ART COLUMN FOR AUGUST

Let's all play "Stump the Actuary"

By Dick Goff

Last month's ART Gallery exhibit of enterprise risk management concepts sparked some interest falling into the "how to" realm. A few responses indicated that readers understood the need to cover unique or nontraditional risks, but still weren't clear on how to establish coverages or their associated premiums.

We summarized the subject in that column with the comment that an actuarially sound captive insurance program would be a good way to approach unusual risks that could devastate an enterprise. But we didn't say anything about how the actuarial process would work.

It's not obvious. Enterprise risks are typically those potential hazards that are both very infrequent and very severe. Traditional insurance typically covers risks that occur more often with likely less severe damages (with the obvious exceptions, life insurance being the best example).

So, what's the actuarial approach for enterprise risk? Is it the often brain-numbing recourse to massive data, or something closer to the approach known as WAG (wild-ass guessing)?

"You'd be surprised at how often we can find data that correlates with seemingly unique events," said Brian Johnson, principal with Bartlett Actuarial Group, Ltd. of Charleston, SC, when I caught up with him for a short course in actuarial work for enterprise risk management. "Of course, that needs to be balanced with the art of applying experience to individual cases. We would call that wisdom rather than WAG."

Our conversation took the form of a game show that could be called "Stump the Actuary" as I tossed out examples of enterprise risks and Brian responded with implications to consider or approaches to follow.

Dick: I just heard of a case of a pro ballplayer who wants insurance against the loss of his contract. Is that possible for ballplayers or maybe even extending to performers or media people?

Brian: First, I don't think you can insure against the obvious exceptions embedded in most contracts, such as the results of illegal or immoral acts. But people can lose their contracts for a variety of reasons. We have the recent example of food celebrity Paula Deen, or going back to people such as Lance Armstrong or Tiger Woods. A sponsor may want to sever ties with a celebrity over a reputation issue that may or may not be based on the narrow definition of illegality.

Contracts of this type state the remuneration so that makes it easy to project possible damages, but you would have to project the possible reasons that could occur for the contract to be cancelled, and how often that might happen.

Dick: Aren't many contracts lost because of events that aren't the fault of the contractor?

Brian: In the case of the ballplayer, a strike or lockout by the owners would be such an example. Or federal contractors can lose their contracts at the whim of the government. Coverage of that risk is called "continuing resolution."

Some contracts could be cancelled as the result of a physical disaster, a union action or political events such as an "eminent domain" action. You could write captive policies that would cover those eventualities. Again, you have to rely on data that exist for a given industry and then research each specific case before you decide to insure. Often writing a policy or establishing a premium comes down to the "sniff test."

Dick: What if a company wanted to insure the exclusions in its existing policy?

Brian: Oh, yes, those pesky exclusions that traditional insurance companies don't want to touch. Generally, you can cover against any risks that are not connected to the policyholder's illegal acts. The common exclusions such as acts of war, certain kinds of air travel or sports activities can be actuarially analyzed. Some athletes' contracts, for example, don't provide coverage for mishaps that occur playing basketball or skiing. You can cover the gaps in property owners' policies through exclusions for damage from floods or earthquakes. You've just got to figure out for each specific case how likely those risks may occur.

There's also the matter of relativity. If you're going to cover exclusions that may amount to ten or twenty percent of your risks, you probably don't want to have to pay a premium greater than that of the base policy.

Dick: What I'm hearing from you is that actuarial analysis of enterprise risks is a logical, step-by-step progression that can be replicated over many kinds of cases.

Brian: I'm glad that came through.

Dick: Thanks for playing "Stump the Actuary."

And for the readers: you can play, too, by sending me your questions or comments and, if you have a subject to cover in depth, send a query describing your article to managing editor Gretchen Grote at ggrote@sipconline.net.

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