Risk and Value: Changing Perceptions and Cultural Challenges for the Property and Casualty Industry

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This contribution deals with the improved ability of the property and casualty industry to meet the challenges that lie ahead.

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Over the last two decades, the world's property and casualty (P&C) insurance and reinsurance industry has considerably strengthened its ability to assess risk and mitigate its financial impact. Natural catastrophe modelling, for example, was in its infancy 25 years ago. Today, advances in technology and predictive analysis and generally more sophisticated technical underwriting capabilities have forever changed the world of the P&C insurance and reinsurance industry. Naive capacity is no more. Gone too are many of the thinly capitalized companies unable to exist in an environment in which losses from natural and man-made catastrophes trend ever higher. (Worldwide insured catastrophe losses topped \$49 billion in 2004 following waves of loss development from the late 1990s.)

Improved capital structures mean that today's global P&C businesses are more robust financially. I believe they also have a much better understanding of the changing characteristics of the risks they underwrite. This is key to their survival. The scope and correlation of existing risks is a complex dynamic, often compounded by advances in technology and changes in economies and societies.

As an industry, the P&C sector has been forced to come to terms with the challenges of increased global urbanization and rural-to-urban migration. The United Nations¹ expects more than 60 per cent of the world's population to be living in cities by 2030. In 1950, it was 30 per cent. Currently, around 50 per cent are living in cities, with approximately 9 per cent of these, or about 280 million people, inhabiting so-called megacities.

Growing urbanization and the increased interdependence of economies have changed the risk characteristics of our business, producing accumulations in all P&C classes and posing continuing major risk management challenges. Additionally, as we have seen recently, post-event demand surge provides a further complexity, which was all too apparent following the multiple hurricanes of 2004 and will, no doubt, be repeated in the aftermath of Hurricane Katrina. For example, the industry's own

¹ United Nations (2004).

Figure 1. Insurance/Broker stocks: hammered by the Spitzer Suit. *Source:* Insurance Information Institute.

demand for loss adjusters has, at times, also proved a huge problem in storm-damaged areas.

Shifting perceptions of value are also producing a changed appreciation of loss, particularly on the casualty side of the business. More recently, I have observed that a raised awareness of risk accumulation inherent in intangible assets has begun to emerge. Aided by a better grasp of the limitations of quantitative data and its tendency to focus on the past, more and more companies are paying attention to factors that influence their future and which provide a more holistic picture of corporate, not just financial, performance.

These non-price factors of competitive advantage can include intellectual capital, differentiating competencies, leadership and management, organizational assets such as networks, corporate culture and, most importantly, reputation.

According to a recent PriceWaterhouseCoopers study,² while investors' analytical models may be financially driven, the factors that give analysts confidence in their models are typically non-financial in nature. Revenue rises because a company is in a growing market and/or is gaining market share. Market share increases through new product innovation, through new business and customer retention.

As a telling example of the power of non-financial information, the accompanying chart (Figure 1) of insurer and broker stock values graphically portrays the impact of a legal investigation that was started by New York Attorney General Eliott Spitzer on October 14, 2004.

Corporate culture can be a unique source of competitive advantage in any industry but I think the intangible asset, which is most fragile and therefore more exposed to risk than perhaps any other intangible is probably that of reputation.

An Economist Intelligence Unit survey³ (Figure 2) ranked reputational risk as the greatest potential threat to an organization's value. The survey was based on interviews with 154 Chief Executive Officers in the financial services industry, almost 40 per cent of them with insurance and reinsurance companies. More than a third of these CEOs said that reputational risk represents the "greatest" potential threat to their company's market value while a further 41 per cent said they thought it was a

² PriceWaterhouseCoopers (2004).

³ Economic Intelligence Unit (2004).

Figure 2. Risk type ranking.

“major” potential threat. Having said that reputational risk ranked as the biggest single threat to their market valuations, the CEOs were asked what action they were taking, specifically what risk management measures they had implemented to safeguard their reputations. Only 11 per cent said they had done anything about the exposure, while fully 68 per cent said they had implemented risk management procedures regarding their credit exposures. Furthermore, when asked about the effectiveness of various safeguards, a quarter of the survey respondents who said they had done something about protecting their reputations admitted that these measures were either ineffective or extremely ineffective.

A survey by Aon Limited⁴ (Figure 3) came up with similar findings in early 2005. Here again, the category of reputational risk was judged to be the greatest threat facing companies, up from the position of fifth most important threat in 2003. The survey, carried out independently for Aon, examined the views of 1,000 public and private sector companies in the United Kingdom, analysing responses from risk managers and finance directors. Interestingly, another intangible – failure to change – was ranked third while physical damage was placed sixth and terrorism eighth. For the first time in this survey, the impact of regulation and legislation was included among the greatest risks. This entered the results in fifth place, driven largely by a growing raft of environmental laws that will require businesses to meet higher levels of disclosure regarding their environmental exposures.

An intangible asset has been described as a claim to future benefits that does not have a physical or financial embodiment. The danger with not having a physical embodiment is that many organizations have little information about these value drivers. They are not easy to capture or measure and their owners can easily fall into the out-of-sight–out-of-mind trap.

⁴ Aon (2005).

2005	2003
1. Loss of reputation	1. Business interruption
2. Business interruption	2. Failure to change
3. Failure to change	3. Employee accidents
4. Product liability	4. Employee recruitment
5. Impact of regulation	5. Loss of reputation
6. Physical damage	6. Strategic alliance failure
7. Employee accidents	7. Professional indemnity
8. Terrorism	8. General liability
9. Corporate governance	9. Product liability
10. Professional indemnity	10. Physical damage

Figure 3. Aon biennial risk management and risk financing survey.

Economies too have reputations that can be damaged, with severe consequences for debt and stock markets. Restricted economic activity, such as that following a major catastrophe, can have a negative impact on the growth of that economy, depressing future profits and share values of exposed companies. The resulting impact on consumer spending, one of the main engines of a national economy, can also be disastrous, leading to consumers losing confidence and reigning in their consumption. Falling consumer confidence and the associated fall in consumption generally weakens almost all sectors of a stock market.

I referred earlier to changing perceptions of value. Clearly, the concept of loss is inextricably linked to the concept of value. While awareness levels of the value of reputation and other intangible, or so-called soft, assets are generally trending higher, most accounting standards do not allow companies to include reputation, intellectual capital, expertise and customer loyalty on their balance sheets. According to PriceWaterhouseCoopers,⁵ this is largely because they do not meet the accounting definition of an asset, that is, the company lacks unilateral control over them and they cannot be separated and sold independently.

This contribution is not intended as a discussion guide to best practice risk management principles that might be applied to the protection of intangible assets. However, the subject has distinct implications for the P&C insurance and reinsurance industry and these implications do need to be aired.

While the main elements of this contribution will surprise no one in the industry, what never fails to surprise me is that so little seems to be done to protect one of our most prized intangible assets: our collective reputation. This inaction is in sharp contrast to the energy with which our industry sets about responding to other exposures. For those who have not drawn the same conclusions as me or perhaps have not been as close to the phenomenon that I have been watching unfold since October 2004, I would like to state the obvious: this particular asset is looking decidedly battered.

Stunned by the onslaught of legal actions commenced by Mr. Spitzer and the SEC, most industry leaders, fearful of providing additional targets in this battle, have hunkered down and either stayed completely silent or focused on responding to regulators' enquiries.

⁵ PriceWaterhouseCoopers (2001).

That is an unacceptable response by a business that plays such a central role in world economic affairs. Our product, our promise to pay, oils the machinery of international trade and industry and keeps its parts moving. The ability to limit and distribute risk is crucial to every aspect of the global economy and we, as an industry, need to recognize that and take steps to protect our collective image.

I have already mentioned the importance of culture. For many companies, my own included, culture is an important differentiator. At XL, we have built a culture based on the core values of ethics, teamwork, excellence, development and respect. This is a very serious undertaking for us, one in which our employees' financial rewards are partly influenced by the extent to which they model these core behaviours.

The P&C industry needs to adapt its culture and business practices to reflect the forces of change. I believe that the time has come for us to develop an enabling culture of integrity that will hold every member of our industry accountable and responsible for adherence to a set of professional core values. Outstanding examples of compliance should be rewarded while violations should be penalized. While I agree that a code of behaviour will not, in and of itself, prevent wrongdoing I believe it will go some way towards encouraging trust and helping to rebuild our reputation in the minds of stakeholders, especially customers and employees.

Implementing such a proposal, however, will not be easy. The P&C industry is not a political entity. Indeed, some would say, and I would be inclined to agree, that the P&C industry does not actually behave like an industry at all. Instead, it acts more like a collection of competing businesses with attendant levels of diversity, dysfunction and disparity. There are, of course, good, longstanding businesses, legal and historical reasons why this is so, and I have no desire to tackle these issues here.

We have entered a new phase of our development. Critical, arguably hostile, attention has been and will continue to be focused on the arcane, inner workings of our business. This has proved to be a testing environment in which some companies have, rightly, received a failing grade. However, the real test is whether the leaders of our industry can see beyond the threat to the opportunity to work together to change the things that are within their power to change: namely, to bring about cultural reform. Other reforms, such as regulatory change, are already being shaped, or even driven, by external influences. Cultural reform is different. It won't happen unless we make it happen.

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