Think piece

Number 104 March 2014

INDEPENDENTLY PROMOTING DEBATE AND FRESH THINKING IN THE FINANCIAL SERVICES INDUSTRY

New Approaches to Risk Management in the Twenty-First Century: Four Big Areas

Andrew Kendrick
President,
ACE European Group

Summary

- Busy management teams are struggling to keep pace with a range of new and emerging risks that pose significant threats to their business. This is the key finding from a major piece of research undertaken by ACE European Group surveying 650 risk managers and senior executives across a range of industries and based in 15 countries in Europe, the Middle East and North Africa.
- The 'big four' emerging risks named by over 40% of executives surveyed as most likely to have a financial impact on their business over the next two years, were supply chain/infrastructure, environmental, cyber and directors' and officers' liability risks.
- The global financial crisis has caused risk management to rise up the corporate agenda, but emerging risks have not yet been embedded in board level discussions on wider risk management issues. 57% of respondents cite lack of management attention as the biggest barrier to effective risk management, and this in turn leads to lack of human resources and risk management tools and processes to manage them.
- Today's risk challenges demand a cross-disciplinary approach, with the risk function working closely alongside the business to identify, assess and mitigate key exposures. Compounding this complexity is that fact that risks are often interconnected: real world events do not respect neatly delineated risk categories.
- Emerging risks create a number of obstacles to success, as they combine to create a hugely challenging environment not just for professional risk managers, but also for all senior executives. Creating the right framework for enterprise risk management, and building the knowledge and tools to track and mitigate all these risks, is hugely challenging.
- If the insurance industry is to meet expectations of risk managers and senior executives it will need to make a shift from 'product' to a 'service' mentality, and clients will need to shift from a transactional to a strategic approach to their insurance partnerships.

CII Introduction: the floods at the start of 2014 brought the UK public another reminder of insurance rising to society's call in a time of need. While there were some stories of difficult claims experiences, for the most part insurance played a major role in mitigating the worst affects of the widespread flooding. These events provide a vivid backdrop to a new report by ACE Group on the biggest emerging insurance risks. It comprised of market research undertaken in 2013 involving 650 senior executives, risk mangers and Chief Financial Officers across a wide range of industries in 15 countries in Europe, the Middle East and North Africa.[1] In this Thinkpiece, Andrew Kendrick returns to our series, and draws on his experience as President of ACE European Group to provide an analysis of the business implications of this research.

The global financial crisis has undoubtedly caused risk management to rise up the corporate agenda and, although the worst of the crisis may now be behind us, its aftermath continues to be felt in an ever more complex and dynamic risk environment.

Some risks, such as cyber risk, are relatively new. Others, like environmental and directors and officers (D&O) risks, have been around for a long time, but have taken on a new dimension due to social, economic and regulatory change. Indeed, the impact of increased regulation can repeatedly be seen in this survey. So too can the impact of increasing globalisation, which is creating new exposures, as companies expand internationally via more complex, extended supply chains.

Identifying and monitoring emerging risks is far from straightforward. It requires non-traditional approaches and a willingness to listen to dissenting voices that are willing to challenge received wisdom.

Compounding this complexity for risk managers is the fact that these risks are often interconnected. Real world events do not respect neat categories. An environmental incident affecting an important supplier in Thailand can quickly become a supply chain risk with a severe financial impact for a company on the other side of the world. Understanding the interdependencies between different processes, operations and players in the global supply chain is one the most critical tasks an organisation can undertake in today's business environment.

New approaches

Identifying and monitoring emerging risks is far from straightforward. It requires non-traditional approaches and a willingness to listen to dissenting voices that are willing to challenge received wisdom. However, the dynamic nature of today's risk environment means that it should be a growing priority for companies to have the right capabilities and processes to monitor their emerging risks, as part of a broader enterprise-wide approach to risk management.

Similarly, identifying and managing emerging risks cannot be an isolated activity. Cyber risks cannot be the responsibility of the IT function alone, any more than supply chain risks being the sole responsibility of the operations team. Today's risk challenges demand a cross-disciplinary approach, with the risk function working closely alongside the business to identify, assess and mitigate key exposures. The risk management function plays a vital role in this process. Perhaps most important of all, this study also suggests that many senior executive teams could give more attention to the discussion of emerging risk. By setting the right tone from the top, their businesses will be more likely to ensure that they take a more proactive approach towards their management.

We must remember, however, that the risks covered in this report are often a corollary of the opportunities that companies are rightly pursuing in their quest for growth. By understanding and responding to this array of emerging threats and challenges, risk managers can help their organisations to put their strategic plans on a sustainable footing. And, by working with them in a collaborative way and taking a strategic approach to their client relationships, insurance brokers and underwriters can ensure they support economic growth and recovery.

Four big risks

It is clear from our study that the issues that most keep risk managers awake at night right now are not only the headline grabbers. Exposure to terrorist threats or confiscation of their assets in far-flung places, important as these are, do not supplant other equally important risks.

Instead, the four big risks named by over 40% of executives as most likely to have a financial impact on their business over the next two years are supply chain/infrastructure, environmental, cyber and D&O liability.

The embedded, systemic nature of these risks makes them difficult to isolate and complex to manage and success will require increasing corporate focus and better quality dialogue between risk managers and their insurers.

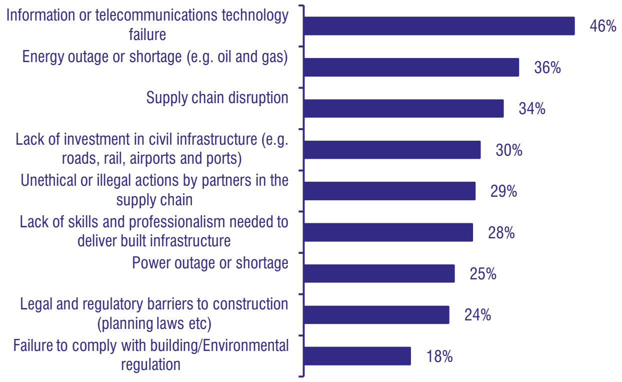
[1] ACE Europe, *Emerging Risks Barometer Risk Briefing 2013*. http://progress.acegroup.com/media/attachments/ACE_Emerging_Risks_Barometer_2013_1.pdf

Supply chain and infrastructure

Of all the risks facing businesses today, supply chain and infrastructure risk is the one that business leaders expect to have the biggest financial impact. Today's high-tech supply chains are the backbone of business performance, but they are also increasingly vulnerable, particularly as companies continue their drive to cut costs. Failing to strike the right balance between lean supply chains and resilience can lead to devastating risk events. Consider, for example, the 2013 horsemeat scandal in Europe, or the impact of the 2011 tsunami in Japan on global supply chains.

Figure 1: Biggest infrastructure/supply chain risks

Which of the following aspects of infrastructure/supply chain risk currently cause you the greatest concern in the key markets where you operate?

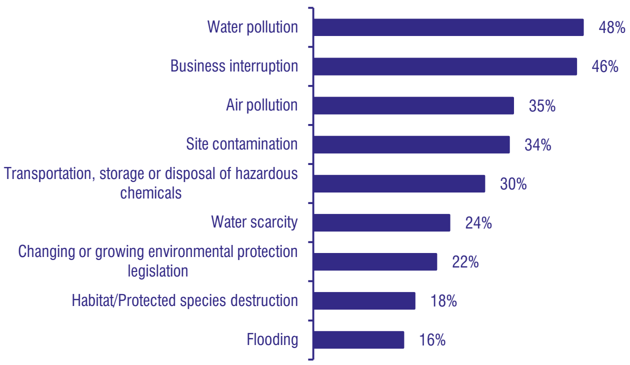


Environmental risk

The risk barometer research also highlights the growing importance of environmental risks, which are second only to supply chain and infrastructure in terms of financial impact. With tougher government regulation and more vocal stakeholder concerns, companies are being held accountable for their environmental impact as never before.

Figure 2: Top environmental risks

Which of the following aspects of environmental risk currently cause you the greatest concern?

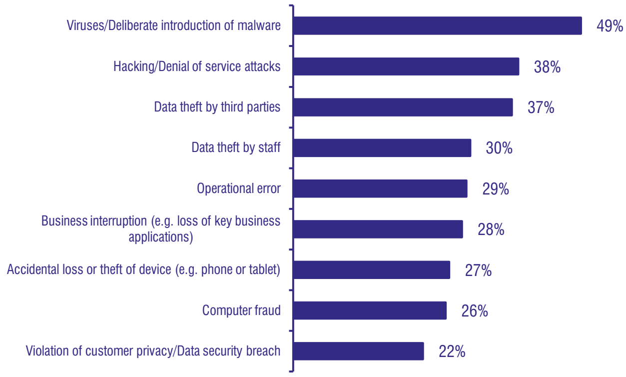


Cyber risk

It is also no surprise that risk managers are becoming increasingly concerned about the possibility of cyber risk. In recent years, cyber risk has become virtually unavoidable as companies become increasingly dependent on technology. Indeed, it was recently identified in other research as the top systemic threat facing global financial markets and infrastructures. But there are signs that companies may still be underestimating cyber risk.

Figure 3: Top cyber risks

Which of the following aspects of cyber risk currently cause you the greatest concern?



D&O liability

Directors and officers risk has been a key issue on the boardroom agenda for the past decade. Respondents place it joint third, in terms of its likely financial impact on their business over the next two years. Although hardly a new risk, D&O liabilities are constantly evolving against the backdrop of the global financial crisis, changing regulation and companies' international footprint. Executives in our survey are particularly concerned about reporting errors and exposures related to bribery, fraud and corruption.

Figure 4: Top D&O risks

Which of the following aspects of directors and officers risk currently cause you the greatest concern?

Obstacles to success

These risks combine to create a hugely challenging environment not just for professional risk managers, but also for all senior executives. Creating the right framework for enterprise risk management, and building the knowledge and tools to track and mitigate all these risks, is hugely challenging.

The obstacles to effective risk management are two-fold. First, companies are not making sure that the right people are giving attention to the right risks at the right time. When asked what they consider to be the biggest barriers to the management of emerging risks, respondents point to lack of management attention as the number one factor.

Managing emerging risks requires a multidisciplinary effort, with all functions working together, and with external experts to augment capabilities and address challenges.

The Chief Risk Officer must lead the corporate response to these challenges, monitoring new threats and pinpointing the right issues for management's attention. But, most important of all, managing emerging risks requires a multidisciplinary effort, with all functions working together to address these challenges effectively, as well as working with external experts to augment capabilities. Ultimately, as ever in risk management, it is a question of having the right culture in place, backed by strong governance and best practice processes.

The second biggest obstacle, according to respondents, is a lack of human resources and skills. Resourcing is itself the a major issue, particularly against a backdrop of ongoing cost-cutting and efficiency drives. In other words, companies are not yet investing in the headcount or external support needed to manage a highly dynamic emerging risk environment.

We were surprised by these responses regarding the barriers to effective risk management. They suggest that emerging risks have not yet become embedded as part of board-level discussion on wider risk management issues, perhaps because many businesses are still grappling with how they can best respond to the growing range of risk priorities that the global financial crisis has brought. However, the senior executive team needs to set the right tone from the top. They need to invest proactively in emerging risk management and build the knowledge and tools necessary to track and mitigate these threats.

The role of the insurance market

Specific insurance market products are evolving as risks become more complex. The industry has an opportunity to bring its wider knowledge and expertise to bear in ways that help its clients to improve their risk management approach.

But it is clear that the insurance industry as a whole—including underwriters, brokers, claims managers and loss adjusters—needs to communicate more effectively with the risk managers that we serve. The big four risks that top our barometer require a more consultative approach.

Ultimately, if the insurance industry is to meet expectations it will need to make a shift from a 'product' to a 'service' mentality and clients will need to shift from a transactional to a strategic approach to their insurance partnerships. This will allow insurers to partner better with companies on risk management as well as risk transfer. Today's more complex operating environment and the era of 'big data' will also require insurers, brokers and clients to get into the habit of sharing more and better quality information with each other.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

Andrew Kendrick is President, ACE European Group and oversees ACE's operations across Europe, the Middle East and Africa. He was appointed to this role in 2004 after being Division President, ACE Bermuda. He joined ACE in 1996, bringing with him more than 18 years of insurance experience. Originally working in London, he previously served as ACE's Director of Underwriting and Active Underwriter of ACE Syndicate 2488 at Lloyd's. He began his career at Sturge Syndicate 210 in 1978, with a focus on underwriting the financial institutions account. He has worked at ACE since ACE purchased Ockham Underwriting Agency (formerly known as Sturge Underwriting Agency). He sits on the International Association Board, the Lloyd's Underwriting and Claims Committee, and (as a non-executive) the Lloyd's Franchise Board. He has also held Chairmanships of the Lloyd's Market Association Board and the Lloyd's Financial Institution Business Panel.

ACE Group is is one of the world's largest multiline property and casualty insurers. With operations in 54 countries, ACE provides commercial and personal property and casualty insurance, personal accident and supplemental health insurance, reinsurance and life insurance to a diverse group of clients. ACE Limited, the parent company of the ACE Group, is listed on the New York Stock Exchange (NYSE: ACE) and is a component of the S&P 500 index.

As the leading professional body for the insurance and financial services sector with over 112,000 members in more than 150 countries, **the Chartered Insurance Institute** is committed to protecting the public interest by guiding practitioners in the sector towards higher technical and ethical standards. We do this by offering them a broad portfolio of services and support,
including membership, qualifications, continuing professional development, thought-leadership and maintenance of a benchmark Code of Ethics. Please see our website: www.cii.co.uk.