Captives Primed to Take On Reputation Risk

During the last seven years, reputation risk has emerged out of nowhere to become one of the biggest enterprise risk worries for companies of any size. Yet, the coverage is so new that insurance products didn't really exist for it before 2010. Now, with the widespread use of online tools and the interconnectedness of businesses across the globe, a company's reputation has become one of its most important assets.

Reputational risk is generally defined as the risk a company may experience in the event of negative publicity. The reputation-damaging event could lead to loss of revenue, increased operating or regulatory costs, or loss of company value through such issues as a product recall, environmental incidents, security breaches, poor labor practices, or even mismanaged customer service.

Reputational risk is complex in that it is not easily quantifiable, as so much of it depends on public perception, which, at the best of times, is problematic to predict. A company's reputation is based on consumer trust and if that trust is felt to be betrayed in any way, it could have a severe economic impact.

In Aon Risk Solutions' 2017 *Global Risk Management Survey,* a biannual survey with nearly 2,000 respondents, the risk that most concerned those surveyed was "Damage to reputation/brand." The Executive Summary of the survey highlights a combination of factors that often play out together—such as a faulty product combined with social media reviews—as concerns for risk managers and companies.

"Social media has created a rapidly expanding network of new connections between individuals and groups, and technologies have accelerated accessibility," as stated in the report, *"But as more people turn to social media for news or to post stories, organizations are becoming more vulnerable to reputational risks. When the dominos start to fall, they fall fast. Damage to reputation restricts a company's ability to attract and retain talent, which in turn results in failure to innovate and meet customer needs."*

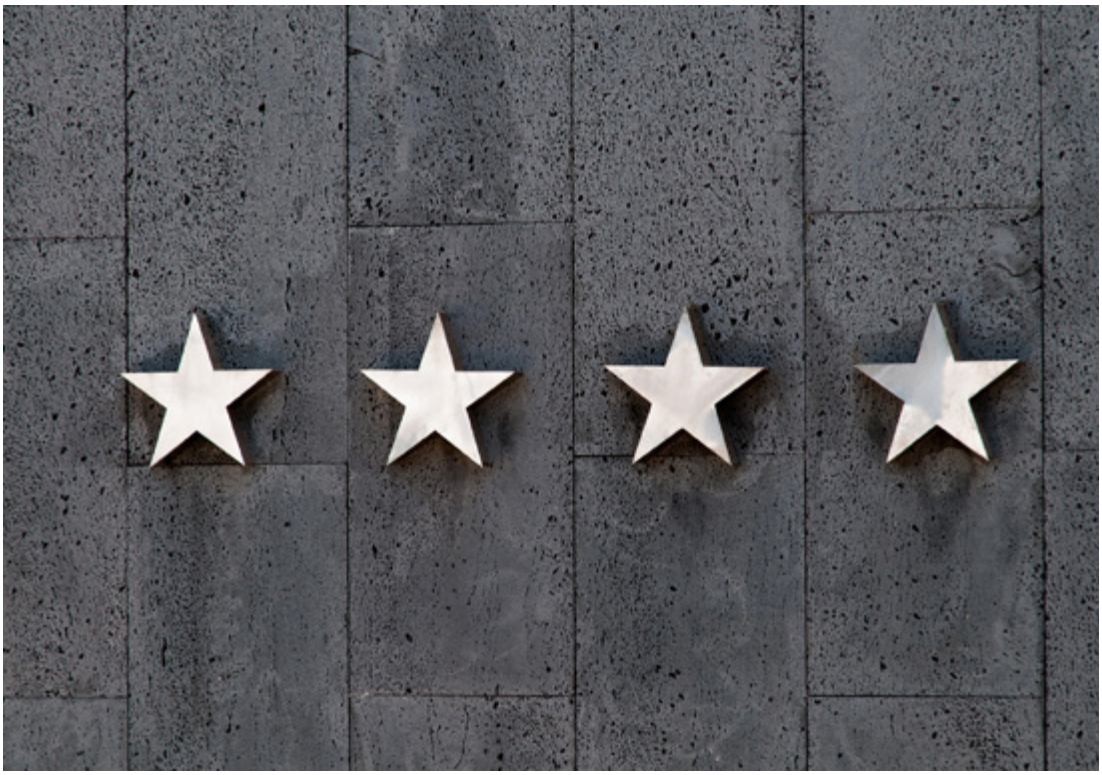
Reputation Insurance

Reputational risk insurance coverage is available to insure a company's valuable reputation, but its reach has not caught up the with need in the market place. According to John J. Kelly, managing partner at Hanover Stone Partners, LLC, "Until recently, reputational risk has been essentially unavailable in the marketplace. Over time, a select few underwriters got their toe in the water with relatively limited coverages that essentially provided indemnification for extra expenses incurred at the time of a major incident….The business interruption products rely heavily on post-event forensic analyses, and have not gained much traction largely due to the vagaries of the claims process."

Even as CEOs and risk managers fear reputational exposure, there are very few insurers that offer a product solely insuring reputational risk. Using captives to self-insure reputational risk is quickly becoming a popular way to address the gaps in available coverage.

Said Kelly, "Companies whose value is enhanced by their reputations for ethics, safety, security, quality, innovation, and sustainability are likely to benefit from reputation insurance [through captives]. This is because captives provide a capital efficient mechanism to address the costs of reputation risk—which have risen 461% over the past five years—and because captives [that are] structured properly signals quality risk financing practices to all stakeholders."

Captives, especially established ones, are in a good position to add reputation risk to their policies. The risk management techniques that go into a well-managed captive makes it easier for captives to create more precise actuarial models of events that could affect reputation, as well as allow them to more accurately underwrite the risk. Captives also have expanding access to reinsurers giving them opportunities expand the risks they cover.



"What holds for most types of risks also holds for reputational risks in captives," said Kelly. "The emergence of captives has materially shifted the focus from risk transfer of insurable loss exposures to third-party underwriters to formalized self-insurance and pre-funding of the enterprise's holistic risks that includes more reliance on the identification, measurement and quantification of risk exposures, as well as greater recognition across the organization of the organization's risk profile and the opportunities to eliminate risks and mitigate loss by earlier detection."

Where commercial reputational risk products do exist, they primarily serve large, well-capitalized companies and have policies with large deductibles—one million dollars or more.

While any company could have a lot to lose in a reputational exposure, medium and small-sized companies could be even harder hit. "Reputation is a vital asset that in some companies is a source of significant value. For small to medium-sized companies, reputation resilience is what may allow them to survive an adverse cyber security event, product recall event, ethical breach or other potentially damaging event," said Kelly. "For them, a captive is even more so important because small to mid-sized companies many times do not have the financial wherewithal to deal with the immediate financial consequences, let alone the potential erosion in market capitalization or net worth."

Reputation Risk Metrics

A big obstacle to getting reputational risk coverage for any company is the lack of actuarial data available for underwriting and pricing. How can actuaries quantify a risk that is based on public perception and was not monitored a decade ago? According to Kelly, "[Combining] big data and the mainstream acceptance of principals of behavioral economics, reputation value can now be quantified in financial terms."

One company, Steel City Re, has taken the lead in using "big data" to create metrics with which to quantify reputational risk in a product called Reputation Assurance. According to the company's website, Steel City Re has created this parametric product based on independent data indexing of reputational value and by measuring stakeholder expectations over a 15-year period.

"Prior to the introduction of the Steel City Re's parametric product … captives were unable to price reputational risk with any actuarial credibility. The objectivity of the parametric approach seems to create a much more attractive strategy for both risk financing and risk transfer and has led to a boomlet in demand for reputation risk financing and transfer solutions that are based on Steel City Re's data," said Kelly, who serves as a marketing strategy advisor to the company.

"Steel City Re prices, underwrites, and supports parametric insurance products that protect companies, their officers and directors against financial losses when reputational crises occur," continued Kelly. *"Because the parametric solution is discriminatory for companies that qualify for risk transfer, Steel City Re's policies, like Federal Deposit insurance or a warranty, express to a wide range of stakeholders both quality and value in a company's leadership, governance and risk management practices. When paired with a captive insurer, Reputation Assurance's expressive affirms quality governance and concurrently signals quality risk financing practices."*

Reputation Risk Emerges

Even with the advances made in underwriting reputational risk, it will be years before it becomes standard risk, if it ever does, with products offered for every type of company through the traditional insurance marketplace.

As stated in Aon's 2017 *Global Risk Management Survey*, "Risks that are currently difficult to insure are emerging as major concerns for global organizations. This means that the insurance industry will have to be more innovative and expand their products and programs to address some of the most complex and challenging risks."

Captives are already stepping up to meet the needs of emerging risks, offering some of the most innovative products in the marketplace. Reputational risk is no different, with captives carving out a new niche for themselves.

According to Kelly, *"The underwriting process for captives helps responsible corporate agents understand the relationship between what a business does to create expectations among its stakeholders, how those expectations underpin its reputation, how operational risks can place that reputation at risk, and the return on investment in mitigation strategies."* ■

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