
Chapter 21: EMPLOYMENT RELATED PRACTICES LIABILITY INSURANCE ....................................37
Chapter 22: BUSINESS AUTOMOBILE INSURANCE ........................................................................38
Chapter 23: CRIME INSURANCE .........................................................................................................39
Chapter 24: CAPITAL MARKETS RISK TRANSFER TOOLS ..............................................................40
Chapter 25: LOSS CONTROL TOOLS ................................................................................................43
Chapter 26: THE CERTIFICATE OF INSURANCE ...............................................................................44
CASE STUDY ONE: The Playskool Travel-Lite Crib .........................................................................45
CASE STUDY TWO: The Ham’s the Thing .........................................................................................49

Supplemental Glossary .......................................................................................................................57

Copyright 2009, The National Underwriter Company
INTRODUCTION

The purpose of this supplement is to bring to students the very latest material available in risk management and insurance. To this end, we provide you with chapter-by-chapter updates—the latest information on the materials in each chapter. You will also find comprehensive case studies.

The Tools & Techniques of Risk Management & Insurance is a comprehensive text covering contemporary issues in the risk management discipline. The focus is primarily on the use of insurance, because insurance continues to be one of the most important tools available to risk managers to manage value for their organizations.

The text is divided into two main sections: one for techniques and the second for the practical tools. Each chapter concludes with a valuable glossary of key terms. Each of these sections and the associated glossaries are updated in this supplement’s Key Terms, Modifications, and Updates section.

The case studies provide practical applications to facilitate immediate use of your new risk management and insurance knowledge.
KEY TERMS, MODIFICATIONS, AND UPDATES

Updates & Modifications: The purpose of this section is to provide you with updates and enhancements to the material provided in *The Tools & Techniques of Risk Management & Insurance*. Like any text, it takes a significant time to prepare and publish. During the period required for this text, many innovations and refinements have occurred in risk management.

Key Terms: In supplementing and updating, we introduce key terms and incorporate them in each chapter’s Glossary. These terms are shown in **bold font**. Enterprise Risk Management (ERM) provides us with the opportunity to reach out to other disciplines. In this regard, we are challenged to modify our language to be in sync with finance, statistics, and general management. The authors’ terminology suggestions are intended to help risk managers better communicate with other stakeholders.

You may consider some of the updates controversial. They may introduce you to new subjects and theories. A healthy discussion of these ideas is encouraged and your feedback and comments are greatly appreciated.

Introduction: Chapters 1 and 2 provide an introduction to concepts of traditional risk management and Enterprise Risk Management. This rapidly evolving industry uses even more terminology now such as: Governance, Risk, and Compliance (GRC); Corporate Social Responsibility (CSR); supply chain management; and sustainability. Also be aware that other disciplines are introducing risk-based concepts such as new accounting principles, international accounting standards, Basel II, and S&P’s risk management standards, to name just a few.

*The focus of all of these ideas is to create value, efficiently allocate scarce resources, comply with modern disclosure regulations, and to do so within the organization’s risk philosophy of appetite and tolerance for risk.*
TECHNIQUES OF RISK MANAGEMENT & INSURANCE

Chapter 1

INTRODUCTION TO TRADITIONAL RISK MANAGEMENT

Traditional risk management. The title of this chapter demands a definition, or an understanding of the context in which the term “risk” is used in the textbook. We suggest Traditional Risk Management be described as the discipline of managing pure risks. That is, managing the adverse consequences of the negative variation from the expected outcome over time. Traditional risk managers generally developed their expertise within the insurance industry and focused on financing losses with insurance. Over time, risk managers assumed new duties including loss control, risk analysis, contractual relationship management, monitoring risks, and compliance with standards, ethics statutes, and regulations. In almost all cases, traditional risk management meant managing losses. Managing traditional risk means:

Managing the adverse consequences of the variation from the expected outcome over time.

UNDERSTANDING THE NATURE OF RISK (p. 1)

Risk: There are many available definitions for us to use when describing risk. However, to effectively communicate with other stakeholders, we suggest using a definition that is almost universally accepted in finance and statistics:

Objective risk is the variation from the expected outcome over time. This definition is objective because it enables the measurement of three key variables. And as management scholars state, “If you can measure it—you can manage it” The three key variables we measure are:

- Expected outcome: The arithmetic mean (average) of a data set is generally accepted as a reasonable forecast of future outcomes.
- Variation: The standard deviation (usual difference) from the expected outcome enables the manager to see the usual range, or spread, from the expected. This knowledge enhances planning.
- Time: A key variable in finance is the timing of an event—when it will occur, and its time horizon—the period of time the event will last. Risk management events must include these two key parameters in the measurement to make a complete description of the risk.

THE RISK MANAGEMENT PROCESS (p. 2)

Enterprise Risk Management (ERM) is a strategic and portfolio approach to a broad variety of RISK. As such the process for managing these additional risks requires more of a management-based framework. There are many proposed ERM frameworks; the industry has not yet adopted a standard. The following ERM framework is suggested for your consideration. It is a framework taught at other schools and professional association seminars.

1. Develop a Risk Management Program

   a. Plan – create and synchronize strategic, operational, and tactical goals
b. Organize – coordinate risk associates with the risk management department. Place the risk function within the organizational chart.

c. Write – articulate the organization’s risk philosophy (tolerance and appetite), and prepare a risk management standard operating procedures manual, update, and adjust.

2. Risk Analysis
   
a. Identify – all possible risks—speculative and pure
   
b. Measure – using quantitative and qualitative analysis tools
   
c. Evaluate – create a portfolio of risks and consider interaction effects (correlations)

3. Solution Analysis
   
a. Identify – all possible opportunities to modify the risks, including first risk control and then risk financing
   
b. Measure – using quantitative and qualitative analysis tools
   
c. Evaluate – the holistic impact of the portfolio of solutions

4. Decision Process
   
a. Decision models – consider all possible models, including benchmarking, financial analysis, experience, ethics, and multi-attribute models
   
b. Support – leadership in gaining stakeholder buy-in and participation
   
c. Implement – allocate resources of people, time, and money; prepare budgets and time allocation charts; including managing and training employees

5. System Administration
   
a. Monitor – use a modern Enterprise Risk Management Information System
   
b. Judge – evaluate the success of the solution portfolio using statistical quality control tools (such as six-sigma)
   
c. Communicate – prepare documents and reports to comply with stakeholder and regulatory demands

THE RISK MANAGEMENT POLICY STATEMENT (p. 4)

An organization’s risk management policy statement should articulate its broad risk philosophy. That is, it should specify both the risk appetite and risk tolerance. The risk appetite is the firm’s desire to accept and invest in projects that have positive variation from the expected outcomes. The firm’s risk tolerance statement expresses its ability and capacity to bear adverse variation from the expected outcome.
TRADITIONAL RISK MANAGEMENT VERSUS ENTERPRISE RISK MANAGEMENT (p. 5)

The second paragraph, line one should be updated to read: “Large, complex organizations employ three separate and distinct forms of risk management.” The three forms of risk in ERM now include:

1) *Strategic risks* – the variation to long-term projects, or events that have long-term impacts

2) *Operational risks* – the variation to short-term projects; also called *business or hazard risk*

3) *Economic risks* – the variation to financial conditions and to other macro-economic conditions (such as political or regulatory environments). Important note: people in finance refer to the term *market risks* as the variation to conditions in the *capital* markets. However, risk managers should be aware that people in economics or marketing refer to this same term *market risks* as the variation in the demand-and-supply chain, or *economic* markets.

GLOSSARY

**Pure risk:** situations in which the only variations from the expected outcome (over the time horizon) are either losses or no losses. There is no possibility for gain.

**Speculative risk:** situations in which the variations from the expected outcomes (over the time horizon) can be positive gains, zero, or losses in values.

**Enterprise Risk Management.** The discipline of creating the desired level of variation from the expected outcome over specified times for **all** of the organization’s opportunities and threats.

**Risk appetite.** The willingness of an organization to invest resources in speculative projects that have a potential positive variation from the expected outcome over a time horizon.

**Risk tolerance.** The willingness of an organization to accept *and* the ability and capacity to bear adverse variation from the expected outcome over a time horizon.
Chapter 2

ENTERPRISE RISK MANAGEMENT

WHAT IS IT? (p. 7)

ERM is sufficiently complex that an entire text book could be written about it (and it is!) This chapter introduces the concept of ERM in relationship to traditional (pure) risk management. The ideas provided in the Tools & Techniques of Risk Management & Insurance represent one perspective of many possibilities. There are many innovations and concepts developing in this evolving discipline.

PURPOSE OF ERM

Volatility (p. 8)

The text asserts that one objective of ERM is to reduce earnings volatility. However, many argue that earnings volatility is directly correlated to the earnings. That is, in order to increase earnings one must accept situations that have greater volatility. Consequently, newer ERM models suggest its purpose is to:

Create the desired level of variation from the expected outcome in the intended time horizon.

The benefit of this updated purpose statement is to enable the risk manager to broaden the perspective from pure risks to include value-creating speculative risks. This new and improved purpose is truly an enterprise-wide risk management paradigm.

Shareholder Value (p. 8)

The early focus of ERM was indeed on creating shareholder value. However, the updated focus is now on creating stakeholder value. Stakeholders are the parties that have an interest in the organization’s success. They include such groups as management and labor, suppliers and customers, owners and boards of directors, governments and non-government organizations, the competition and copetition, and all the intermediaries who facilitate transactions between the stakeholders. The importance of this modification is evidenced by the rapid adoption of ERM by not-for-profit firms and government agencies. ERM appeals to more than publicly traded stock corporations; ERM appeals to all organizations. Not all stakeholders are after only economic performance. While cash flows are an important value desired by shareholders, they and other stakeholders also are increasingly demanding that the firm provide environmental stewardship and social justice values in addition to economic performance. The combination of these three values is what is now called the “triple bottom line” concept of “value.”

RISK CLASSIFICATIONS IN ERM (p. 9)

A contemporary and simplifying update to ERM is to reduce the number of risk classifications to three. These more modern sets of risks are:

1. Strategic risks,
2. Operational risks, and
3. Economic risks.

Strategic risks, such as reputation, compliance, and market position, have become very important to organizations, as they try to preserve and enhance their long-term goals.
Operational risks now include event/hazard risks, as all impact the organization’s output of goods and services. Any variation from these desired outcomes should be managed as a portfolio. An operational audit assists in the risk identification of these variations.

Economic risks include all the traditional financial risks (such as exchange rate, interest, and credit risks) plus many political risks. These macro-economic variables can significantly affect global operations—and many organizations are now global. Moreover, even local regulatory risks can be significant factors in the organization's economic health.

Overlay of Risks (p. 10)

Given the new taxonomy of risks, the overlay of risks (figure 2.4) is now modified where the core risks are the strategic risks; these are surrounded by operational risks; which are then surrounded on the outside by the economic risks. This new overlay provides an enhanced perspective of how the various risks interact.

Figure 2.4 Revised: The Interrelationships between risk categories

Concepts in ERM (p. 10)

There are five key concepts that differentiate ERM from traditional risk management:

1. Horizontal integrations. This includes the ideas of interdependencies and correlations between variables. This interaction of factors is the basis for portfolio theory and modification of a portfolio’s standard deviation of returns.

2. Vertical integrations. While traditional risk managers focused on operational goals, enterprise risk managers focus on all of the goals at all of the organization’s levels. The long-term strategic plans and strategies are now carefully knit into a tapestry of medium-term operational objectives, plus short-term tactics or action plans. All goals are synchronized to assure the organization's activities are vertically aligned.
3. **Facilitation.** The risk manager (or chief risk officer) is a facilitator of risk associates. Instead of a situation where the traditional risk manager is a one person shop doing all the risk management functions, the ERM manager is a C-level leader who serves as an internal consultant helping others achieve their risk-sensitive goals.

4. **Integrated tools** are used to achieve the many ERM functions. These include tools from finance (e.g., portfolio theory), statistics (e.g., six-sigma), decision science, and general management (e.g., behavior modification). The ERM manager uses all these techniques to assure that others will achieve their goals. Enterprise risk managers have a **fiduciary duty** to apply these tools in order to satisfy their legal responsibility as agents for the principals. The failure to learn and apply these “best practices” tools is a breach of that fiduciary duty.

5. **Focus on value creation (speculative risks).** Whereas the traditional risk manager attempts to minimize silos of risks, the ERM manager focuses on enabling and enhancing portfolios’ desired risks so as to achieve the commensurate returns.

**RISK ASSESSMENT AND ANALYSIS**

**Risk Mapping (p. 15)**

ERM risk maps continue to evolve. The latest risk maps are illustrations that plot all the organization’s risks—both pure and speculative. Following financial practices, these maps show gains in value on the right side of the origin and losses on the left side. This update enables the Chief Risk Officer (CRO) to visualize how all risks fit together—not just the pure risks. The illustration shows a more appropriate ERM risk map. In addition, computers allow modern risk maps to plot events on a continuous scale. No longer are risk managers confined to discrete sets of boxes to describe possible outcome probabilities and values. Thus, this improved information enhances quality decision making.

**Figure 2.6 (revised)**

**Financial Solutions in an ERM Environment (p. 15)**

The solutions provided in this section of the text are excellent examples of integrated financial solutions. The solutions illustrated in figure 2.7 show ways to integrate various lines of insurance products to create a portfolio of risk financing solutions.

**GLOSSARY (p. 21)**

**CAPM:** The Capital Asset Pricing Model – a seminal finance work that defined the relationship between an asset’s risk (beta) and the asset’s expected return.

**Stakeholder value:** the interest a party has in the organization’s success.

**Fiduciary duty:** The legal obligations of an agent to the principal of care (due diligence), loyalty, and disclosure (transparency).
Chapter 3

RISK ASSESSMENT: IDENTIFICATION

WHAT IS IT? (p. 23)

Current ERM risk assessment now contains three separate and distinct activities:

1. Risk identification,
2. Risk measurement (quantification and qualification), and now
3. Risk portfolio evaluation

Risk identification includes two parts:

a. Using the seven proven methods to discover risks, plus
b. Describing the five attributes that determine the essential quality of the risk.
   - The seven identification methods are provided on page 25.
   - The three risk attributes that must be described at this point in the risk management process are:
     1) A description of the subject (the exposure or project),
     2) The source of the change in value (peril or opportunity), and
     3) The factors that modify the likelihood or impact (hazards or drivers).

This “descriptive analysis” of the risk is a critical first step in ERM because it (1) forces the risk analyst to clearly explain the three dimensions of the risk and (2) enables better understanding of the variation.

Risk measurement (quantification and qualification) is the topic of Chapter 4.

Risk portfolio evaluation requires the risk manager to identify and measure the interaction effects of combining risks into a portfolio. While correlations can be extremely difficult to accurately assess, at a minimum the risk manager should attempt to express the associations and relationships between risks. A fundamental concept in risk management is that when two or more risks are combined in a portfolio there is often an interaction between the two risks. Sometimes, the interaction is beneficial, such as in natural and financial hedges; at other times, the interaction is adverse and creates additional, new risks.

STEP ONE: CATEGORIZING OWNED AND NONOWNED ASSETS (p. 23)

Most risk management authorities agree that there are four categories of traditional (pure) exposures (subjects or objects that may sustain a loss in value):

1. Assets (real and personal, including financial and intangible assets),
2. Third-party liabilities (legal obligations to others),
3. Human resources (including their intellectual capital), and
4. Net income (earnings losses, decreased revenues, or increased expenses)

**STEP TWO: IDENTIFYING THIRD-PARTY LIABILITY (p. 24)**

In addition to the five major categories listed, add the following public liability exposures:

- Statutory obligations such as compliance and governance or conduct
- Social obligations and public policy (use of the Corporate Social Responsibility (CSR) report standards could act as a guide here)
- Stakeholder obligations—employees, owners, stockholders, pensioners—those owed a heightened duty of care, or fiduciary duty

**STEP THREE: CHOOSING THE RESOURCES (p. 25)**

In addition to the identification techniques shown, add the following:

- Experts. There are many internal and external “experts” who can be used to help identify risks, such as user or focus groups
- The loss history report, an important company document used to identify risks, should be used to manage litigation, claims costs, and claims reports to management.
- Job analysis, incident analysis report
- Physical inspections, or surveys, audit documents, litigation records
- Loss control cost evaluations

**GLOSSARY (p. 36)**

**Corporate Social Responsibility report:** a written document that attests to an organization’s commitment to its stakeholders and the processes used to attain that position.

**Correlation:** the association between variables. In statistics, the correlation describes the linear relationship between two variables and is expressed as a value between -1 and +1. The value’s sign indicates the direction of movement between the two variables.

**Loss history report:** a document that shows an organization’s loss values over a period of time (sometimes called a loss run).

**Natural hedge:** a project (a product or service) whose change in value is inversely proportional to the change in value of another project. As the second project’s value goes down, the first project’s value goes up (and vice versa). Frequently, a diverse mix of products is used as a natural hedge.

**Financial hedge:** a financial project (an investment or asset) whose change in value is inversely proportional to another financial project’s change in value. As the second project’s value goes down, the first project’s value goes up (and vice versa). Frequently, derivatives are used as financial hedges.

**Risk audits:** an inspection of not just the financial but also operating procedures related to managing variation in the organization’s operations.
Chapter 4

RISK ASSESSMENT: QUANTIFICATION

WHAT IS IT? (p. 37)

This chapter contains important information about making decisions about financing losses either through retention or transfer techniques, to help the organization follow its positions of risk tolerance and risk appetite. To make these decisions, the material provides some loss quantification techniques. However, risk assessment (measurement) is done for many other reasons. For example, once risks are measured, managers can use this information to plan strategies or select among risk control projects. Determining the proper insurance policy deductibles is an important exercise, but risk measurement involves much more.

As the text points out, quantification of risk factors is an inexact science—but it is still one of the best methods available to shed light on the current states of nature. Risk assessment involves two types of measurements: quantitative and qualitative.

In the quantitative assessment, the risk manager measures the exposure’s value—the expected outcome and associated possible changes in value, and the likelihood of each possibility over time. The result is a probability distribution of possible outcomes.

Valuable information is provided from this quantification exercise, including the:

- Time of the occurrence,
- Time (length) or duration,
- Expected outcome (arithmetic mean),
- Mode,
- Median,
- Standard deviation from the mean,
- Range, and perhaps most importantly the
- Coefficient of variation.

Loss triangulation is an important tool in assisting risk managers in forecasting ultimate loss values. It should be pointed out that actuaries have developed many techniques to use and analyze loss triangle data. Moreover, the data may be obtained from the organization’s own loss experience, the industry loss experience, a combination of the two, or from data simulation. This final method is especially important in catastrophe modeling—such as hurricane modeling.

The risk management and insurance discipline is historically saddled with some unfortunate choices of “terms of art.” These terms may confuse students and stakeholders in other disciplines. Three examples are found in this chapter: exposure, guaranteed cost, and self-insurance.
Exposure. An exposure is defined as “an asset or person that may have a loss in value.” Examples include real property, money, and key personnel. However, on page 40, this same term is used to describe the physical conditions surrounding real property. It is used as the “E” in COPE—the acronym for the asset hazards. The new preferred E word is environment. By referring to the E as the environment, the risk management student is not confused over the use of a homonym. Industry practitioners formerly used the “E” to denote “exposing occupancies,” or properties adjacent or contiguous to the organization applying for insurance. What types of hazards are located nearby? What problems—such as fire or explosion—could the nearby hazards create for our organization?

Guaranteed rate. In assessing the cash flows associated with risk financing plans, it is important to accurately describe that plan. One such plan is misleadingly named a “guaranteed cost” plan. This name infers that the price (cost) is a fixed expense and will not change during the policy period. In reality, this plan charges a rate per exposure unit, multiplied by the actual exposure units during the policy period, as determined by an audit at the policy expiration.

What is “guaranteed” is not the cost—but instead the rate is guaranteed. This confusing term has resulted in potentially unethical behavior by the rare, unscrupulous intermediaries who solicit new accounts on a guaranteed cost basis using an unrealistic low exposure basis (also called low-balling), hoping the consumer will not realize the true cost is based on the audited exposure basis and the guaranteed rate. To emphasize the importance of correcting this diachronic term you should replace all instances of “guaranteed cost” with “guaranteed rate.”

Self-funding. An unfortunately common oxymoron prevalently used in daily conversation is self-insurance. The term is usually used to suggest an organization is funding losses through a form of retention. By definition, insurance is a transfer and pooling of pure risks. However, if the organization pays for its own losses then no risk financing transfer to another distinct party occurs.

Moreover, no other organizations have pooled funds to pay for these losses. Thus, at best, the term presents a contradiction. A result is to make users of this term appear to not truly understand their discipline. At worst, the use of this term may encourage an unfounded reliance on an inadequate or poorly constructed funding mechanism.

A superior, more accurate, and simpler term is self-funding. Alternatively, the risk manager may wish to call these types of risk financing plans retention. Again, you are encouraged to substitute the words self-funding whenever appropriate.

There is one exception in which a state has approved a regulated and collateralized plan, referred to as a qualified self-insurance plan. This plan is discussed in Chapters 8 (p. 87) and 18 (p. 341, 363). This plan is a form of a single parent, pure captive carefully regulated by state insurance departments to protect the public.
Chapter 5

OVERVIEW OF RISK TREATMENT ALTERNATIVES

This chapter could be re-titled as “Overview of Risk Financing Alternatives” and expanded to elaborate on the risk control options.

THE OPTIONS (p. 49)

You should add the options of prevention and reduction to those stated in the textbook. This addition makes the concept of risk treatment alternatives complete.

In addition, recognize that when deciding between risk alternative treatments, the organization (or its insurance and loss control broker) will consider the market appetite of the insurance and financial services industry.

An unfortunate assumption (although often true) is that organizations will adopt the risk control measures of prevention and reduction only if it reduces the overall cost of risk. For some not-for-profit and governmental organizations, these risk control measures are adopted for non-pecuniary reasons. For example, safety projects may be adopted to protect lives, to realize long-term goals of community service, or to support its Corporate Social Responsibility (CSR) goals.

Figure 5.1 includes risk control options. An updated illustration follows: 5.1a: Risk Management Solution Tree.
GLOSSARY (p. 53)

Market (insurance) appetite: the current condition of the insurance industry to accept the transfer of the financing of losses. In a soft market, the industry wants business and will either charge low premiums or permit less stringent underwriting. In a hard market, the industry is usually recovering from catastrophic losses (such as hurricanes) and either increases premiums or enforces more stringent underwriting. Thus, it is “hard” for the consumer to obtain insurance in this market appetite.

Risk philosophy (position): the willingness of an organization to both invest in new projects and to accept losses. This position is made up of the risk appetite and risk tolerance.

Risk appetite: an organization’s willingness to invest in projects that have positive variation in the expected outcome over the project’s time horizon.

Risk tolerance: an organization’s willingness to accept projects that have negative variation from the expected outcome over the project’s time horizon (losses).
Chapter 6

NONINSURANCE TRANSFER OF RISK

It should be noted that these noninsurance transfers are attempts to transfer risk. The courts may “reform” transfer contracts or other parties (transferees) may default.

BEFORE-LOSS TRANSFERS

Incorporation (p. 55)

The transferee who accepts the risk from the corporation owners is society. The consideration (payment) for this significant risk transfer is a government-imposed scheme of corporate taxes and fees. This payment for the risk transfer dispels the erroneous, but common, notion of “double taxation.” The corporate owners are paying for their limited personal liability.

Surety, Guarantee, and Performance Bonds (p.57)

There are two main categories of bonds which are not related to financial institution transactions: fidelity bonds and surety bonds.

Fidelity bonds protect an employer from the costs of financial losses caused by the dishonest acts of employees. The basic differences between bonds and insurance still apply to fidelity bonds, though they may appear to be risk transfers like insurance.

Surety bonds have two main categories: commercial bonds and public bonds. The sub-categories of commercial bonds include (1) contract bonds (such as bid, performance, payment, or maintenance bonds), (2) license, (3) lost securities, and many others. Public bonds include public official, permit, judicial (court bail, fiduciary—such as guardianship or executor bonds, and probate bonds), and many others.

AFTER-LOSS TRANSFERS

Hold-Harmless Agreements (p. 59)

As the examples provided on pages 64 – 66 and 541 – 542 demonstrate, the application of a hold-harmless agreement can be quite broad. Because attorneys commonly combine hold-harmless agreements with indemnity clauses, the practical difference between the two concepts is now blurred and courts may interchange the two. Theoretically, hold-harmless agreements are based on the concept that one party agrees to hold a second party “harmless” if a third party sues the first party for events in which the second party may have participated. In other words, if sued by a third party, the first party agrees not to sue the second party. This could be considered a form of a waiver of rights. As the examples show, the first party often also agrees to indemnify the second party if the second party is sued by the third party. In theory, the two concepts could be written as separate agreements but in practice they are often combined. Risk managers should understand this subtle and important difference in agreements and tailor these transfers to their benefit.
Chapter 7

INSURANCE AS A RISK TRANSFER MECHANISM

WHAT IS IT? (p. 67)

The third sentence in the first paragraph contains an important error. It falsely states that an insurance contract transfers to the insurer the legal responsibilities for the insured’s acts. However, insurance is merely an indemnity contract—it transfers the financing of the loss to the insurer. A property insurance contract indemnifies the insured for specified losses. A liability insurance contract indemnifies (pays on behalf of) the insured for legal and/or financial obligations to third parties (but only up to the policy limit), and associated defense expenses. This is a subtle, yet important, distinction.

STEP THREE: BINDERS OF INSURANCE (p. 71)

There are other documents that an insurer provides to the organization—they may be entitled evidence of insurance document, or certificate of insurance. These documents may be supplied at the time of binding coverage or intermittently to verify renewal or as a snapshot of coverage to outside parties. These documents do not provide insurance coverage - as do Binders of Insurance.

STEP FOUR: RECEIVING AND REVIEWING POLICIES (p. 74)

The Declarations page may also indicate state-specific taxes and fees, how to contact regulators to log a compliant, and the audit or inspection intervals.
Chapter 8

OVERVIEW OF ALTERNATIVE RISK TRANSFER
TECHNIQUES

STEP THREE: UNDERSTANDING TYPES OF CAPTIVES
Classifications and Types of Captives (p. 88)

Single parent captives may be sub-classified as either a pure or broad form. The single parent captive is a pure form when the captive’s only client is the parent. When the captive also sells insurance to independent third parties, it is called a broad form captive. The IRS has ruled that the third parties may declare their premiums paid to the broad form captive as a tax deductible expense; however, the parent’s premiums are not tax deductible because the IRS has ruled the parent’s payments are not a risk transfer.

STEP SEVEN: UNDERSTANDING CAPTIVE TAX ISSUES (p. 96)

Captive (and other alternative risk transfer plan) tax issues are complex and require significant study before well-informed decisions can be made. The risk manager should seek appropriate tax advice from a qualified tax consultant. Tax rules are continuously reviewed and subject to change. For example, FAS 113, FASB 133, and EITF 93-6 are but a few opinions that should be considered.

OTHER ALTERNATIVE RISK FINANCING TECHNIQUES (p. 97)

Besides the finite risk transfers introduced here, Alternative Risk Financing (ARF) tools are the topic of Chapter 24: Capital Markets Risk Transfer Tools. Some other alternative risk financing techniques include catastrophe bonds, insurance derivatives, securitization, and contingent capital arrangements (borrowing).

Finite Risk Reinsurance (p. 98)

The last sentence in the first paragraph contains an error: The word “low” should be replaced with the word “high.” It should read: “Typically, a prototypical finite risk prospect is a firm with a high severity, high frequency exposure for which adequate coverage is either unavailable or prohibitively priced.” Finite risk insurance was originally developed as a retroactive plan to respond to events that already occurred (the infamous MGM Grand Hotel fire was the genesis of this type of plan). In this case the event’s probability was certain and the timing of the payment was the only issue. Some current finite risk insurance plans are now prospective plans arranged to cover losses from events that are highly probable but have not yet occurred.
Chapter 9

GLOBAL RISK MANAGEMENT

IDENTIFYING TERRITORIAL LIMITS

Transportation of Property (p. 110)

The risk manager should be aware there are many forms of shipping contracts. For example, free on board (FOB) and free along side (FAS) can be either point of origin or point of destination. In a CIF—a point of destination contract, the good’s ownership and, thus, the risk of financial loss—usually transfers at the point of destination; the seller provides insurance and freight costs to the point of destination.

Another shipping contract is seen in installment or conditional sales contracts. In these forms, the seller maintains ownership rights until the goods are delivered, installed, operating as specified, and final payment has been made.

Here is a list of the more common shipping options. The significance is the point in time and location where the organization’s risk manager accepts—and acknowledges in the insurance and risk management program—the risk of financial loss.

- FAS – point of origin
- FOB – point of origin
- C & F
- CIF – point of destination
- FAS – point of destination
- FOB – point of destination
- Installment or conditional sales contract
Chapter 10

LOSS CONTROL TECHNIQUES

LOSS CONTROL THEORIES

System Safety Approach (p. 161)

The system safety approach is a very broad approach to loss control. It actually got its start in the 1960s when engineers were unsatisfied that the engineering approach alone was solving the accident rate problem. The system safety concept initially focused on the application of systems engineering and systems management. Now the approach is broadened to encompass all four loss control theories.

Some apply life cycle theory to system safety. This enables viewing a hazardous process or condition as a part of a larger system. In this case, the system can be the entire enterprise, or the society in which the enterprise exists. For example, a manufacturing plant may produce a product that is at the peak of its life cycle and is about to turn into a cash cow product—one that can be safely milked until some future date. However, the plant itself may still be in the growth phase of its life cycle. Hence the system’s hazards must be perceived with regard to all components that affect the risks.

THE FIVE-STEP PROCESS (p. 161)

There are many risk management frameworks, or analytical models. The ERM framework presented in this chapter provides an opportunity to discuss the advantages and disadvantages of the various frameworks.

Step Three: Loss Control Solution Analysis (p. 162)

There is a printing error on page 163 for equations LC-1 and LC-2. The Sigma was replaced by an E (Sigma is the symbol for summation). The correct equations are:

Eqn. LC-1: \[ E(L) = \sum p(L_i) \times $(L_i) \]

Eqn. LC-2: \[ S_L = \left( \sum \left[ E(L) - $(L_i) \right]^2 \times p(L_i) \right)^{\frac{1}{2}} \]

A similar error occurs on pages 164 in Eqn. LC-4 and in the example provided in Figure 10.1.

Eqn. LC-4: \[ NPV = \sum PVCF_t \]

On page 165 the final calculation is the coefficient of variation. The title of this should read “Coefficient of Variation after the loss control project.”
Chapter 11

EMERGENCY RESPONSE PLANNING

Emergency Response Planning is a part of the larger field that includes three phases of an emergency: before, during, and after the emergency. The emergency is sometimes called a disaster or catastrophe. The pre-emergency planning phase is disaster preparation planning. During the emergency, the firm implements its emergency action plan. After the emergency, firms will frequently implement their follow up plans, which are frequently called business continuity plans. Sometimes these are also called disaster recovery or business interruption plans. It is prudent loss control to develop and practice all three types of plans. The three plans might be collectively referred to as a Disaster Planning and Recovery Manual.

A practical and informative exercise:

- Develop a personal disaster preparation plan, for a specific peril—such as avian flu, a terrorist attack, or a hurricane.
- Prepare an emergency action plan—what to do in the event the peril occurs.
- Finally, prepare a business continuity plan to get life back to normal.

This personal exercise will not only help you understand how to plan the three phases of a disaster planning and recovery process, but it may also save lives.
Chapter 12

BUSINESS CONTINUITY PLANNING

STEPS TO IMPLEMENT

Step One: Project Initiation and Management (p. 199)

The abbreviation NASD refers to the National Association of Securities Dealers. In 2007, the NASD merged with the New York Stock Exchange's regulation committee to form the Financial Industry Regulatory Authority, or FINRA.

Step Six: Plan Implementation, Training, and Testing (p. 207)

An evaluation of salvage opportunities and replacement of key materials should be considered here. No plan is useful unless routinely communicated and practiced, at all levels.
Chapter 13

CLAIMS MANAGEMENT

WHAT IS IT? (p. 215)

The text states claims management

“...contrasts with loss control, which attempts to stop or decrease the severity of losses before they happen. Claims management is a post-loss activity, whereas loss control is a preloss activity.”

In reality, loss control is a broader discipline that includes prevention (pre-loss activities) and reduction (post-loss activities) of losses. Claims management is one type of reduction. Not all post-loss activities involve evaluation and mitigation of claims for damage or loss to covered property by an insured loss event. For example, a retail company may observe a small amount of inventory shrinkage. The company may not file a claim with its risk financing scheme but instead install a detection system at the exits and place metal strips on the merchandise. This reduction technique will decrease the severity of losses (and may prevent some too). However, the reduction technique does not involve a claim.

Claims management is a valuable reduction tool. It is a system to process and monitor losses through a risk financing scheme—such as insurance.

STEPS IN THE CLAIMS MANAGEMENT PROCESS

Step Three: Claim Is Denied, Accepted, or Conditionally Investigated (p. 220)

The third bullet states an adjuster may conditionally investigate the claim. A good example is when the insurer issues a reservation of rights letter.
Chapter 14

MONITORING CLAIMS FOR FINANCIAL ACCURACY

WHAT IS IT?

Figure 14.1 on page 230 has data errors.

- The incurred losses amount for policy term 1/1/1998-99 has a transposition error: the 52 is printed as 25. The correct value is $97,852.

- This transposition error is carried through to the total for incurred losses. The correct total incurred losses value is $554,139.

- The same transposition error is carried down to the second and third tables. The total incurred losses for table 2 is $578,944.

- The total incurred losses for table 3 is $540,433.

Subsequent loss ratio calculations on page 231 use the incorrect total incurred losses.

A practical exercise would be to recalculate the loss ratios using the corrected sums.
Chapter 15

INSURANCE COMPANIES AND RISK MANAGEMENT

This chapter should also mention risk management services available through insurers. A more appropriate title might be simply “Insurance Companies.”

CHOOSING AN INSURANCE ARRANGEMENT

Admitted and Nonadmitted Insurers (p. 241)

There is an error in the description of an admitted insurer. Technically, an insurer must be licensed by a state (or national government) before it can transact business in that state. Once licensed, the insurer may apply for admitted status. All domestic insurers must be licensed and authorized by state insurance officials to conduct insurance business in the state. Foreign and alien insurers apply for licenses to transact insurance business, either as primary insurers or under the state’s surplus lines insurance laws. An insurance company is said to be *authorized* to do business in a jurisdiction by being licensed to conduct business with clients whose locations and operations emanate from that state.

A licensed insurer may further apply to become an *admitted* insurer. An admitted insurer agrees to abide by all regulations and laws relating to insurance in that state. These provisions are imposed to protect the consumer. A key condition of admitted insurers is their participation in the state’s guarantee fund. Other conditions include complying with insurance policy form, rate filing, and distribution rules. Many countries require the use of insurance companies admitted to write insurance within their country.

Some jurisdictions (for example all states) permit a nonadmitted insurer (if licensed) to write insurance in the jurisdiction if the insurer pays a penalty or fee, or complies with other regulations. For example, surplus lines brokers collect a surplus lines state fee or tax for placing business with nonadmitted insurers. In addition, most states require the insured to sign an acknowledgment that they have purchased insurance from a nonadmitted insurer. Most forms also provide that the insured understands that this insurer does not participate in the state’s guarantee fund and the insurer does not have approved policy forms, rates, distribution, or other rules.

Some jurisdictions do not make the distinction between licensing and admitting, but regard them as synonymous.

Risk-Based Capital

The text, on page 248, references the ratio of written premiums to surplus as “the Kenny [sic] Rule.”

Actually there are several Kenney rules that were originally proposed in *Fundamentals of Fire and Casualty Insurance Strength, 3rd ed.* Dedham, Massachusetts: Kenney Insurance Studies (1957) Roger Kenney.

- Kenney’s “Fire Ratio” = policyholder surplus: unearned premium reserves ≥ 1.
- Kenney’s “Casualty Ratio” = written premiums: policyholder surplus ≤ 2.

These and the other Kenney rules are based on heuristics and experience, rather than theoretic concepts or empirical evidence. Despite this limitation, they are fairly robust.

Kenney is also misspelled in the glossary page 262.
Chapter 16

WORKING WITH AN AGENT OR BROKER

QUESTIONS AND ANSWERS (p. 288)

Almost all commercial insurance and a great deal of personal lines insurance is obtained by using the services of an agent or broker. This is because, as shown in the “What is it?” section, an intermediary provides many valuable services in addition to the placing of coverage. Many risk managers consider their intermediary a long-term partner in their businesses. As a result, the decision to shop for a new intermediary can be an important business decision.

The text correctly suggests an annual review of the intermediaries’ fees and services. However, this does not imply that the business should prepare annual RFPs for insurance coverages. Due diligence—and corporate management documents—suggests that shopping the program and the broker every three to five years is the optimal recommended interval.
TOOLS OF RISK MANAGEMENT & INSURANCE

While the preceding section, “Techniques of Risk Management & Insurance,” provides the theory and concepts of risk management, these subsequent chapters provide practical details on how to create a risk management and principally an insurance program.

Chapter 17

COMMERCIAL GENERAL LIABILITY INSURANCE

DESIGN FEATURES

Definitions (p. 311)

Definitions are frequently italicized—or perhaps shown in bold type face, or in quotation marks—in insurance policies. This brings attention to these key concepts and provides the insurer with a means to give these terms a special meaning within the contract of insurance.

OTHER BUSINESS USES

Premium (p. 312)

When reviewing rates filed by insurers, state insurance regulators often use a reasonable and feasible rule of thumb, or a fair and adequate rule. Reasonable suggests that the insurance premium should be reasonably close to the actuarially fair price. That is, the premium should not be too far from the arithmetic average (mean) loss value. This criterion prevents the insurer from collecting an unreasonable risk premium.

Feasible (or fair) suggests that the premium should be affordable by the insured. In the case of some perils (e.g., earthquake or windstorm), the mean value may be such a large amount that the average consumer may not be able to afford the coverage. Therefore, as a matter of social policy, regulators require insurers to reduce the rate to create a more affordable and feasible premium.

FORMS AND CHECKLISTS (p. 322)

The ISO Commercial General Liability Coverage Form (CG 00 01 10 01) is an occurrence form.

A practical exercise is to compare this form to the ISO claims made form. This exercise will help you appreciate the differences in coverages and analyze policies that are commonly issued as claims made forms (such as D&O and other professional liability coverages).

Another exercise is to identify and evaluate policy exclusions. Many are listed specifically in the exclusions section (ISO page 2), but many others are provided as exceptions to coverages or placed within an insuring agreement.

You should also relate coverages, exclusions, definitions, and limitations within each jurisdiction within which a claims or suit may be brought against the organization. Contracts of insurance, as with other contracts between parties, must comply with statutes and laws, as they are interpreted within the jurisdiction—state or federal—in which the case is heard.
Chapter 18
THE WORKERS’ COMPENSATION SYSTEM

WHAT IS IT? (p. 341)

A practical exercise involves the quid-pro-quo of workers’ compensation laws. Compare the trade-offs of employer and employee. Under state-specific workers’ compensation laws, each party gives up certain legal rights in exchange for a certain, predictable result. What are these rights and results?

The employer gives up the legal right of defense in certain employment incidents. In exchange the employer receives the certainty of the amounts paid for employee damages. Simultaneously, the employee gives up the legal right to sue the employer in these employment incidents.

In exchange the employee receives the assurance of indemnification. The state statute is incorporated into the policy contract and prescribes expenses that will be reimbursed to the employee or medical practitioner as damages, limited lost wages reimbursement, and expenses that support return-to-work programs mandated by statute.

See also Exclusive Remedy on page 343 and Employee Advantages and Employer Advantages on pp. 345 – 346.

Need for Self-Insurance Approval (p. 341)

An employer must file with the state for approval to self-fund a workers’ compensation insurance plan. Additional requirements may include depositing some collateral with the state or posting a surety bond. If approved, the employer has then created a Qualified Self-Insurance Plan.

DESIGN FEATURES
The Insurance Policy (p. 348)

As of 2008, there are five workers’ compensation monopolistic states. Private insurers cannot operate in these monopolistic fund states: North Dakota, Ohio, Washington, West Virginia, and Wyoming. Additionally, Puerto Rico and the US Virgin Islands also operate monopolistic funds. Nevada was a monopolistic fund state; however, effective 7/1/1999, the state allows private insurers to compete for business.

Other Factors (p. 353)

The fifth bullet point should read “increased employer liability limits of liability.”

The sixth bullet—audits—is an important point: Workers’ compensation (like most other commercial insurance) policies are subject to an annual audit. The audit records the actual employee classifications and remuneration in each actual classification. Occasionally, a state insurance department will revise the manual rate for selected classifications. The rate change is applied to the actual exposure basis. The total (or audit) earned policy premium is based on this audit; the deposit premium is subtracted from the total earned premium. The insured may have either an additional premium or a return premium due. See “Audit” on page 354.
EXPERIENCE RATING
The Modifier (p. 355)

The experience modification ("mod") factor is also referred to as the EMF. A mod greater than 1.00 (or 100% of the indicated rate) creates an increase in premium. A mod of less than one would decrease the premium.

PART TWO: FINANCIAL PLANS
Choosing a Plan (p. 363)

The following table is an enhancement of Figure 18.4: “The Progression of Risk and Return” on page 364. The table adds self-funded plans and loss control and claims adjusting attributes.

Figure 18.4 (revised)

<table>
<thead>
<tr>
<th>Guaranteed Cost</th>
<th>Standard Dividend Plan</th>
<th>Sliding-Scale Dividend</th>
<th>Incurred Loss Retro</th>
<th>Paid Loss Retro</th>
<th>Large Deductible Plan</th>
<th>Self-Funded Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>More</td>
<td>Insurance</td>
<td>Less</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Worse</td>
<td>Cash Flow</td>
<td>Better</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Higher</td>
<td>Fixed Costs</td>
<td>Lower</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less</td>
<td>Risk</td>
<td>Higher</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lower</td>
<td>Collateral Requirement</td>
<td>Higher</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less</td>
<td>Loss Control</td>
<td>More</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>More</td>
<td>Claims Adjusting</td>
<td>Less</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Guaranteed Rate Plans (p. 364)

This type of plan is unfortunately called a guaranteed cost plan. This may mislead consumers into the belief that their workers’ compensation costs (premiums) are fixed at inception. A better description is a guaranteed rate plan. The rate is usually guaranteed by the insurer. However, even this may be adjusted if the state insurance department adjusts the rate mid-term.

Retrospective Rating Plans (p. 367)

The last paragraph on page 367 describes the dates when a retrospective rating plan (a “retro”) is audited and adjusted. A retro plan is auditable and adjustable until all claims are closed.
Retrospective Rating Formula (p. 368)

The retrospective rating formula can also be expressed as shown in the following box.

<table>
<thead>
<tr>
<th>Retrospective Rating Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retrospective Premium = ( Basic Premium + Converted Losses + Excess Loss Premium ) × Tax Multiplier</td>
</tr>
<tr>
<td>Basic Premium = ( Standard Premium × Basic % Factor )</td>
</tr>
<tr>
<td>Standard Premium = ( Manual Premium × Experience Mod Factor )</td>
</tr>
<tr>
<td>Manual Premium = ( Exposure Units × Manual Rate/unit )</td>
</tr>
<tr>
<td>Converted Losses = ( Incurred Losses × Loss Conversion Factor ) + Allocated Loss Adjusting Expenses (ALAE)</td>
</tr>
<tr>
<td>Excess Loss Premium = ( Standard Premium × Excess Loss Factor )</td>
</tr>
</tbody>
</table>

Qualified Self-Insurance Plans (new)

A viable workers’ compensation financing option is a state-approved, qualified self-insurance plan. Although the plan will usually have stringent collateral requirements, the plan affords the organization with the opportunity to use the collateral for investing, lowering fixed costs, and improving loss control incentives. However, the plan also provides less true insurance, much more financial risk or uncertainty, and generally the consumer must provide his or her own claims adjusting services. The plan is defined further on pages 87, 341, and 380.
Chapter 19

COMMERCIAL PROPERTY INSURANCE

DISADVANTAGES (p. 390)

An additional disadvantage of commercial property insurance is that it may be very expensive for some exposures or perils. For example, coverage for the windstorm peril is very expensive for buildings located on the Gulf Coast.

DESIGN FEATURES

Coverage Extensions (p. 392)

The text introduces in this section the property coinsurance clause. A more appropriate position for this discussion would be in next section—section 8. How Losses Are Settled—as the clause only pertains if a loss occurs.

How Losses are Settled (p. 393)

Valuation (p. 393)

The following additional material is added as other valuation methods (besides replacement cost, agreed value, and actual cash value) that may or may not affect loss payments:

(a) Valued policy clause – pays the insurance policy face amount for total losses.

(b) Pair or set clause – pays the difference in value of the set before and after the loss.

(c) Specified value – or stated amount. An amount provided by the insured prior to a loss. The insurer’s claim payment is subject to adjusting.

(d) Market value – the fair price in an open market. E.g., NADA blue book, or realtor’s estimate.

(e) Economic value – the value or potential value an asset contributes to an organization’s income statement or balance sheet.

(f) Abandonment value – the salvage value of an asset that will not be repaired or replaced.

At this point, you should review the coinsurance clause as this clause applies to claims where the asset value is not properly insured.

PERILS INSURED AGAINST (p. 394)

Figure 19.1: Cause of Loss has some inaccuracies. The current ISO cause-of-loss forms specify coverages for the following perils as shown in the revised Figure 19.1: Causes of Loss. An important point to remember is to always read the actual insurance contract to determine the causes of loss (perils) covered in the policy.
### Causes of Loss

<table>
<thead>
<tr>
<th>Basic Form</th>
<th>Broad Form</th>
<th>Special Form</th>
<th>Earthquake Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>CP 10 10 06 07</td>
<td>CP 10 20 06 07</td>
<td>CP 10 30 06 07</td>
<td>CP 10 40</td>
</tr>
<tr>
<td>Fire</td>
<td>Fire</td>
<td>Covered Causes of Loss</td>
<td>Earthquake and volcanic eruption.</td>
</tr>
<tr>
<td>Lightning</td>
<td>Lightning</td>
<td>means Risks Of Direct Physical Loss unless the loss is:</td>
<td></td>
</tr>
<tr>
<td>Explosion</td>
<td>Explosion</td>
<td>1. Excluded in Section B., Exclusions; or</td>
<td></td>
</tr>
<tr>
<td>Windstorm or Hail</td>
<td>Windstorm or Hail</td>
<td>2. Limited in Section C., Limitations.</td>
<td></td>
</tr>
<tr>
<td>Smoke</td>
<td>Smoke</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aircraft or Vehicles</td>
<td>Aircraft or Vehicles</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Riot or Civil Commotion</td>
<td>Riot or Civil Commotion</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Vandalism</td>
<td>Vandalism</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sprinkler Leakage</td>
<td>Sprinkler Leakage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sinkhole Collapse</td>
<td>Sinkhole Collapse</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volcanic Action</td>
<td>Volcanic Action</td>
<td>Falling Objects</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Weight of Snow, Ice, or Sleet Water Damage</td>
<td></td>
</tr>
</tbody>
</table>

Plus limited coverage under the Basic and Broad forms for "Fungus," Wet Rot, Dry Rot, and Bacteria

---

**Business Income Coverage (p. 397)**

In addition to the ISO filed forms for business income—with or without extra expense coverage—insurers may file company-tailored forms with the state insurance department. On page 398, column two, paragraph five, line three, insert the word “outages” between “utility” and “forces.” It is a utility outage that forces the insured business to sustain a covered loss, which may result in suspension of the business operations and loss of business income for that time required to restore the insured objects such as the building or contents values.
**Chapter 20**

**DIRECTORS’ AND OFFICERS’ LIABILITY INSURANCE**

**WHAT IS IT?**

**General Categories of Exposures (p. 406)**

This section describes the *peril of liability* in the context of D&O coverage, which is a claim or legal lawsuit for damages. The policy is triggered by a claim or lawsuit for *damages* arising from the liability of the directors and officers for actual or alleged wrongful acts.

As noted elsewhere in this chapter, directors' and officers' liability policies promise to pay losses that insureds are legally obligated to pay as a result of claims for wrongful acts. Wrongful acts, which are defined on the policy, typically include actual or alleged actions such as errors, misstatements, misleading statements, acts, omissions, neglect, or breach of duty by the directors and officers acting in those capacities. Claims for wrongful acts may be made by shareholders, employees, customers, competitors, governments, and other third parties. The exposures (the subject that could have a loss in value) are the organization’s assets and its reputation.

These claims may come in the form of a written demand for civil damages or relief, notice of lawsuit, or a notice of charges in a regulatory or administrative proceeding. They may lead to significant defense expenses, even if they are resolved with a minimal settlement or judgment for damages. Because of this, D&O insurance may be considered *legal defense expense insurance*, although the payment of actual damages is a significant part of the coverage.

It is important to point out that the threat of a lawsuit against the directors and officers may trigger action. When a third party threatens a lawsuit the organization will usually immediately seek legal counsel.

**BUSINESS USES**

**So Why Buy D&O Insurance? (p. 408)**

Since the first publication of *the Tools & Techniques of Risk Management & Insurance*, many changes have occurred in the D&O insurance market. An organization interested in purchasing D&O insurance should discuss the coverages carefully with the intermediary and, if possible, read the policy before purchasing the insurance. Pay particular attention to the definition of who is an insured, what is considered a covered wrongful act, whether defense expenses are considered as within the limits or provisions for damages, and of course in which jurisdiction the case may be decided, as states differ in their statutes as to compensability and enforcement of public policy interests.

**GLOSSARY (p. 420)**

**Claim:** For the purposes of D&O insurance, claim means a written demand for civil damages or relief, notice of a civil lawsuit, or a notice of charges or similar document involving a formal administrative or regulatory proceeding.

**Liability exposure:** The possibility of a decrease in value in the organization’s assets or its reputation

**Liability hazard:** The condition or act that increases the likelihood and/or impact of a liability claim.
Chapter 21

EMPLOYMENT RELATED PRACTICES LIABILITY INSURANCE

WHAT IS IT? (p. 491)

On page 491, column one, paragraph one, line three, insert the word “unfair” in between the words “of” and “employment.” Firms can and do discriminate between people when selecting employees. For example, it is both legal and good business practice to differentiate (discriminate) between people of different muscular-skeletal build when selecting employees who must do heavy lifting on a loading dock. Likewise, it is both legal and good business practice to differentiate (discriminate) between blind people and people with adequate vision, when selecting operators of hazardous machinery.

Risk management of this exposure to loss involves an internal discussion, and documentation of decisions, where it is felt appropriate for the organization to fairly discriminate between employees.

DESIGN FEATURES (p. 493)

There was no industry standard policy form, for EPLI insurance until the Insurance Services Office, Inc. (ISO) filed the 1998 Employment Related Practices Liability Coverage Form. Despite this, many insurance companies have filed their own forms with the individual state regulators. However, even with a standard ISO form, many insurers file their own forms with the individual state regulators. The risk manager who is considering the purchase of EPLI insurance should carefully discuss the coverage with the intermediary and, if possible, read the policy before purchasing insurance.
Chapter 22

BUSINESS AUTOMOBILE INSURANCE

WHAT IS IT? (p. 505)

While the description in this paragraph is correct, it might be more accurate to state that business automobile insurance is a tool used to indemnify an insured organization for specified losses.

DESIGN FEATURES

Policy Structure Declarations Form (p. 506)

Figure 22.1: Business Auto Policy Coverage Symbols provides a good opportunity for a practical exercise—consider when each symbol would be appropriate for a business.

LEGAL ASPECTS

Uninsured Motorists Coverage Laws (p. 513)

Most insurance intermediaries will offer uninsured and/or underinsured motorist coverages to applicants for automobile insurance.

As a practical exercise, determine the appropriate limits for this coverage. Some suggest the uninsured/underinsured motorist limits of liability should be equal to those in the liability section. Some suggest purchasing the state minimum amount. Is the cost for the higher limits justified?
Chapter 23

CRIME INSURANCE

BUSINESS USES (p. 521)

This section describes the causes of loss—the perils for crime insurance policies.

DESIGN FEATURES (p. 522)

There is confusion and controversy over when to use crime insurance and when to use a crime bond. A bond is generally used as a financial backstop ensuring faithful performance of a prescribed obligation or duty. Insurance reimburses for the consequences of loss to or damage of property, by natural or man-made causes, or a result of allegations of negligence. The remedies differ and may be the cost of fines, penalties, bond forfeiture, the cost of property restoration, or damages.

As a practical exercise, research the sometimes subtle differences in an organization’s needed and discretionary coverages.
Chapter 24

CAPITAL MARKETS RISK TRANSFER TOOLS

Financial risk management contains many “terms of art” that may be confusing at first glance. Financial managers (like engineers) sometimes use these unique terms pretty loosely. A good exercise is to make a glossary of these special terms, as used within an organization and in documents related to governance, regulation, and compliance. You can start with the glossary provided at the end of this chapter.

WHAT IS IT?

On page 529, paragraph one, line one, insert the words “the financing of” between “Transferring” and “risk.” It is important to point out that risk (variation from the expected financial outcome) remains with the transferor. The tools described in this chapter transfer the financing of losses to the capital markets. Also, recall that the transfer is dependent on the financial solvency of the party accepting the instrument.

See also “insuritization” as described in chapter 1: Introduction to Traditional Risk Management on page 5, for a brief introduction to financial risk management.

DESIGN FEATURES OF CATASTROPHE BONDS (p. 529)

The concept of a special purpose vehicle (SPV) is introduced at this point. There is a definition of an SPV in the glossary—this is a distinct party to the specific securitization transaction (e.g., a reinsurance company).

Loss Triggers (p. 529)

Catastrophe bonds have three types of triggers. This is a key decision in the cost/benefit analysis of capital market risk transfer tools.

1) Indemnification (loss) triggers,

2) Parametric (event) triggers, and

3) Special index (data) triggers.
ADVANTAGES AND DISADVANTAGES OF CATASTROPHE BONDS (p. 529)

Figure 24.1: Anatomy of a Catastrophe Bond can also be presented as shown in Figure 24.1 (revised).

DESIGN FEATURES OF INSURANCE DERIVATIVES (p. 530)

The text introduces four concepts in this section: the option exercise price, the strike price, the option premium, and the option period.

The strike price and exercise price are synonyms. This is the price at which the holder of the option has the right to buy (if a call option) or sell (if a put option) the underlying asset. The option premium is the option holder’s cost for having the right to buy or sell the underlying asset. The option period is the time frame in which the option holder may exercise the right to buy or sell the underlying asset.

The foreign exchange rate risk (FX) example in the text has a strike (exercise) price of $.50 per share of ABC Manufacturing stock. This option contract is the right to purchase one share of stock at $.50; it is a “call option.” The option premium is not given. The option period is one week. The market price at the end of the one week option period is $.75 per share. The market price is also called the “spot price” (note in Figure 24.2 the spot price is incorrectly labeled as the exercise price). At the end of the option period this option is said to be “in the money” because the investor can buy one share at $.50 and immediately sell it again at the market (spot) price of $.75 (this example assumes no transaction fees to exercise the option).

There are many different forms of derivative instruments. The four major types are options, forward, futures, and swap contracts. These derivative instruments can be combined together or with other securities in many creative ways. Often a financial intermediary, such as an investment bank, is involved instructing and placement of these in the various investor marketplaces.
Options (p. 531)

Here are some useful definitions to help you understand these important financial risk management tools:

- A **call option** is the right (but not the obligation) to buy a specified amount of an underlying asset at a specified price at a specified time.

- A **put option** is the right (but not the obligation) to sell a specified amount of an underlying asset at a specified price at a specified time.

- **Basis risk** is the variation between the underlying asset’s spot (current market) price and the derivative strike price. This difference occurs when there is an imperfect “hedge” using the derivative instrument.

Catastrophe Equity Put (p. 531)

A catastrophe equity put is defined as an option that gives the issuer (e.g., an insurer) the right to sell a specified amount of its equity (its stock or shares) at a specified price in the event of a catastrophe that exceeds a certain magnitude. This is an example of a parameter (event) trigger. After the catastrophic loss, the insurer sells the specified number of shares and pays the catastrophe claims with the money received from the sale of the shares. The option holder (the insurer) pays the investors the option premium to compensate for the risk that the strike price (the price at which the investor must sell the shares) would be greater than the stock's market (spot) price at the time of the loss. Typically, the market (spot) price of the insurer’s stock after the catastrophe should go down and be less than the option’s exercise (strike) price. Hence, the insurer would partly hedge the catastrophic loss expenses with the option sale revenues.

GLOSSARY (p. 534)

**Call option**: the right (but not the obligation) to buy a specified amount of an underlying asset at a specified price at a specified time.

**Put option**: the right (but not the obligation) to sell a specified amount of an underlying asset at a specified price at a specified time.

**Basis risk**: the variation between the underlying asset’s spot (current market) price and the derivative strike price. This difference occurs when there is an imperfect “hedge” using the derivative instrument.
Chapter 25

LOSS CONTROL TOOLS

BUSINESS USES

Avoidance

Reactive avoidance (p. 535)

Some prefer to separate loss exposures into four categories: assets (property), legal liabilities, human resources, and net income (earnings). The justification for separating the net income exposure into a separate category is because a net income loss can occur without a direct loss to assets, legal liability, or human resources. Net income losses are grouped into two categories: contingent losses and consequential losses. A contingent net income loss occurs when the organization does not have a direct loss. For example, an anchor (major) department store in a mall may have a fire. The small retailer down the hall may not have any damage from the fire but because the anchor store temporarily closes the small retailer may suffer a decrease in revenue (a net income loss). In contrast, a consequential net income loss occurs as a result of a direct loss of the organization’s assets, legal liability, or human resources. For example, if the owner of a store is disabled, then the store may not be able to have the same revenues as before the loss. This is a good opportunity to research Frank Bird’s famous Iceberg Theory.

HUMAN RESOURCE LOSS CONTROL

Human Resource Loss Prevention

Activities (p. 544)

The A in SOAP should stand for “Available labor.” The human resource (HR) activities then would be part of the S – specialization of skills. Available labor can be a significant factor (hazard) in the indirect cost of HR losses. For example, in a boom economy the available labor pool is usually very small. Unemployment rates are a good proxy for available labor. The lower the unemployment rate the more difficult it would be to replace employees who suffer HR losses. In times of low unemployment the cost of labor is higher than when unemployment is higher.
Chapter 26

THE CERTIFICATE OF INSURANCE

WHAT IS IT?

On page 549, column one, paragraph one, line one insert the words “the financing of” between “that” and “risks.” Insurance is a mechanism to transfer only the financing of the risk; the risk (variation in the expected outcome) remains with the organization.

Case Study: Certificates of Insurance

ABC Manufacturing Company purchased an ISO occurrence form commercial general liability policy from BIG Insurance Company on January 1, 2008. The policy had the following limits:

- $1 million each occurrence
- $50,000 damage to rented premises
- $5,000 medical expense
- $1 million personal & advertising injury
- $1 million general aggregate
- $1 million products/completed operations.

On February 1, a third party loss occurred when one of ABC’s customers was injured when using ABC’s product. The claim was immediately reported to BIG. BIG investigated, adjusted, settled, and closed the claim by August 1, 2008. The loss paid under the claim included $100,000 for third party property damage, $300,000 for third party bodily injury, and $300,000 for the insurer’s legal defense costs. On September 10, 2008, ABC asked the intermediary to provide a certificate of liability insurance to one of ABC’s vendors—TTRM, Inc.

As a practical exercise use Figure 26.4: ACORD™ Certificate of Liability Insurance on page 559 as a template to complete the certificate.
Case Study One

THE PLAYSKOOL TRAVEL-LITE CRIB

Description:

A portable crib incident creates legal and regulatory risks to the manufacturer. The case provides material for discussing ethically responsible corporate policy and practice.

Learning Objective:

Students must analyze the company's risk management processes, including communications, selection and management of work outsourced to others, and review established regulatory standards. Students then should make recommendations. Introduces the pattern of leadership in a company and provides an exercise in the identification of consumer product safety as a legal hazard risk.

Subjects Covered:

Risk management subjects, including

- Business Ethics
- Brand Integrity
- Governmental Regulations
- Organizational Behavior
- Business Law
- Crisis Management
- New Product Development
- Succession Management

Setting:

United States; Juvenile Products industry

Teaching Notes:

There are several resources available—free—through the public domain, at

- http://www.chicagocdr.org/cases

Our thanks to Linda Ginzel PhD, of the Center for Decision Research, The University of Chicago, Graduate School of Business, 1101 East 58th Street, Chicago, IL 60637

Valuable links:

- Hasbro (Playskool): http://www.hasbro.com/playskool/
Abstract: The Playskool Travel-Lite Crib*1

The Playskool Travel-Lite, a portable crib manufactured by Kolcraft Enterprises and licensed by Hasbro’s Playskool division, came to market in December 1989, stopped shipping in April 1992, and was recalled in February 1993. The crib’s recall was initiated after three children were killed, in separate incidents, when one of its top rails collapsed and strangled them.

Approximately 11,600 of the cribs were manufactured, and, by June 1996, when the U.S. Consumer Product Safety Commission (CPSC) closed its case, only 2,736 Travel-Lites could be accounted for. To date, six children have been killed in Playskool Travel-Lite cribs.

This case discusses the design, development, marketing, sale, and recall of the Travel-Lite.

Part A discusses how the Travel-Lite came to market, details the deaths of three infants in the product, and brings Sanfred Koltun, CEO of Kolcraft, to a point where he must decide how the company will conduct a recall, as ordered by the CPSC.

Part B details the recall process as it occurred, including negotiations between Kolcraft and the CPSC, and Kolcraft’s actions in conducting its recall. It also discusses three additional infant deaths that occurred after the recall.

Part C considers the numerous issues surrounding the succession of the company to Sanfred Koltun’s son Thomas and details Travel-Lite deaths that occurred during and after the recall. The case ends with Thomas Koltun facing a major lawsuit, public relations challenges, maneuverings by Hasbro to separate itself from the product’s liabilities, and the possibility that Travel-Lites are still in use by the public.

The materials are 23 pages in length, and can be downloaded from http://www.chicagocdr.org/cases.

A story entitled One Travel-Lite’s Deadly Journey can be found on the pages that follow, including the timeline of the litigation and identification of the people and organizations involved.

---

1. Excerpt from flyer at http://www.kidsindanger.org/publications/fact_flyer/PlayskoolFlyer.pdf - Written by David Zivan, Senior Editor, Chicago magazine. Funded by the James S. Kemper Ethics in Business Grant to the Graduate School of Business at the University of Chicago, under the direction of Professor Linda Ginzel, Nov 5, 2002.
Questions:

a. What is the problem as you (state role) perceive it? What pre-loss risk management is each responsible for?

b. How could the manufacturer and outsource firm be held responsible for injuries and legally-imposed damages suffered by a third party?

c. What value can be placed on the damages? How would this be determined?

d. Is an insurance risk transfer appropriate? What other options are available?

e. What could the companies have done differently in order to change the outcome? What are the lessons learned?

One Travel-Lite’s Deadly Journey

One of the persistent dangers of recalled juvenile products is the fact that they often make their way into the homes of neighbors and friends, are sold at yard sales or thrift stores, or arrive in childcare facilities. The story of the Travel-Lite crib that killed Danny Keysar illustrates the seemingly innocuous way that dangerous products can continue to be used by the public.

In March 1991, Julie Deroin, her husband, Brian, and their five-month-old son, Joey, traveled from their home in Union Pier, Michigan, to the town of Matteson, Illinois, where Brian's nephew was having a birthday party. Finding themselves with a little extra time, they decided to make a trip to a local Toys 'R' Us store in order to shop for a portable crib. On Wednesday nights, Julie and Brian usually spent the night with her mother in Chicago, and they wanted to purchase something for Joey to stay in during their visits. From a half-dozen or so models on display, Julie chose the Playskool Travel-Lite crib, and the parents used the Travel-Lite once a week for the next six months, after which they moved to Chicago, and had no further use for it. A year later, along with a stationary crib and a high chair, Julie gave the portable crib to Katherine McCord, an acquaintance who owned a flower shop down the block from Julie's apartment. Katherine's daughter, Kristen, had just been born, and Katherine thought it would be a good idea to nap her in the crib while she was at work. Julie demonstrated setting up the crib for Katherine, who was pleased with the crib and used it each workday, from the time Kristen was 3 months old until she was about 18 months. Except for perhaps half-dozen trips the family took, Katherine simply left the crib set up in her back room.

Kristen outgrew the Travel-Lite. She had also outgrown coming to work with her mother, and Katherine began looking for a childcare provider. Through a bulletin board at a local store, she found Anna Salazar, who was starting her own child care business in her apartment in the upscale Chicago neighborhood of Lincoln Park. Salazar had extensive experience with childcare, including two years in a professional child care center and three years as a live-in provider in a private home. In the summer of 1995, Kristen became the first client of Salazar's Sweet Tots childcare. In September of 1995, after an inspection by the Department of Children and Family Services (DCFS) that included Salazar's setting up the Travel-Lite, Salazar received her childcare license.

Katherine had given Salazar several items that Kristen had outgrown, including the Travel-Lite crib. The crib was used daily by other children, especially during their naptime from 1 p.m. to 3 p.m. Based upon her schedule of approximately 250 working days every year, Salazar estimated that she used the crib 125 times in 1995 and thereafter, up to the first five months of 1998, 500 times.
In the first week of May 1998, Salazar's facility received a routine visit by a DCFS inspector. The inspector gave Sweet Tots her approval.

At about 1 p.m. on May 12, 1998, after the five children she was watching had finished lunch, Salazar put them down for their naps. Danny Keysar, the 16-month-old son of University of Chicago professors Linda Ginzel and Boaz Keysar, was the first that day because he had finished his lunch. Then the other four went to sleep. One of the children was fussy that day, however, and naptime ended a little early; by 2:40 p.m. Salazar changed the children’s diapers and about 3 p.m. she went in to wake Danny. Usually when he woke up, Danny would begin talking or, as Salazar put it, “almost singing,” and Salazar had not yet heard any sounds from the bedroom.

When she stepped into the bedroom, Salazar immediately saw that Danny was trapped, unconscious in the “V” where one of the Travel-Lite's top rails had collapsed. He was face down, with one hand under his head and the other grasping the rail. Salazar lifted him out of the crib, called 911, and administered CPR. Police and paramedics arrived quickly, and took Danny to the nearby Children's Memorial Hospital. But he could not be revived.
Case Study Two

THE HAM’S THE THING

Description:

A family-owned food business attracts attention when it serves local churches, schools, and outdoor political events. Its operation involves processing of pork and turkey into specialty finished products sold through retail outlets country wide. In addition to processed hams and turkeys, the company sells refrigerated side dishes acquired from a national distributor and shipped to their stores. Employees ship packaged meat products to serve the seasonal demand, taking orders over a web-based shopping site. The company plans to expand to the operation of a warehouse distribution center, in addition to its corporate offices, and to 45 stores from the existing 22 stores.

The case provides material for discussing the insurance program, as developed and practiced at the corporate level.

Learning Objective:

Students must analyze the company's insurance program dynamics, identifying, qualifying, and quantifying emerging risks and the challenges to the company’s established insurance policy. This case introduces the development of ERM patterns in the management of company risks in a dynamic environment.

Subjects Covered:

Risk management subjects, including

- Legal, environmental, sourcing risk
- Vendor contracts and insurance
- Emerging products liability risks
- Insurance program evolution
- Work with agents, brokers, insurers, and reinsurers

Setting:

United States; Food industry

Teaching Notes:

There are several resources available—free—through the public domain, at

- Sustainability Risk Management, Dan Anderson, PhD, CPCU
  http://gwfact.rso.wisc.edu/readings/Sustainability2.pdf
- Corporate Survival: The Critical Importance of Sustainability Risk Management
- National Pork Producer’s Assoc.;
The Ham’s the Thing is a corporation based in Topeka, Kansas. The company processes meats purchased from pork farmers, ships the processed meat through its new warehouse, and then distributes the meat to its local retail stores. At the retail locations, the employees finish the processing and packaging and sell over the counter. The company’s annual sales consistently exceed $5,000,000. Customers include households and commercial clientele.

The company has several emerging risk management problems including: genetically modified food ingredients; regulations regarding product tracking, refrigeration, and shipping; and sustainability concerns. Recent food recalls of seafood, pet food, products using additives, and condiments came out of the tomato/chili food scares—and mass lawsuits are an issue.

The company’s current insurance program is placed through local agents—both independent and exclusive. There are multiple policies providing property and liability protection on a primary basis, workers compensation protection in each state, equipment breakdown and spoilage coverage, and an umbrella liability policy for all entities, subsidiaries, and affiliates.

This case discusses the development of policies and programs for effective risk management and use of insurance in a dynamic environment.

Part A details the heightened awareness of food safety risks nationwide, the emerging interest in cost savings from use of genetically modified constituents in food products, and legislation as a result of recent food safety outbreaks. It uses the Menu Foods pet food recall to illustrate the public policy concerns with mass-food-distribution businesses.

How would The Ham’s the Thing conduct an insurance assessment and, if necessary, modify its insurance program and limits, to meet and match newly identified responsibilities and obligations?
Part B considers sustainability and shareholder/public demand for responsible and environmentally sensitive business conduct. Shipping in refrigerated trucks is costly and poses environmental concerns as its trucks use diesel fuel. What changes should be considered to its insurance program as the company adapts to these environmental demands?

How should The Ham’s the Thing revise its company policy regarding the selection of vendors as part of its risk management program evolution? What changes need to take place in the administration of its insurance program regarding contracts? It utilizes The Ham’s the Thing’s insurance certificate, and an article from the CPCU Journal by Dan Anderson, PhD, CPCU, on sustainable risk management, as a basis for discussion.

Table-top “team” workshop:

- Roles
  - Owner – CEO of The Ham’s the Thing
  - Retailer – a retail outlet, responsible for purchasing its own insurance and accountable for problems as a profit center
  - Regulator – Food and Drug Administration or other regulatory body with jurisdiction
  - Attorney for product user – the household or business purchasing and using product for a specific purpose (legal advocate for user)
  - Underwriter – at insurer and/or reinsurer level (may substitute broker role here)

- Answer the questions that follow, going around the table in the previous sequence using the resources for Part A, then proceed with Part B resources review and discussion in a like manner.

- Debate risk management issues and insurance program alternatives, as well as changes in the cost of risk and self-funding or retention options.

- Recommend a course of action for The Ham’s the Thing to adopt with its insurer (and broker or agent) to manage changing demands and public expectations within its insurance program coverages and limits.

Read Sustainability Risk Management, by Dan Anderson, PhD, CPCU, located at http://gwfact.rso.wisc.edu/readings/Sustainability2.pdf and answer these questions:

1. What new risks are posed to those you represent? What information do you need to gather?

2. What values are at risk for you or your organization? How would this be determined (exposures, limits, reserves, and capital)?

3. What changes would impact you most, if you could alter the company’s current risk management program?
   a. Are the current insurance risk transfer mechanisms still appropriate to finance the potential losses?
   b. What other risk financing options are available and appropriate?
4. If the management were to change its business alliances (such as with brokers or suppliers of insurance products), what insurance-related items should be included in the review?

5. What are the lessons learned from this review for your organization? How will you know if the new program is doing its job? What processes, investments, resources, and related activities will be required? How will they be coordinated across the enterprise?
Part A: Menu Foods

PRESS RELEASE

Menu Foods Income Fund

Menu Foods Income Fund Announces Precautionary Dog and Cat Food Recall

TORONTO, ONTARIO—(CNW Group - March 16, 2007)

NOT FOR RELEASE OVER US NEWSWIRE SERVICES

Attention Business/Financial Editors

Menu Foods Income Fund (the "Fund") (TSX: MEW.UN) today announced the precautionary recall of a portion of the dog and cat food manufactured between December 3, 2006 and March 6, 2007. The recall is limited to "cuts and gravy" style pet food in cans and pouches manufactured at two of the Fund's United States facilities. These products are both manufactured and sold under private-label and are contract-manufactured for some national brands.

Over the past several days, the Fund has received feedback in the United States (none in Canada) raising concerns about pet food manufactured since early December, and its impact on the renal health of the pets consuming the products. Shortly after receipt of the first complaint, the Fund initiated a substantial battery of technical tests, conducted by both internal and external specialists, but has failed to identify any issues with the products in question. The Fund has, however, discovered that timing of the production associated with these complaints, coincides with the introduction of an ingredient from a new supplier. The Fund stopped using this ingredient shortly after this discovery and production since then has been undertaken using ingredients from another source.

At the same time, the Fund's largest customer, for which it manufactures on a contract basis, received a small number of consumer complaints and has initiated its own recall. Furthermore, for the time being, the customer has put future orders for cuts and gravy products on hold. This customer's cuts and gravy purchases in 2006 represented approximately 11% of the Fund's annual revenue.

"We take these complaints very seriously and, while we are still looking for a specific cause, we are acting to err on the side of caution," said Paul K. Henderson, President and CEO, Menu Foods. "We will do whatever is necessary to ensure that our products maintain the very highest quality standards."

While the number of complaints has been relatively small, Menu is taking this proactive step out of an abundance of caution, because the health and well-being of pets is paramount to the Fund.

In addition to changing suppliers, for production after March 6, the Fund has increased testing of all raw materials and finished goods. It is also working closely with regulatory authorities and its customers to learn more and will take whatever additional actions are appropriate. The Fund estimates that based on currently available information, this recall could cost between $30 million and $40 million, which will be financed from a combination of internally generated cash flow and bank credit facilities. Furthermore, the Fund is aggressively producing product, utilizing a different supplier for the ingredient in question, to reestablish customers as quickly as possible.

In order to determine whether cat and dog food in their possession is subject to recall, consumers should refer to the list of brand names ("listed products") at www.menufoods.com/recall. This will be available by 6 a.m. Saturday March 17, 2007. Products not identified on the website can continue to be used.

Menu is the leading North American private-label/contract manufacturer of wet pet food products sold by supermarket retailers, mass merchandisers, pet specialty retailers and other retail and wholesale outlets. In 2006, the Fund produced more than one billion containers.

CONTACT INFORMATION

Menu Foods Income Fund
Menu Foods Income Fund
Consumers
1-888-895-2708
Website: www.menufoods.com
**Part B: Current certificate of insurance**

**ACORD CERTIFICATE OF LIABILITY INSURANCE**

**PRODUCER**

**INSURED**

**Coverages**

The policies of insurance listed below have been issued to the insured named above for the policy period indicated. Notwithstanding any requirement, term or condition of any contract or other document with respect to which this certificate may be issued or may pertain, the insurance afforded by the policies described herein is subject to all the terms, exclusions and conditions of such policies. Aggregate limits shown may have been reduced by paid claims.

<table>
<thead>
<tr>
<th>Type of Insurance</th>
<th>Policy Number</th>
<th>Policy Effective Date (MM/DD/YYYY)</th>
<th>Policy Expiration Date (MM/DD/YYYY)</th>
<th>Limits</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>OCCUPATIONAL LIABILITY</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Any Auto</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All Covered Auto</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All Other Auto</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>WORKERS' COMPENSATION AND DEPENDENT DEATH</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SUDDEN &amp; UNEXPECTED LIABILTY</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Occur</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SUDDEN &amp; UNEXPECTED LIABILTY</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Occur</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SPECIAL PROVIDING ANY</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>CERTIFICATE HOLDER</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Excerpt:** Dan Anderson’s *Sustainability Risk Management*, May 2006 CPCU Journal

“In my new book, Corporate Survival: The Critical Importance of Sustainability Risk Management, I have coined the term “sustainability risk management.” Sustainability risk management deals with risks emanating from the environmental and social justice areas. Examples include:

- global warming/climate change
- boycotts against major corporations by non-governmental organizations (NGOs)
- water contamination by chemicals
- pressures brought by socially responsible investors
- directors’ and officers’ failure to disclose environmental liabilities
- gender discrimination class-action suits
- damages to natural ecosystems
- impacts on multinational corporations by international regulations

“While these sustainability risks are not necessarily new, it is only recently that their impacts are being felt by businesses. Environmental and social risk costs, which for years were externalized, are increasingly internalized to the firm. I firmly believe that sustainability risks are evolving into one of the critical risk areas of the twenty-first century. I hope this article and my book will spark more awareness and help the risk management and insurance industry to better manage sustainability risks. Sustainability issues are examined within a risk management framework. I argue that a strong business case can be made for firms improving their environmental quality and social programs. Environmental and social justice risk costs are reduced with the result being an improved financial performance. Reputation is improved, and competitive advantages are gained. Ignoring these risk costs results in lower profits, damaged reputation, and loss of competitive advantages.”

These subjects should be part of your discussion:

- Boycott Risks
- Global Warming/Climate Change Risks
- Ecosystem Services Risks
- Social Justice Risks
- Chemicals and Harmful Substances
- Directors and Officers Risks (good discussion item, though The Ham’s the Thing is not publicly traded)
- Waste Reduction
- ISO 14001 Certification
- Product Design
• Energy Efficiency
• Green Building
• Transportation Efficiency
• Partnerships
• Business Associations
• Sustainability Reports
• Regulatory Preparations
• Risk Financing
SUPPLEMENTAL GLOSSARY

**Basis risk:** the variation between the underlying asset’s spot (current market) price and the derivative strike price. This difference occurs when there is an imperfect “hedge” using the derivative instrument.

**Call option:** the right (but not the obligation) to buy a specified amount of an underlying asset at a specified price at a specified time.

**CAPM:** The Capital Asset Pricing Model – a seminal finance work that defined the relationship between an asset’s risk (beta) and the asset’s expected return.

**Corporate Social Responsibility report:** a written document that attests to an organization’s commitment to its stakeholders and the processes used to attain that position.

**Correlation:** the association between variables. In statistics the correlation describes the linear relationship between two variables and is expressed as a value between -1 and +1. The value’s sign indicates the direction of movement between the two variables.

**Enterprise Risk Management:** The discipline of creating the desired level of variation from the expected outcome over specified times for all of the organization’s opportunities and threats.

**Fiduciary duty:** The legal obligations of an agent to the principal of care (due diligence), loyalty, and disclosure (transparency).

**Financial hedge:** a financial project (an investment or asset) whose change in value is inversely proportional to another financial project’s change in value. As the second project’s value goes down the first project’s value goes up (and vice versa). Frequently, derivatives are used as financial hedges.

**Liability exposure:** the subject that can have a decrease in value in the liability category of exposures is the organization’s assets (money) or its reputation.

**Liability peril:** The cause of loss for the liability exposure is a law suit or the threat of a law suit. Only in these two instances will the organization incur the expenses (a loss). In either case, the organization will engage in activities that will cost it money—usually the company will engage an attorney to begin the defense process.

**Loss history report:** a document that shows an organization’s loss values over a period of time (sometimes called a loss run).

**Market (insurance) appetite:** the current condition of the insurance industry to accept the transfer of the financing of losses. In a soft market, the industry wants business and will either charge low premiums or permit less stringent underwriting. In a hard market, the industry is usually recovering from catastrophic losses (such as hurricanes) and either increases premiums or enforces more stringent underwriting. Thus it is “hard” for the consumer to obtain insurance in this market appetite.
Natural hedge: a project (a product or service) whose change in value is inversely proportional to the change in value of another project. As the second project’s value goes down the first project’s value goes up (and vice versa). Frequently, a diverse mix of products is used as a natural hedge.

Put option: the right (but not the obligation) to sell a specified amount of an underlying asset at a specified price at a specified time.

Pure risk: situations in which the only variations from the expected outcome (over the time horizon) are either losses or no losses. There is no possibility for gain.

Risk: Objective risk is the variation from the expected outcome over time.

Risk appetite: an organization’s willingness to invest in projects that have positive variation in the expected outcome over the project’s time horizon.

Risk audits: an inspection of not just the financial but also operating procedures related to managing variation in the organization’s operations.

Risk philosophy (position): the willingness of an organization to both invest in new projects and to accept losses. This position is made up of the risk appetite and risk tolerance.

Risk tolerance: an organization’s willingness to accept, and the ability and capacity to bear, adverse variation (losses) from the expected outcome over a time horizon.

Speculative risk: situations in which the variations from the expected outcomes (over the time horizon) can be positive, zero, or losses in values.

Stakeholder value: the interest a party has in the organization’s success.

Triple bottom line value: The concept that an organization’s value is a function of three components: economic performance (profit), social justice (people), and environmental stewardship (planet). The concept suggests that all three components must be managed in an ERM system.