A Better Way to Manage Risk

Through an innovative insurance policy, Honeywell has taken a first step toward making integrated risk management a reality.

by Lisa Meulbroek

Most managers treat risk management as a series of unrelated tasks best delegated to specialized experts. If a company needs to insure its plant and equipment, an insurance team in the treasury department runs the numbers and negotiates a contract. If it starts exporting to Japan, another team of foreign exchange specialists will hedge the company's exposure to currency movements using futures and options.

Yet these two very different tasks share one goal—trying to control the company's exposure to financial distress. On the face of it, then, unifying the management of a company's diverse risks would seem a ripe source of efficiency gains and cost savings. But until recently that hasn't really been a practical option, since no insurers offered coverage for a company's consolidated risk exposure.

A Brave Pioneer

A few companies have now begun to work with insurers to develop more comprehensive risk-management agreements. And they're finding that such policies not only save them money but bring wider organizational and strategic benefits as well. One of these is the U.S. engineering giant Honeywell. Through an innovative insurance contract it developed in partnership with its main insurer, American International Group (AIG), Honeywell has successfully integrated its management of several different kinds of risks.

Under this single policy, Honeywell now groups together not only traditionally insurable risks—product liability, property, employee crime, and so on—but also protection against changes in a host of foreign exchange rates. Previously, the insurance risk-management unit in Honeywell's treasury department had covered each risk under a separate policy, while its derivatives group hedged currency risks through the usual array of forwards, futures, and options.

Bundling the company's risks like this has enabled Honeywell to cut its overall risk-abatement costs by more than 15%.

By bundling its diverse insurance risks, Honeywell has cut its overall risk-abatement costs by 15%.

Combining the Deductibles. First, the new policy lets Honeywell pool previously separate deductibles. This not only saves money but, perhaps more important, puts the company in better control of the amount of risk it can afford to underwrite itself. Here's how that works: Let's say Honeywell can safely withstand unexpected losses of up to $30 million a year, but it has to buy separate policies for product liability, fire, and foreign exchange risks. To keep its losses to no more than $30 million, it would have to set deductibles at $10 million for each policy. The lower the deductible, of course, the more expensive the policy for coverage the company really does not need. If a factory caught fire, for instance, causing damage worth $25 million, Honeywell would shoulder only the $10 million deductible, when it could afford to absorb the entire amount. It would end up unnecessarily paying for the insurer to pick up the remaining $15 million. But by negotiating...
an aggregated deductible of $30 million, Honeywell pays for exactly the level of protection it needs.

**Netting Off Diverse Risks.** Some of the risks in a company like Honeywell are mutually exclusive; a fire that destroys a factory eliminates the chance that the company will have to pay out on defective products that the factory might otherwise have produced. Apart from the issue of deductibles, insuring these risks with one company is cheaper than insuring with two because the reserve that a single carrier would put aside for insuring against fire can be offset against the reserve put aside for product liability. That translates into a much lower premium than if the two risks were insured separately.

**Winning Organizational Acceptance**

Honeywell recognized that an integrated approach might meet with internal resistance. After all, although they were nominally grouped under the common treasury umbrella, the insurance and financial risk-management units actually had little to do with each other. They came from different cultures, used different tools, and thought of themselves as having different objectives; on the face of it, traditional insurance contracts would seem to have little in common with traded financial securities.

To overcome this resistance, Honeywell created a team drawn from both units to prepare a detailed design and evaluation of the proposed policy. To foster unity and encourage members to think beyond their traditional risk-management frameworks, Honeywell eliminated all titles within the team. As a result, everyone has been able to take ownership of the new policy's success. In fact, the former head of the insurance risk-management unit—initially the person who was the most skeptical of the integrated approach—is today its chief proponent.

**The Real Buried Treasure**

Honeywell's new policy is only a taste of the benefits of integrated risk management. The savings possible from freeing up expensive equity capital are potentially far greater. A company that does not identify and measure its risk accurately has no choice but to adopt a conservative capital structure, using equity as a cushion against financial distress. But a company that carefully controls its risk of financial distress contractually can afford a more aggressive capital structure. An effective risk-management strategy, therefore, frees a company to become as fully leveraged as it should be and capture the significant tax and other benefits that accompany debt financing.

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**The Law of the Pack**

Move over, Metcalfe. Here's a new technique for measuring the value of networks.

*by David P. Reed*

The Internet is a network of networks, and its value lies in the connections it enables. As managers and entrepreneurs try to measure that value, they have paid a great deal of attention to two types of networks. The simplest is the one-to-many— or broadcast— network, through which a central supplier broadcasts information to a large number of users. An example is the Web portal, which delivers news and other content to many visitors. More complex, and more valuable, is the one-to-one— or transactional— network, which connects individual users with other individual users to exchange information or complete other transactions. Common examples are e-mail and instant messaging.

But there's a third type of network that, although less understood than the other two, is actually the most valuable of all. It's the many-to-many— or group-forming— network, which allows network members to form and maintain...