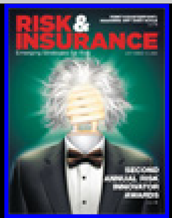
RISK & INSURANCE

Emerging Strategies for Risk



Financial

2009 Risk Innovators: Financial

Mark Robinson
Vice President
Trade Protection Service
UPS Capital
Atlanta

Flexible Parcel Insurance goes where Declared Value coverage has never gone before.

Getting packages to their final destination is important. But sometimes it's even more important that they arrive, not just at the right place, but also at the right time.

Mark Robinson, vice president for trade protection services at UPS Capital, began to recognize this problem in the late 1990s, when he began to see problems with the late delivery of mortgage loan documents.

Mortgage closing documents are carefully prepared, and the loan amounts and interest are calculated to the day. Late delivery means that all of those figures have to recalculated, and it means that the closing cannot be completed on time.

This can result in losses and delays and potentially lead to the collapse of a deal. At that time, transportation carriers offered Declared Value coverages, but that coverage only protects a shipper for the value of the item, and only if the item is damaged or lost.

The mortgage loan documents themselves are just paper and have very little value in and of themselves. Furthermore, documents were not lost or damaged from Robinson's observations; they simply showed up at their destination a day or two late from time to time.

Mortgage closing documents that show up a day or two late might as well not arrive at all. While the paper the loans are written on may have little value, the consequences of the delay, any delay, is often significant.

That got Robinson thinking about whether there were similar kinds of cases that are time-in-transit related and falling through the

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cracks with the Declared Value coverages.

He found there were other items, such as concert tickets and event tickets that also are worthless if they were delivered late. Certain intravenous pharmaceuticals that are shipped on dry ice, meanwhile, have a limited shelf life and have to be delivered within 72 hours or they would be ruined. Perishable foods, such as seafood and steaks, also have to be delivered by a certain date or they are also worthless.

"We heard from customers that this was an area that gave them some concern," Robinson said. "We followed it through to determine why aren't these coverages provided and talking to them about what their losses were."

He then began exploring whether it was possible to determine how often there was such a delay, what the potential losses would be and whether it might be possible to build an insurance coverage around that risk that might make sense.

The result was the Flexible Parcel Insurance program, which protects against the costs associated with delayed shipments and protects against items that are ineligible for standard carrier liability programs such as Declared Value.

The Flexible Parcel program reimburses shippers for specific losses associated with a late delivery. With standard carrier liability offerings such as Declared Value, there is no coverage because the goods are ultimately delivered and undamaged.

Flexible Parcel Insurance covers this gap.

NOTHING LIKE IT

"You can't find anything else like this out there," said Derrick Johnson, a director in trade protection services at UPS Capital.

Demand for the product in certain industries is "absolutely huge," he said.

Since 2008, UPS Capital has added more than 500 Flexible Parcel Insurance customers and has experienced nearly 20 percent growth.

The program generated more than $5 million in annual premium in 2003. By 2008, that had grown to more than $50 million in annual premium.

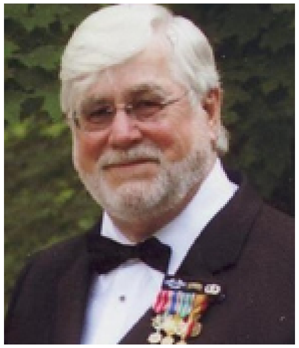
The product is offered through UPS Capital, an insurance subsidiary of UPS created in 1999. The unit focuses on mitigation of supply chain risk, specifically transportation risks and risks associated with the movement of goods and movement of money.

The program assesses the likelihood of a package failing to arrive on time and the impact of the delay on the customer. In many cases, it's not only the potential loss of the goods themselves, but also the potential for litigation, reputational damage and other replacement costs.

UPS Capital, which also acts as the broker for the product, then crafts a flexible solution designed to meet the needs of each customer and each type of shipment. The coverage is underwritten by AIG and ACE, and the premiums are typically very affordable because delays that result in a loss are actually infrequent.

"The rate of loss was so small that the insurance premium could be much less, so it was affordable for them to buy," Robinson said. But for those times when there is a delay resulting in a loss, the insurance makes a significant difference.

--By Patricia Vowinkel



John A. Martin
Chairman
Pension Benefit Insurance Services Inc.
Sparta, N.J.

Burned by incidents in the past, John Martin found a way to prevent retirement misfortunes from happening to others.

John Martin left his job with JPMorgan Chase in 2001 to pursue an idea for a new insurance product that would help protect the retirement assets of "the little guy."

Over the years, Martin, now the chairman of Pension Benefit Insurance Services Inc., has seen just how easy it was for "the little guy" to lose everything due to a sudden financial crisis.

Two incidents in particular shaped his thinking.

The first was the death of his father and the forced sale of the Texas cattle ranch where he grew up. It was the early 1970s and Martin, who was 28 at the time, had been in the service and had just resigned his commission. He had hoped to take over the ranch after his father's death. The bank demanded repayment of the mortgage and, unable to do that, Martin was forced to sell the ranch into a bad real estate market at a low price.

"That's where I first started to see first hand that survivors often don't have a lot of options," Martin said.

The second incident was in the 1980s when he was working at Hudson Valley Financial Services, where Martin had been hired by Manufacturers Hanover to start an insurance unit. Hudson Valley was a joint venture of Manufacturers Hanover and Monarch Capital. It fell apart when Monarch declared bankruptcy and Manufacturers Hanover merged with Chemical Bank, which then purchased the assets of Hudson Valley as well.

The bankruptcy of Monarch Capital had a devastating impact on the retirement plans of many employees, who had been forced to invest in the company's stock. Martin, who was a senior vice president and chief marketing officer at Hudson Valley at the time, knew that some employees had taken out loans against their retirement plans and were then forced to repay those loans in spite of the collapse of their retirement assets.

Those incidents, and others like them, inspired Martin to use his insurance expertise to find a way to protect the retirement assets of nonhighly compensated workers (those earning less than $105,000 annually). Those who are highly compensated typically have other assets to draw on in a crisis. It's those lower down on the totem pole who are often in a bind.

In difficult financial times, for instance, nonhighly compensated workers are sometimes forced to take out loans against their 401(k) s. They then repay those loans through paycheck deductions.

If the employee dies or becomes disabled, the surviving family members may not be able to repay the loan and this can result in a forced distribution, which then triggers tax liabilities.

By the time the loan and the taxes are paid out, there may be little or no pension assets left for the worker or the beneficiaries.

ALL PROTECTED

Martin's idea, trademarked as Pension Loan Completion, is simply to provide insurance that would pay off the balance of the loan in case of death or pick up the monthly loan payments in case of disability. "The concept was that no pension loan should outlive its maker," Martin said.

This would protect not only the employees and their families from an unexpected crisis, but also would help protect retirement plan sponsors and their fiduciaries, which incur corporate and personal liability in the administration of their pension plans, including plan loan administration.

ERISA, the Employee Retirement Income Security Act, requires that the "duty of loyalty" and the "duty of care" be used as tools in the prudent administration of plans and protection of plan assets. Plans and fiduciaries that fail in these responsibilities face the risk of litigation, and fiduciary liability insurers face the risk of fiduciary breach claims.

The idea was implemented by forming the firm Pension Benefit, filing utility patents on processes, trade marking the program and selecting partners with institutional credibility for implementation in the pension market.

Martin compared the situation of plan sponsors to that of banks making consumer loans. Banks making loans to consumers for big-ticket items like automobiles, for instance, require the borrower to have insurance on the asset. This is a similar concept.

The cost of the insurance could be picked up as a benefit by the plan sponsor or employer, or passed on to the employees, who would pay the cost through a small paycheck deduction.

Martin said he has just started rolling the product out to the Fortune 1000 and is working with Aegon and Aon on the program.

--By Patricia Vowinkel

Responsibility Leader: John A. Martin

At the same time that the big money men on Wall Street resumed their multimillion dollar bonuses, John Martin, chairman of Pension Benefit Insurance Services Inc., came up with a way to protect the little guy who may have seen his 401(k) retirement account reduced by half.

Martin pointed out that, in this difficult economy, it's common for employees to borrow against a pension account. Then the worst happens--death or disability--leaving the spouse or the employee without retirement savings.

Martin's solution is fairly simple. An insurance product would pay the balance of any loans outstanding on a 401(k), for example, if the employee died. Or, in the case of a disability, it would cover monthly loan payments for as long as the employee is disabled.

The idea is innovative in its simplicity and "responsible" to its clients, who are the "little guys" who may well be human fallout from a far bigger financial catastrophe.

Eric Guichard
Chairman and CEO
GRAVITAS Capital Advisors Inc.
Washington, D.C.

Giving state pension funds access to capital markets at reasonable rates.

When you're a foreign state pension fund, it's not always that easy to tap the capital markets the way that a U.S. fund can like a CalPERS.

One reason is that the credit rating of these foreign state pension funds is not separate and apart from the credit rating of the country itself and many times emerging market countries have poor credit ratings because of various levels of financial mismanagement.

That means the financing, if available, is often far too expensive to make it worthwhile.

Without easy access to the capital markets, these funds sometimes end up in financial trouble and default on their obligations to retirees.

It doesn't help that assumptions about actuarial hurdle rates for emerging economies wrongly assume similarities with those of developed countries and that state pension risk control parameters are too stringent.

Eric Guichard recognized this problem after leaving his job at the World Bank in the late 1990s and founded GRAVITAS Capital, which works mostly with emerging market countries in Latin America, the Caribbean, Asia and Africa.

The mission of GRAVITAS, he said, is to pick up where the World Bank left off and customize solutions that the World Bank could not do because of its own limitations.

The idea, he said, is to approach a number of highly rated banks in Europe and "borrow" their balance sheet at a reasonable cost.

In other words, the Pension Support Fund founded by GRAVITAS would borrow from these banks and then invest the funds in a variety of safe, but diversified investments, such as U.S. Treasuries, high-yield corporate bonds, emerging market bonds and emerging market equities.

Those investments would then generate enough yield to pay back the bank debt, as well as help the pension funds generate higher yields than they otherwise could get to meet their long-term obligations.

The Pension Support Fund was implemented as a fund or hedging platform that is offered as a limited partnership to participating state pensions.

"The benefit of all of this is that the pension funds are now able to meet their long-term obligations, and the beneficiaries don't have to worry about defaults," Guichard said.

This also has a significant impact on these countries, and their economies are now able to provide for retirees and prevent these funds from defaulting.

A VALUABLE HEDGE

Guichard is able to make this work because, when the fund borrows from banks, it gives them a say in how the money is invested. In addition, the banks can see that the Pension Support Fund itself has good credit and holds collateral from the state pension funds. In addition, the banks generate fees from the lending activity.

GRAVITAS also generates an investment fee, but the returns on the investment are enough to cover that and the other expenses and still provide a good return to the funds.

Guichard launched the program in 2008 and got "very, very good response from the countries and good response from the banks"--albeit delayed by the financial collapse.

"Nevertheless, the need for a way for state pension funds to hedge their future liabilities is further exacerbated by the 2008 collapse and I expect the solution to be in demand," he said.

About two or three countries participate in the program, and smaller commercial banks in emerging markets are interested in offering a similar program to retail clients.

Guichard said he has not actively marketed the concept yet but would seek to find a distribution platform that could market this solution to a larger group of clients.

"We are extremely proud of the implications for households in these countries as the impact is quite significant," he said.

The Pension Support Fund solves a longstanding problem that state pensions have had and at the same time provides GRAVITAS with a first-mover advantage, Guichard said.

Gravitas has submitted the solution to the U.S. Patent and Trademark Office and it has granted GRAVITAS a "patent pending' status on the innovation.
--By Patricia Vowinkel

Mario Marcel
Manager, Institutional Capacity and Finance Sector
Inter-American Development Bank
Washington, D.C.

Banking head pushes for financing risk on a pre-event basis in developing countries to avoid more debt and higher taxes.

Natural disasters are a serious concern for people in Latin America and the Caribbean. Every year, natural disasters affect about 4 million people in the region, causing some 5,000 deaths and $3.2 billion in physical losses.

On top of that, the exposure to natural hazards such as earthquakes, hurricanes, drought and flood has steadily increased over the last decade, with annual losses rising at a rate of more than four times the gross domestic product growth.

Mario Marcel, in his role as head of the capital and financial markets team at the Inter-American Development Bank, has developed policies and financial instruments to help the sovereign governments better manage and finance their risk from natural disasters.

Marcel found, for example, that the resources needed to pay for natural disaster losses have been based almost exclusively on post-event financing, such as debt or higher taxes. That often proves inadequate because these countries typically face a serious liquidity gap in the immediate aftermath of these events, said Guillermo Collich, senior policy specialist at Inter-American Development Bank.

Instead, it is crucial for these countries to financial this risk on a pre-event basis. "What we want is for them to start pre-emptive financing," Collich said.

The pre-event financing, however, involves accessing insurance and the capital markets in ways that are unusual and innovative for sovereign governments, said Reto Schnarwiler, director in insurance and specialty at Swiss Re, which is working with the IDB.

"The truly innovative piece here is the IDB combines the traditional banking instruments with the insurance and capital market instruments," said Schnarwiler. He noted banks tend to be conservative and are not often familiar with how to use insurance or capital markets to finance risks.

One of the products Marcel and his team have designed and implemented in the last year includes a $600 million credit facility to help countries in Latin America and the Caribbean better cope with natural disasters contingent on their development of integrated risk management plans that are acceptable to the bank.

The loans, which are triggered based on the magnitude of the disaster, will provide member countries with liquid resources to cover urgent financing needs after a natural disaster of unusual proportions, until other sources of funding can be accessed.

Another idea has been the development of a regional natural catastrophe insurance facility that will provide parametric insurance to Central America.

As Schnarwiler described, the parametric insurance contracts are devised ahead of time based on a parametric payout formula--objective data that can be easily tracked, such as an earthquake magnitude or the wind speed of a hurricane. When an event happens, those figures will be plugged into the formula to determine the insurance payout.

QUICK AND EASY

By using this approach, the insurance payout can be determined quickly and easily with little to no dispute. This is a benefit for the sovereign governments as they will receive a payout relatively quickly. It also spares the insurers on the contract from the potential for disputes with sovereign governments over the amount owed. Everything is objective and agreed upon in advance, Schnarwiler said.

"It's very difficult to raise new funding quickly after an event, and many of these countries' budgets are already stretched and they cannot raise more debt," he said. "They need to think in different terms how to manage disasters."

Marcel, who recently served as chairman of the Presidential Advisory Board on Pension Reform in Chile, also has provided substantial funding to assist the nations of Latin America and the Caribbean to examine, revise and update their existing regulatory structures to support a new range of insurance instruments catering to the complex risks these nations face, particulary with regard to property and agriculture insurance.

Marcel and his team have already begun working with Honduras and the Dominican Republic preparing those countries for participation in the contingent loan financing program by the end of the year. The IDB is beginning the first phase of the process and developing integrated disaster risk management programs for four other countries in Central America: Panama, Costa Rica, Guatemal and El Salvador. Other countries are expected to begin working with the IDB on this program in the next year, Collich said.

"We are very, very excited. It's a new line of work for us, and we really look forward to continuing under his (Marcel's) guidance," Collich said.

--By Patricia Vowinkel

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