ACE BENELUX RISK FORUM—GHENT 2013

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A View from the Top

Belgian and Dutch risk managers who attended the ACE Benelux Risk Forum 2013 at Vlerick Business School in Ghent recently were fortunate to witness some fascinating insights into the world of risk from a group of academic and working risk professionals.

The day was highly thought-provoking and at times challenging and thus well worth an afternoon taken out of the office to emerge from the day-to-day grind of managing risk to take a step back and try to piece it all together.

Professor Filip Abraham focused his research on international trade, European and international business. His speech targeted the global business environment, risks connected with the 'death of distance' and how the world has become 'flatter'.

He focused on the core economic, political and societal risks that combine to present risk professionals with an ever more challenging environment in which to work.

His top-down perspective provided the risk managers present with an invaluable insight into the causes of current macro trends and likely direction in future.

Some risk managers may well ask what such highbrow stuff has to do with their daily jobs.

But risk and insurance managers have to face up to the fact that they cannot ignore the big picture and hope to beaver away in splendid isolation anymore. As Professor Abraham pointed out, risk is everywhere and moving at an ever faster pace and this risk needs to be managed.

And such risk can only be managed if it is properly understood in the first place and then analysed closely to work out how it will directly impact the individual corporation. Attempting to manage risk without a macro view and understanding in an international economy such as we have today is basically pointless and the recent focus upon supply chain has heavily underlined this fact.

Professor Dr André Thibeault of Vlerick Business School used his speech to reveal how recent research on the potential capital impact of Solvency II backs up fears among Europe's risk managers that the new rules will lead to higher prices and reduced capacity for the industrial insurance market.

This was specific and directly relevant to the risk and insurance managers in the room and provided them with some interesting food for thought on the new capital adequacy and reporting rules and the potential impact.

The message was loud and clear that once again this big change cannot be ignored. It may well be delayed and it may well still be open to debate. But the bottom line is that risk managers really cannot afford to stick their heads in the sand on this one and hope for the best.

Trevor Maynard's role at the Corporation of Lloyd's is to maintain an overview of the whole market place and aggregate all the risks to try and make sure that the market does not build too much exposure in any one place—a risk management role if ever there was one.

He focused on the hot topic of cyber risk and provided a fascinating overview of the potential risks, and pointed out that a surprisingly high number of companies still do not give this risk high priority.

The really interesting part of his contribution for me, however, was his in-depth review of the current coverage available for risk and insurance managers, which is quite rare to find in one place and I am sure that CRE readers will find this particularly useful.

Finally Suresh Krishnan, General Counsel for the ACE Group's Multinational Client Group, who has global legal oversight for matters connected with the company's multinational products and services, wrapped up with an excellent presentation on global programmes.

I followed this talk up with a Q&A around the topic and I believe that ACE clients, readers of CRE and our specialist monthly newsletter International Programme News will find this informative.

It has to be said that to gain full value from Mr Krishnan's knowledge and experience risk managers really need to attend his speeches where possible as much of the detail and analysis is difficult to convey through the print media. Mr Krishnan is really one of the few experts who can explain this complex area in a succinct manner.

Overall then this was an excellent event that I was honoured to host and we are delighted to be able to share the content with a wider audience.

Please do enjoy the read.

Adrian Ladbury,
Editorial Director
Commercial Risk Europe, Commercial Risk Africa and International Programme News

Macro Risks — Professor Filip Abraham

The risk of a flat world

Professor Filip Abraham of Vlerick Business School focuses his research on international trade, European and international business. He teaches in the Vlerick Business school, the KU Leuven and selected foreign universities, has advised on policymaking and also sits on a number of company boards. His speech during the ACE Benelux Risk Forum therefore not surprisingly focused upon the global business environment, risks connected with the 'death of distance' and how the world has become 'flatter'. ADRIAN LADBURY reports

PROFESSOR ABRAHAM USED A NUMBER OF QUOTES TO introduce the big topics that face business leaders and risk managers the world over.

He first quoted Pascal Lamy, Director General of the World Trade Organisation (WTO) who recently stressed the recent profound change by referring to shipping.

"It now costs less to ship a global container from Marseilles to Shanghai, over half way around the world, than it does from Marseilles to Avignon which is only 100km away," he said.

Next he quoted Christine Lagarde, Head of the International Monetary Fund (IMF), who recently said: "In the flat world there is no room for economic silos, but old instincts die hard. Countries face the perennial temptation only to look at the national interest. We have avoided collapse but we need to guard against any relapse. 2013 will be a make or break year."

'LAISSEZ-FAIRE IS FINISHED'

The third quote came from former French president Nicolas Sarkozy, who questioned the basic idea of the free market in a global context. "The idea of an all-powerful market without any rules and any political intervention is mad. Self-regulation is finished. Laissez-faire is finished. The all-powerful market that is always right is finished," he said.

Then there is the so-called alternative view expressed neatly by Bob Geldof of the One Campaign who said: "The IMF was viewed with genuine repulsion. You called in basically these economic thugs who imposed a dictat."

And Professor Abraham pointed out to the audience that Mr Geldof's views should no longer be regarded as that alternative or fringe as a fast rising number of people in many countries think that way.

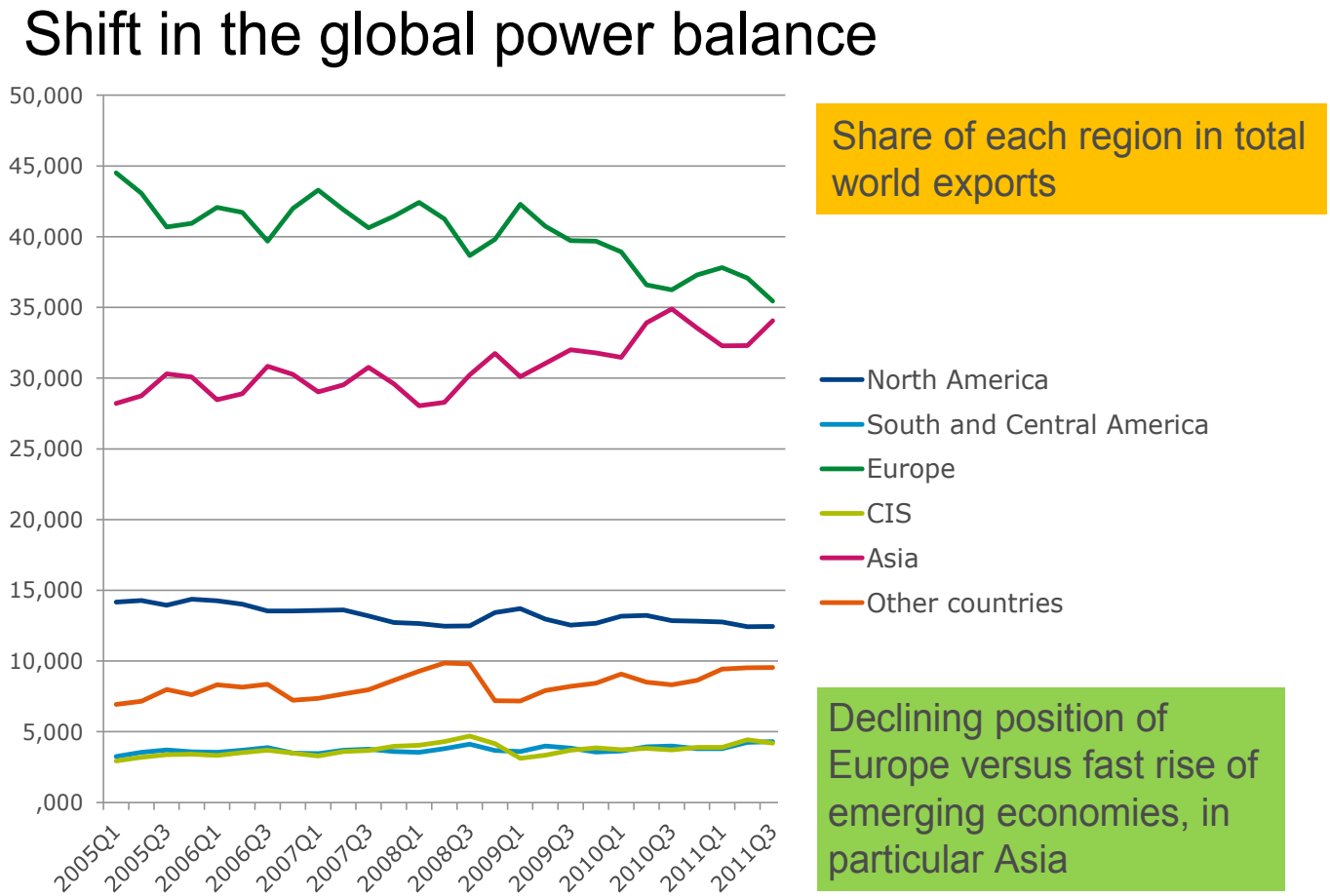
Mr Abraham's overall point was that business managers must accept that the world has changed and so the way risks are viewed and managed also have to be viewed with a different perspective.

But it is not that simple because the world remains, as ever, in a state of transition. There are no absolutes.

'THE WORLD IS FLAT...'

"We go from this view where the world is flat and companies can move across the world and have to assess their risk in a global way, taking the market as an integrated market place, driven by new technologies, new opportunities, to a view that is in-between. Here the world is semi-global, what Miss Lagarde was saying. Yes we are seeing integration but you have national governments which impose barriers and regulations and old instincts die hard," said Professor Abraham.

The academic pointed out that even if one believes



that the world is becoming more 'semi-global' than 'flat' then it is clear that Miss Lagarde's economic silos are significant.

There is this growing interdependence within the global economy, particularly in the financial market, and as was witnessed during the recent crisis, local shocks will quickly move from one country and region to another.

And, what was not included within the quotes above but is still very important to help understand the global business environment, one has to understand that a shift in the balance of power is occurring across the world, said Professor Abraham.

'A MULTIPOLAR WORLD'

"We are moving away from a unipolar world to a multipolar world which is dominated by the global imbalances, the differences between what is happening in the emerging economies and in the industrialised countries," he said.

At this point Professor Abraham referred to his first table (*above*) which showed the share of the main geographic regions of the world in global trade between 2005 and 2011.

The European share of world over this period has diminished from about 45% to about 35% while the Asian share has risen from about 28% to 34%. This clearly proves that the shift in the power balance is 'really happening' said Professor Abraham.

Against this backdrop the professor asked what risk and business managers need to ask themselves.

"If we have to do risk assessment, if we have to do risk management in a global way, what are the things that we have to look at? What are the risks that we are facing? What should we be thinking about this year, next year and somewhat longer-term?" he asked.

Professor Abraham said that typically people look at three types of risk. These are economic, political and societal which are clearly three closely connected areas. He then analysed these three big areas in-depth and delivered the following thought-provoking conclusions.

Economic Risk

Time to make your mind up

Within the economic basket, Professor Filip Abraham said that the main risk for the industrialised and advanced economies in particular is the prospect of a 'Japanese scenario' of structural low growth.

There is a big debate about public policy and whether it is really working and hence calls for more government intervention. "This makes it a very difficult environment for risk managers," said Professor Abraham.

He pointed out that the world is now embroiled in the sixth year of a major economic recession, which is a long time by any measure.

"This is a very deep recession. Where are we? Are we in recovery? No. Are we in recession? Presumably. Are we in dip, double-dip, third-dip? The situation is that we are not really sure where we are at this moment. If you are involved in risk management this is a very uncomfortable feeling," he pointed out.

While the situation in Europe may appear desperate for many nations the US does not look so bad from a growth perspective but of course it is still not clear whether the country will fall off another 'fiscal cliff', pointed out the professor.

Asia of course is in much better shape but even these economies experienced a dip in 2012 and arguably there is a weakening underway in China and other developing Asian countries.

Professor Abraham pointed out that the latest World Economic Outlook from the IMF had generally deteriorated since October.

Overall world growth fell from 3.9% in 2011 down to 3.2% last year, is expected to regain a little this year up to 3.5% and again in 2014 to 4.1%.

As the table shows (*opposite page, top*) there are big differences in growth projections across the world.

The US is expected to deliver 2% this year and 3% next year. But as Professor Abraham pointed out the eurozone is a 'disaster' as a whole, forecast to deliver negative growth again of -0.2% this year and recover to 1% in 2014. But there are big differences between countries with Germany and the UK faring not so badly but Italy and Spain really struggling.

The numbers for the emerging countries are much better of course but as Professor Abraham pointed out 7.5% is actually a 'red warning light' for China and it is forecast to dip pretty close to that with 7.8% in 2012.

Professor Filip Abraham

Moreover, the level of confidence in Europe is not great.

The IMF numbers suggest that 2014 will be significantly better than 2012 but when Professor Abraham asked how many in the room felt relatively confident that 2014 would be a better year than 2012 very few hands shot up. Most seemed to think that 2014 would be more or less the same as 2012.

Professor Abraham's big fear for Europe is that low structural growth will continue for this year and maybe more years to come. "This I think is a risk. I hope that we will not come to a situation in Europe and in other countries where we follow the Japanese experience. Japan had a crash at the end of the 1980s and then had 20 years of low growth. That's something I think that we have to avoid and I consider this to be an important risk to think about," he said.

One concerned risk manager asked how likely it is that the Japanese scenario could actually occur and what evidence there is to support the fear.

Professor Abraham explained that one of the elements of the Japanese low growth is a deflationary scenario under which prices decline over time. He said that Europe is not in that state yet. Inflation rates are somewhere between 1.5% and 2.5% across the continent. The US has a similar level.

"The big thing about deflation is that people postpone spending habits. If you know that the products you are going to buy tomorrow are going to be lower, what consumers very rationally do is wait. We are not in that scenario yet. I am not claiming that we will have a Japanese scenario but I am starting to be a bit more worried as we are now already seeing so many years of very low growth in the economy," replied the professor.

Table 1. Overview of the World Economic Outlook Projections

(Percent change unless noted otherwise)

	Year over Year					
			Projections		Difference from October 2012 WEO	
	2011	2012	2013	2014	2013	2014
World Output 1/	**3.9**	**3.2**	**3.5**	**4.1**	**–0.1**	**–0.1**
Advanced Economies	**1.6**	**1.3**	**1.4**	**2.2**	**–0.2**	**–0.1**
United States	1.8	2.3	2.0	3.0	–0.1	0.1
Euro Area	1.4	–0.4	–0.2	1.0	–0.3	–0.1
Germany	3.1	0.9	0.6	1.4	–0.3	0.1
France	1.7	0.2	0.3	0.9	–0.1	–0.2
Italy	0.4	–2.1	–1.0	0.5	–0.3	0.0
Spain	0.4	–1.4	–1.5	0.8	–0.1	–0.2
Japan	–0.6	2.0	1.2	0.7	0.0	–0.4
United Kingdom	0.9	–0.2	1.0	1.9	–0.1	–0.3
Canada	2.6	2.0	1.8	2.3	–0.2	–0.1
Other Advanced Economies 2/	3.3	1.9	2.7	3.3	–0.3	–0.1
Newly Industrialized Asian Economies	4.0	1.8	3.2	3.9	–0.4	–0.2
Emerging Market and Developing Economies 3/	**6.3**	**5.1**	**5.5**	**5.9**	**–0.1**	**0.0**
Central and Eastern Europe	5.3	1.8	2.4	3.1	–0.1	0.0
Commonwealth of Independent States	4.9	3.6	3.8	4.1	–0.3	–0.1
Russia	4.3	3.6	3.7	3.8	–0.2	–0.1
Excluding Russia	6.2	3.9	4.3	4.7	–0.5	–0.1
Developing Asia	8.0	6.6	7.1	7.5	–0.1	0.0
China	9.3	7.8	8.2	8.5	0.0	0.0
India	7.9	4.5	5.9	6.4	–0.1	0.0
ASEAN-5 4/	4.5	5.7	5.5	5.7	–0.2	0.0
Latin America and the Caribbean	4.5	3.0	3.6	3.9	–0.3	–0.1
Brazil	2.7	1.0	3.5	4.0	–0.4	–0.2
Mexico	3.9	3.8	3.5	3.5	0.0	0.0
Middle East and North Africa	3.5	5.2	3.4	3.8	–0.2	0.0
Sub-Saharan Africa 5/	5.3	4.8	5.8	5.7	0.0	0.1
South Africa	3.5	2.3	2.8	4.1	–0.2	0.3

Another risk manager asked if there was actually anything wrong with living in a zero growth or even a deflationary society.

Professor Abraham was not convinced the Japanese scenario could be desirable but did say it delivered two advantages.

The first is that the Japanese have been able to create jobs. "We are not so sure that in the European case whether we would be as equally successful," he commented.

The second thing is that, to an extent, the Japanese have adjusted to living in a society and environment where growth is expected to be low. What this means is that as individuals you have to make different choices, he said.

"We are not yet in the first phases of that debate. If I had a choice I would rather not go through a Japanese scenario. I would rather have a scenario where an economy is growing by 2–2.5%, where jobs are regularly created, where people have the feeling that things move on without always being unrealistic of what we can have in our societies in Europe and in the United States. That is my personal choice," said Professor Abraham.

The second big economic risk according to the academic is that the policies adopted to cope with the crisis will simply not be as effective as hoped.

Professor Abraham said that the first important topic to tackle is the debate about monetary policy (*See chart, overleaf, top*). Professor Abraham said that the central bank policy of the US and Europe to drop interest rates down to 0.25% and about 0.5% respectively and to funnel a lot of money into the economy was the correct response. But the firepower has been used.

There is, however, again a big difference between the US and Europe and China.

The Chinese actually started the crisis with interest rates way below the European and US but now have interest rates nudging up towards 4%.

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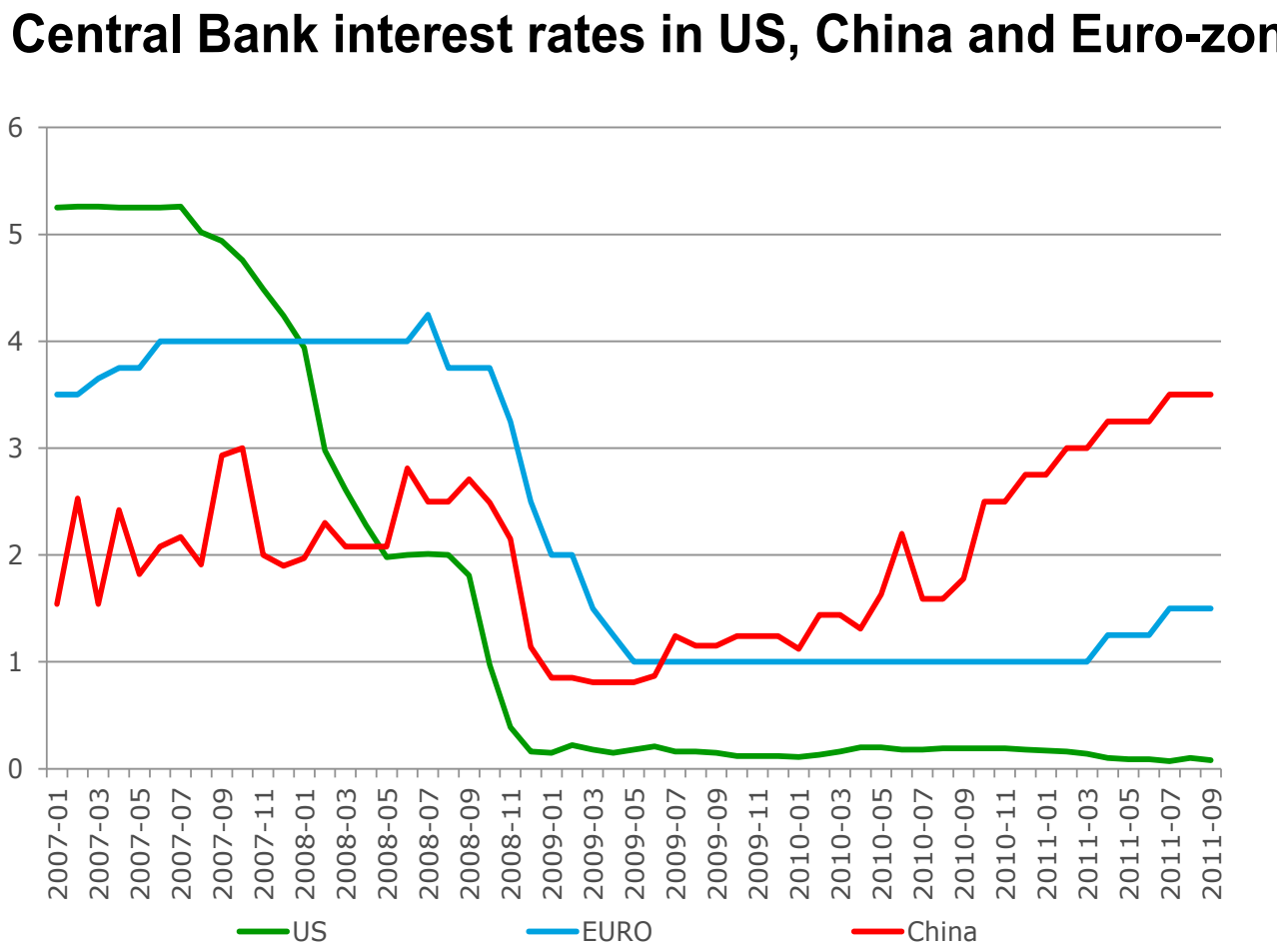
Economic risk: monetary policy



"In China they have more ammunition but they are not confronted by the very low economic growth that we are confronted with... and with high inflation so they have to keep the interest rates a bit higher," he explained.

The professor said that the first question to ask is: What should be the response if the economy does not start to recover even in the face of the central bank efforts to continue to provide low interest rates, liquidity to the banking system, consumers and so on?

The second question is whether the policies, particularly those designed to keep liquidity going and interest rates low, are really reaching the people that they are supposed to help. "Are low interest rates helping companies to invest and to spend?" asked Professor Abraham.

Another risk manager in the audience asked about the hot debate in the media about the opposing strategies of austerity versus spending. The academic said that, once again, this is not a simple risk to assess.

"Governments have had to intervene and do something and as a result you will see a further build up of government deficits and higher debt ratios. How far can this continue? You need to make sure that governments can pay their debts otherwise in the longer run you will have to bail them out. And bailing out is also an expensive and disruptive process," said Professor Abraham.

"So you want to keep your government household in order. On the other hand, if everyone is doing this at the same time, then you run the risk of lower growth and lesser revenues for governments. In the end, rather than cutting your budget deficit you will then end up with a situation where governments are still in trouble. This is the big discussion," he continued.

Professor Abraham pointed out that only the day before his speech the German government had proudly announced that it had been able to balance its budget.

On the day of the event, the French and other countries in Europe made it clear that they were not so happy about

this German success because they think the Germans need to spend to bolster growth for themselves and the wider European region.

Professor Abraham concluded that he believed that we should not be unduly concerned about a particular number or a particular debt ratio or deficit. Incentives should be maintained for governments to bring their house in order to ensure that necessary reforms take place.

But at the same time those countries that can afford to spend more and invest in growth should do so otherwise a 'vicious cycle' of austerity and low growth can be invited in.

"This is a crucial discussion as it will influence the risk of growth in the years to come," he said.

A show of hands revealed that the Belgian and Dutch risk managers present were mixed between those in favour of austerity and those in favour of growth.

Professor Abraham said that this was a correct balance and differences of opinion are fine so long as people hold the discussion based on true facts and come up with a firm strategy as a result of the discussion.

"Then we have to sell our strategy to an increasingly reluctant population who say 'why do we have to pay the price of something that we did not cost in the first place? It's very difficult this fiscal policy, the question of when, how or if we should have austerity? I see this as a part of economic risk that we are facing," said the professor.

The third big economic risk according to the professor is based around the debate on liberalisation, competition, the opening up of markets and globalisation against the argument that the economic crisis demands more regulation.

The professor pointed out that there is a wide divergence of opinion on this matter across Europe and worldwide.

He also pointed out that, on this topic, there tends to be a very strong correlation between the lending collapse, the recession that followed and the belief that people have in the values of the free market system.

"Today the debate is all about government intervention and regulation and less about opening up markets and making the road flatter than say it was ten years ago," pointed out Professor Abraham.

"We are seeing a focus on fragmentation and balkanisation as national governments in particular intervene more directly and put regulations in place based on national interests," he continued.

Professor Abraham added that the risk is accentuated as this occurs in parallel with efforts to introduce global regulation.

"If that is going to continue to happen you will see a period of very heavy regulation at every possible level, making it very difficult for markets to do what they are supposed to do. I consider this situation to be a major economic risk," said the professor.

Political Risk

Rising uncertainty breeds its own risk

François Hollande, President of France

THE NEXT MACRO RISK THAT PROFESSOR ABRAHAM focused upon was political risk, a topic that sits high on the agenda of many risk managers in Europe and worldwide currently, based upon *Commercial Risk Europe's* research.

The first important fact to consider in this sense is what the professor described as the recent 'changing of the guard'.

He pointed out that in the last six or seven months across the world there have been many shifts in governments in important countries. The United States has a new president, the Chinese have a new leader, the Catholic church has elected a new pope, Italy is in a state of flux and later in the year Germany could have a new leader.

Professor Abraham said that risks will emerge from this change.

NATIONAL INTEREST

The first such risk will be the return of national interest, he said. "When countries start to think as countries. For example, the major economies are trying to prevent their currency gaining in value against major competitors. The Chinese, who were typically the champions of exchange rate management, are now complaining that the Japanese and the Americans are now trying to do the same thing," explained Professor Abraham.

"It was always the Americans and Europeans who complained that the Chinese kept their exchange rate at too low a value. Now it comes to a situation that everyone is turning to the Chinese strategies of exchange rate management. Now they are all trying to do the same," he continued.

In such an environment in which devaluations can occur to catch a short-term advantage, it becomes very hard to assess the risks, concluded the professor.

TRADE CONFLICTS

Professor Abraham pointed out that recent recession has led to a relatively low incidence of trade conflicts between countries when compared with history, a phenomenon that he described as a 'miracle' but probably not one that will last.

"The last couple of months this has changed. We see an escalation of trade conflicts. We have to constrain this because in this situation risk management becomes more difficult," he pointed out.

"You could be doom and gloom about this and worry about whether this will have an impact on military tensions. Some of it is maybe happening between Japan and China but not yet as something as I would put on my number one priority of risk management. What the North Koreans are doing... I have no idea. But this is something that even with the best risk management systems that you can build, nobody can predict," continued Professor Abraham.

EUROZONE CRISIS

Professor Abraham said that many in the English-speaking world are actually amazed that the eurozone has not already collapsed. But, he added, that does not mean that Europe is not facing some fundamental questions over the eurozone and the European Union and how the political structure should evolve to create a sustainable and relatively efficient political constellation in the years to come.

Interestingly, since Professor Abraham gave this presentation exactly that discussion has opened in Brussels and Strasbourg at the highest level and big decisions could be made soon.

But for now there is plenty of uncertainty because there are basically two views on the future of Europe politically and economically and, as Professor Abraham pointed out, 'we are not yet at the situation where the views are being reconciled'.

The professor said that the eurozone is currently like a (re)construction site.

Angela Merkel, Chancellor of Germany, is doing a lot of work to put together the building blocks, François Hollande, President of France, focuses on more social elements such as education and solidarity and then you have Mario Draghi, President of the European Central Bank, following his agenda.

"They are all putting in some other building blocks. What is their objective? They are trying to build the dream house of Herman van Rompuy, President of the European Council [the first full-time one]…I do not think they will get there in full, but at least that is their plan," commented Professor Abraham.

The professor said that, in his view, the leaders mentioned above all want to build a eurozone that is much more like the US system.

"Firstly like the United States they want to maintain this military union with a common federal reserve, setting exchange rate and monetary policies. This is what we have already in the eurozone at least and they want to keep this and if possible persuade other countries in the European Union to join that initiative," he explained.

"Secondly they want to create a banking and financial union. So rather than have the regulation and supervision in banking all at a national level they want to have a mix of local and European regulations. They want to achieve stability of the European financial system, banking and financial supervision in different areas at a European level," continued the professor.

"The third component is a fiscal union, where, just like in the United States, responsibilities on the budgetary side sit at the local levels but on top of this sits the federal authority which can say that if the country does not behave according to the set rules, then the budget will not be accepted and either you face a heavy fine or you are on your own," added Professor Abraham.

The professor said that his personal view is that it would not be a good idea to give up the multi-union at this moment.

"I believe that we really have to do something about having responsibility at a national level but you still to realise that financial markets in Europe and world-wide are integrated and we cannot take all our decisions at a national level because of the effects of interdependency between markets," he said.

But the professor said that he would really like to see more clarity, whatever the decision.

"Clear rules on what countries can do in terms of budgetary deficits and how solidarity will be organised. This is something that we can learn from the United States. Here it is very clearly set out. If, say, California goes into a recession, what can California expect in terms of solidarity from the other states to the federal budget and what it cannot expect," said Professor Abraham.

"If California cannot get its act together with the support of the other states with the federal budget then California is on its own and will be facing (which is what is happening) high interest rates. If it wants to go to the market then it will need dramatic cuts in its public expenditure to get its act together," he continued.

He added that in the US system it is possible for states to go bankrupt. The state of New York went bankrupt in 1979. "It is perfectly feasible," he added.

"This system does have one advantage...at least the rules are clear. Whether that means we have to let everything be decided by Brussels, I am not so sure on that. But we should have common rules about these things. On the economic union, I do not consider that to be a priority at this moment," said Professor Abraham.

THE BRITISH COUNTRY CLUB

The professor pointed out that the British have a very different way of looking at things. "I love their arguments, not that I necessarily follow what they say," he quipped.

The basic argument is that the UK joined the European Union on the basis that it wanted to be part of an integrated area where markets were integrated and companies could compete. At the same time the UK wanted to make sure that every country retained as much autonomy as possible.

So, the British do not want monetary union and believe every country should have its own national bank system and own currency, he said.

The British also do not want a unified banking and financial system. Rather they want to make sure that national governments are in charge, so forget the European Union and a unified fiscal policy and leave the member states to run things.

"Mr Cameron is trying, if not with much success, to make sure that its deficits are all in order. So this is really a country club model. You have a club of countries, each country has its own autonomy and responsibilities, and you maximise the win-wins in the area where according to the British it matters most," concluded Professor Abraham.

"Now you have to get those very different views together and come to a compromise. That's a challenging act if we want to see one. Don't ask me how I would do it... I don't have a clue!" added the professor.

What really makes this whole process difficult is the pace that the change and decision-making has to be made because the process of globalisation simply does not allow the same amount of time to solve the problems.

"We have to rush because we may wake up one morning and see that Moody's has downgraded another government. This is what makes this process very difficult," said Professor Abraham.

Societal Risk

Freedom or prosperity?

PROFESSOR ABRAHAM KICKED OFF HIS FINAL BIG RISK analysis with some powerful quotes from leading US and European politicians. These were:

- **Mitt Romney, former presidential candidate:**

  "It is free men and women that drive our economy, freedom is what makes America work. President Obama, bless his heart, has tried to substitute government for free people and it has not worked and it will never work."

- **President Barack Obama**

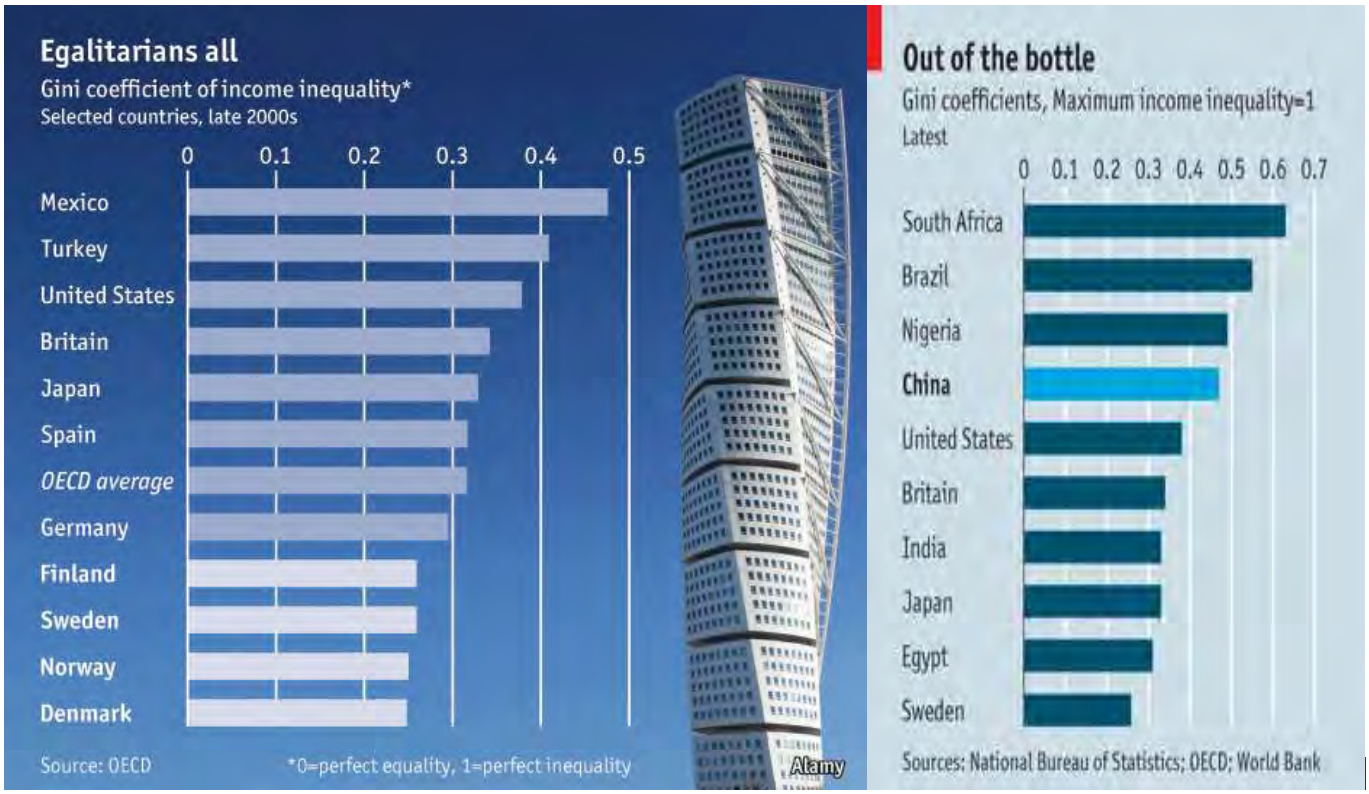
  "Nor is the question before us whether the market is a force for good or ill. Its power to generate wealth and expand freedom is unmatched. But this crisis has reminded us that without a watchful eye, the market can spin out of control—and that a nation cannot prosper long when it favours only the prosperous. The success of our economy has always depended not just on the size of our gross domestic product, but on the reach of our prosperity; on our ability to extend opportunity to every willing heart—not out of charity, but because it is the surest route to our common good."

- **President François Hollande**

  "All countries have a soul. The soul of France is equality."

Professor Abraham suggested that the main lesson from these quotes is that the biggest single risk to emerge from the current crisis from a societal perspective is that of the

Social risks: cohesion or inequality



imbalance between incentives and equality. "How can we strike this right balance so that people feel protected to some extent, but that we don't kill the incentives?" he asked.

The professor said that this is not a national or regional debate. It is a debate in Europe, a debate in the United States and a debate in China as well.

But there is also a strong degree of inequality that exists between countries.

At this point he referred to the table above, (*opposite page, bottom*) which is a measure of inequality based on statistics from the National Bureau of Statistics, OECD and World Bank.

The closer a country is to zero, the more equal it is in terms of income distribution. The further away from one the country sits the less equal it is and the difference between richer and poorer people is larger in distribution.

The statistics of course like any have to be read carefully. "China is somewhere in between but, as Winston Churchill said, 'you have lies, big lies and statistics'. And you have also a bigger lie and those are Chinese statistics!" said Professor Abraham.

"This is a big political issue in China to keep this inequality under control. So you have people at the top who have incentives [to manipulate the numbers] and the people at the bottom are not planning the next social revolution," he continued.

Professor Abraham next pointed out that increases in US real income depend on the level of education that people have.

"Now what's interesting is that when I look at the top 1% of the US society we have seen that since the 1990s, in percentage terms, there has been a huge increase in their real income," said Professor Abraham.

"But all of the others, even those with high degrees, have seen a relatively flat scenario...not too much of an increase. Indeed from 2000 onwards, there has gradually been a decrease in their real income. This is, from a social point of view, something that you have to worry about," said the professor.

The next big issue Professor Abraham identified was that of the 'lost generation' caused by unemployment rates.

For the EU 27 the rate is 10.4%, for the EU 15 it is 10.5% and for the eurozone 11.2%. This compares with the US at 8.2% the UK at 7.8% and Japan at 4.4%.

Unemployment in Spain and Greece is of course close to 25%, for example, and this does not include youth unemployment figures, which are even larger, close to double.

"This is a social risk of a lost generation who may at one moment revolt," commented Professor Abraham.

A big conclusion

In search of the perfect combination

Professor Abraham concluded his contribution to the event by pointing out that it is all too easy to come up with scenarios of a perfect storm.

"A perfect storm would be the continuing deepening of this economic crisis, the shift in the global power balance, the political instability that we have because of all those social tensions and low growth."

The professor said that if such a storm happens, in whatever guise, it simply again underlines the importance and difficulty of carrying out risk management. "Your job is not an easy one. It is very difficult to manage the risks in the eye of the storm," he said.

Professor Abraham said that we are currently in the midst of a 'make or break' period. He said that, in his view, most risk managers are currently trying to find the best combination of strategies for short, medium and long-terms risks.

"The short run is just survival, not to take too much risk because you want to make sure that you are still around next year," explained the professor.

"The medium run is what risk managers tell me they are trying to build. They are thinking about what they should do when growth returns. The questions are: 'What are the measures that we have to take today? How can we take scenarios that may happen in the growth?" continued Professor Abraham.

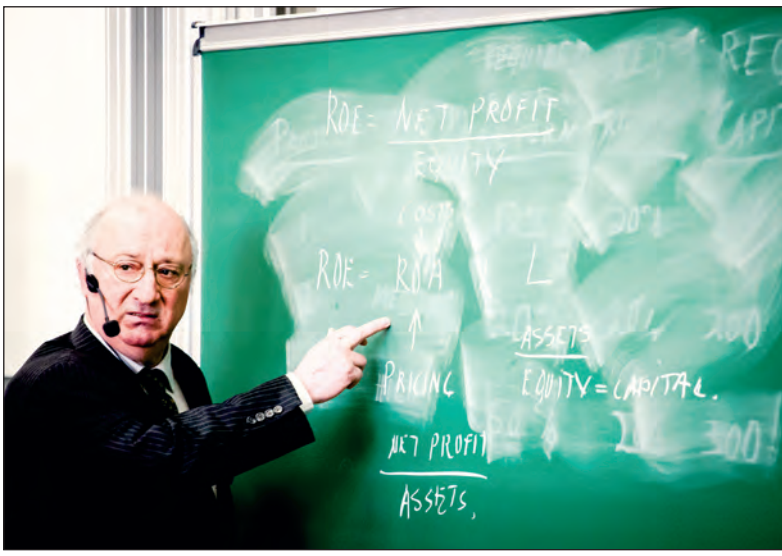
"Then you ask: 'How can you build for the longer-term future in your organisation? What are the building blocks that you have to put in place? What are the decisions in the long term that you can take now?" he said.

"This combination of having to think about a very hard short run, to think about what you can do in the medium run and to think about what the longer run may bring you—this is a real challenge. I think in terms of risk management this is an environment where I hand respect to all of you as this is not an easy task," concluded the professor.

Return On Capital—1

Watch out for naked swimmers

Professor Dr André Thibeault of Vlerick Business School used his speech at the ACE Benelux Risk Forum 2013 to reveal how recent research on the potential capital impact of Solvency II backs up fears among Europe's risk managers that the new rules will lead to higher prices and reduced capacity for the industrial insurance market



Professor Dr André Thibeault

THE DEVIL IS IN THE DETAIL WITH SOLVENCY II JUST AS IT is with all such complex and far reaching supervisory instruments and Professor Dr André Thibeault of Vlerick Business School took the opportunity presented to him at the ACE Benelux Risk Forum in Ghent to explain to risk managers present just how the new regime could impact the capital position of Europe's insurers.

Professor Thibeault drew extensively on a study released two years ago by Morgan Stanley that looked at the impact of Solvency II on the Return On Capital (ROC).

He explained that the bank looked at the ROC on the asset side of the balance sheet of an insurance company.

For example it decided that for credit operations of short maturity, say three years, the ROC is 15%, for five years 13%, for seven years 10% and for 10 years 9%.

"The longer the maturity, the ROC started to decline. Why was this? It is not because the price is falling but because the capital requirement increases and this lowers the leverage factor," said Professor Thibeault.

Morgan Stanley also looked at the impact on property.

Then the return was 10% in the simulation. For private equity it was 11% and standard equity 10%. The return on equity is normally much higher than the return on a loan.

"Why is the risk adjustment return on the loan much better? Because it is consuming less capital. The Solvency Capital Ratio (SCR) is lower," explained Professor Thibeault.

To analyse the impact of Solvency II, Morgan Stanley created some fake insurance companies. These were:

- Mosaic Composite Company—A composite company with exposure in the US
- Mystic Global Life—A pure global life insurer with US life business
- Fantasy Re—A diversified reinsurer writing both life and reinsurance
- Accidental P&C—A primary commercial retail non-life insurer that does not write life business.

The solvency ratio in all cases moves down and those that are the most impacted by the change in regulation are in reinsurance and P&C.

However, Professor Thibeault noted that reinsurance is still the one with the highest solvency ratio.

The first conclusion the academic reached was that the solvency ratio is impacted negatively 'everywhere'.

"This suggests that insurers will need to maintain a higher solvency capital ratio under Solvency II," he said.

"We also see the impact of diversification, which should help to consume less capital," he added.

The analysis showed that the fake composite company is able to enjoy the benefit of diversification by almost 35% because it is a well-diversified company.

Fantasy Re is a well-diversified reinsurance company and so also enjoyed some benefits from diversification.

The two other companies—Mystic Global Life and Accidental—are just below 25%.

The conclusion is that well-diversified companies will gain significant competitive advantage from the new regulation, said Professor Thibeault. (*See chart, next page, top.*)

The professor said that it is also worth looking at the impact on different types of product.

He explained that if the resource requirement increases that means the solvency requirement increases and so the return on required capital falls.

If it is the reverse then there will be an improvement and if there is no change then there is no change in required capital.

"Thus, in the case of Solvency II, if you are able to adequately

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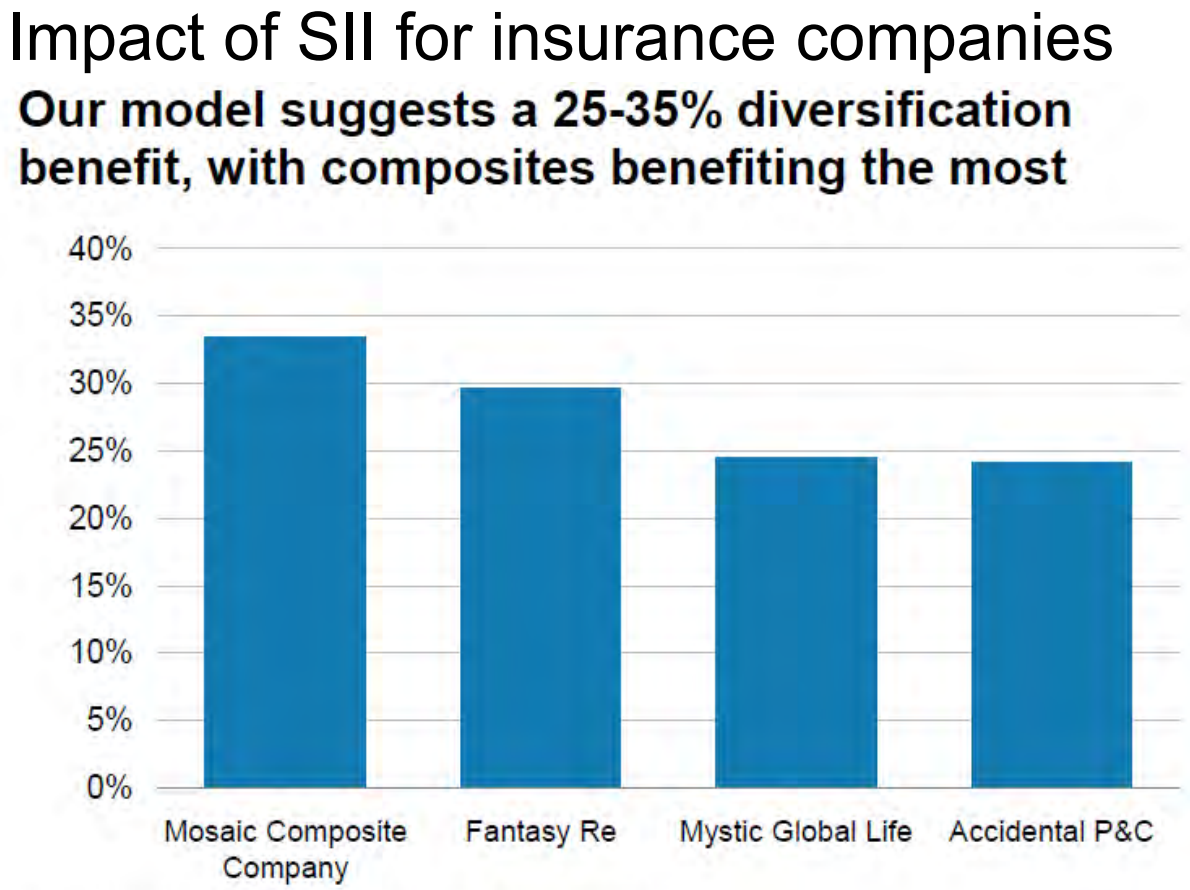

manage your asset liability management, all the risk related to interest rate, equity, property and spread, then you will be able to reduce your capital requirement because you are diversified," explained Professor Thibeault.

Then there is the trade off for the insurance company and the consequences for the clients to consider, he pointed out.

One simple relationship that has been used a lot in the criticism of Basel II and Basel III is that if the capital requirement is increased too much, leverage will drop by so much that banks will not be able to achieve relevant RAROC (Risk Adjusted Return on Capital).

"That, in turn, will lead to fewer products and so less finance for SMEs. This is a strong argument," pointed out the professor.

"If the SCR increases then one option is to increase the price. You can also try to reduce cost but there is a limit to cost reduction. Costs cannot be reduced to zero.

And at one point in time the insurer [in a competitive market] will decide not to reduce the price. It will simply drop the product," said Professor Thibeault.

The impact for the client would therefore seem to be that prices will simply increase, he concluded.

"This is what the survey of delegates for this event told us at the beginning, that risk managers expect a moderate increase in price of the product as a result of the introduction of Solvency II," said Professor Thibeault.

On availability of capacity the survey participants were not so sure, he pointed out.

But there clearly can be an impact there for those that are not so well diversified because if SCR increases then capacity will effectively drop, he said.

"Only the big and well-diversified player will be able to retain the solvency capital requirement that makes sense to develop and to provide specific products," said Professor Thibeault.

To be able to deliver product innovation you might also need to be a big and well-diversified player, he added.

"This is because with these new products it will probably be difficult to find the relevant data to compute the models. That means that, at least at the beginning, the product might consume more capital," explained the professor.

Thus only those insurers that will be able to balance their portfolio by diversification will be able to offer products at a price that makes sense, he said.

Professor Thibeault also pointed out that risk volatility will impact the SCR.

If this volatility increases then the solvency capital requirement will increase.

"Finally, it seems that what this new regulation tells us is, in Warren Buffett's words, that only when the tide goes out do you discover who has been swimming naked," said the professor.

"Solvency II is the equivalent of being at low tide. Then you will see the company that is really short of capital. It will be very visible on the market," he concluded.

Return On Capital—2

Risk managers expect modest price increase from Solvency II

Prof Dr André Thibeault, Professor in Banking & Financial Markets at Vlerick University, revealed the findings of a survey of the risk managers who attended the Ghent seminar about the likely impact of Solvency II on the corporate insurance market. ADRIAN LADBURY reports

PROF DR ANDRÉ THIBEAULT, PROFESSOR IN BANKING & Financial Markets at Vlerick University, told delegates at the ACE Benelux Risk Forum that Solvency II is the most important regulatory move within the last decade in the world of insurance.

And risk managers would be foolish to presume or perhaps hope that they can bury their heads in the sand because it will not affect them, because it will. "It will certainly impact insurance and reinsurance companies of course, but in doing so will probably impact the business of those that buy insurance products—risk managers," said the professor.

Professor Thibeault said that it is therefore important to ask what will be the final impact of Solvency II on the client. "We need to ask what will be the practical immediate impact and also what will be the chain of effects in the financial service industry," he said.

'KNOCK ON EFFECTS'

The academic pointed out that when regulators started to 'play with' regulations such as Basel I and Basel II for the banking sector, for example, the knock on effects were unexpected and unplanned. SMEs [small and medium size enterprises] faced problems finding financing on the market as a result of the new capital adequacy regime for example.

Professor Thibeault reported that to help work out how risk managers believe Solvency II will impact their business he had carried out a survey of delegates at the ACE event beforehand and gathered some 26 responses. From this sample 70% were active on two or more continents, 15% were from the Benelux and 15% from the rest of Europe, so it was a decent sample.

In terms of company size, about half of the respondents have less than €2bn in assets and the other half more than €2bn in assets.

The first question asked was whether they were actually familiar with Solvency II. Some 88% said that they were familiar. However the way the question was worded meant that there was no information to show the level of familiarity so one had to assume a basic level of understanding, said Professor Thibeault.

The second question showed that the risk management community clearly expects an increase in the required capital for insurance companies as a result of Solvency II, he said.

IMPACT ON PROFITABILITY

"It is assumed that this might impact the profitability of the insurance sector as well as the pricing of insurance products and even on the viability of some lines of products," concluded Professor Thibeault on this response.

The third question asked: 'As an insurance buyer how do you see the evolution of insurance pricing following the implementation of Solvency II?'

Professor Thibeault reported that there has so far been no indication of a big shift in price, adding that the survey showed that most risk managers expect a moderate increase or no change in price.

The fourth question tried to identify in which lines—accident and health, environmental risk, large property risk and general liability—the impact would be most felt.

Large property risk came in first place, second was environmental risk and general liability third, he reported.

The next set of questions deal with the idea of innovation.

The first question was simply: 'Is innovation important for your business?' Some 50% said very important and 28% important. "We can therefore conclude that innovation, from the client's point of view, is considered very important or important," said Professor Thibeault.

Then we asked: 'Will Solvency II impact the profitability of these innovative products?' Most of the respondents said that they don't know and the rest of the group was split between yes and no, thus providing no clear conclusion, he said.

The next question addressed the changing environment for corporate insurance buyers.

The responses indicated that risk managers expect that they will need to provide more information to the insurer in order to place the business with them. Risk managers expect some change in the product design and a longer

procedure.

Interestingly, a very small portion of the population of this survey and attendees of the Ghent conference expect no change in the future in the acquisition of insurance products.

Next Professor Thibeault reported that the risk managers had been asked about the viability of various insurance products, whether it will be economically possible for insurers to provide the coverage given the capital charges, following the implementation of Solvency II.

The answer was no impact 38%, some impact 35% and don't know was 27%.

Then the risk managers were asked whether they expect a higher volatility in the pricing practices of insurance companies because of the implementation of Solvency II. Some 50% said they do not know, 31% answered yes and the rest no. So there was no clear conclusion on the pricing impact of the new rules, concluded the professor.

"The overall conclusion of this small survey is that risk managers believe that Solvency II will require more capital from the insurance companies and, as a result, they expect a moderate increase in price or no change," said Professor Thibeault.

"If there is a moderate increase in prices, then risk managers believe that it will impact mainly large property risk," he added.

Professor Thibeault also said that the survey shows that innovative products are important to risk managers. But he noted that 50% do not know the impact that Solvency II will have on the profitability of the insurance product for insurance companies and thus their ability to respond.

"The participants also think that in the future they will need to provide more information to insurers. They believe they may see a change in product design and will experience a longer procedure," he concluded.

Cyber risk—1

Cyber risk still underestimated

Trevor Maynard's role at the Corporation of Lloyd's is to maintain an overview of the whole market place, all the competing syndicates that write insurance, and aggregate up all the risks to try and make sure that the market does not build too much exposure in any one place. As a result cyber risk, as a rising exposure with limited claims experience and potentially very broad impact, is an important area for Lloyd's to assess. ADRIAN LADBURY reports from his speech at the ACE Benelux Risk Seminar, during which he outlined the extent of the potential risk and relative lack of awareness that is still evident among companies

Trevor Maynard

TREVOR MAYNARD KICKED OFF HIS OVERVIEW OF THE cyber risk and insurance markets with statistics from a survey that ACE recently carried out as part of its series of European Risk Briefings.

For this survey, the insurer surveyed 606 European risk managers and some 27% ranked cyber as a key risk, which Mr Maynard suggested was a surprisingly low percentage given the potential threat.

"It's certainly something that is occupying governments around the world. I have been lucky enough to be in various meetings with representatives from the UK government, which is now really thinking through the impact of cyber. It is seen as a really significant risk now," he said.

'EVERY 19 SECONDS'

To underline this point Mr Maynard pointed out that there is a cyber attack [criminal, terrorism and the like] somewhere in the world every 19 seconds and these attacks spread incredibly quickly across the globe.

Despite such scary numbers and the fact that 99% of companies surveyed had actually experienced some form of attack or data breach, the ACE research found that only 48% of companies are prepared to manage cyber risks. "I guess that leaves over half with rather a lot of work to do," he added.

The survey asked what would most worry the risk managers if they did experience a cyber attack.

Some 30% suggested negative media coverage and reputational of damage would be the key thing that they would be worried about.

But it is not just the media that is focused upon how companies manage and protect their data. Governments are also closing in, not least the European Union, which is currently drafting a data directive.

DISCLOSURE DEFINED

Mr Maynard noted that under this directive the EU is 'talking about' the potential for hitting companies with fines for failing to disclose that they have been attacked. This he said could represent up to 2% of worldwide revenue and could lead to a cost of €300bn. "So it's got teeth this new regulation, it could be quite painful," said the Lloyd's man.

And Mr Maynard does not think the regulatory focus in Europe will stop there. "We have an evolving regulatory context. There is the general data protection regulation proposal, which is aiming for harmonisation across the region. There is also a cyber security strategy, which is not, in itself, regulation. But whenever people in Brussels start talking about strategy, that makes me a little bit worried that there is going to be a bit more regulation down the pipeline," he said.

Mr Maynard also pointed out that stronger action is also underway in the US. President Obama recently released an executive order because a couple of attempts to regulate the

area more effectively were blocked in the Senate and the House of Representatives.

And Mr Maynard stressed the further complication brought by the fact that cyber risk and regulation is truly global and cross-border.

"Keeping track of different regulatory regimes is very difficult in the cyber world, which extends beyond borders. Also where you have the cloud situation, where your data goes beyond and could be stored in one country but track through several, you will be subject to the laws of those different countries. So it becomes quite difficult to keep on top of the different rules across these regions," he said.

Mr Maynard also pointed out that the pace of change in attack is always ahead of the regulations. "The regulation is always lagging behind. Some may see that as a good thing but it does leave gaps," he pointed out.

"If you cast your mind back 10 years with hackers... they were out there, some kind of spotty teenager sitting in their garage, they wanted credibility for putting out a virus and they wanted the virus to be obvious in what it did. So quite quickly, maybe in a matter of days, people would be infected. It would be out there as a news story and then a patch would be delivered eventually and that particular one would go away," said Mr Maynard.

But this is far from the case with the new breed of cyber criminals who are playing a completely different game and thus present a far higher risk.

"It's a very different mindset of course with criminals who don't want to be caught. They want the infections that they put on computer systems to go unnoticed for as long as possible. So they can get as much data off the system as they possibly can. That difference in approach and mindset is very important to bear in mind here," he continued.

Then on top of this there is the problem of the ease of access to hacking technology.

"It's quite incredible to me that you can buy online what are called hacker kits, actually ways of training yourself to hack businesses. So there is a vibrant black market in hacking technology out there so you can only expect the range, frequency and scale of attacks on businesses will grow as it becomes more of a business in itself," pointed out the Lloyd's expert.

The multiple sources of threat and variety of motivations of the attackers including the criminal and political element that simply seeks to destabilise the system is a big headache for those who are trying to manage this risk whether in the private or public sector, pointed out Mr Maynard.

And another point to note is that although the risk resides in 'cyber space' serious physical outcomes of cyber attacks can actually occur.

The stuxnet virus that hit Iran, for example, was designed to cause a physical outcome and safety systems were compromised deliberately by this attack, pointed out Mr Maynard.

And, in a personal context, there is a rising fear that the use of computer technology to control cars could lead to nasty surprise such as attacks on braking systems.

And of course there is also a personal and corporate fear of the rise in web-based fraud. "One in ten internet users have become a victim of fraud. It's a big deal," said Mr Maynard.

The UK government for one has appreciated the scale of this threat. It recently published a cyber security strategy that included 10 useful steps to help manage cyber security, which may seem pretty basic but are surprisingly steps that many companies have not yet taken (*See panel*).

UK GOVERNMENT 10 USEFUL FOR CYBER SECURITY

- **Develop a mobile working policy and train staff to adhere to it**
- **Establish a staff training programme for cyber risk**
- **Establish an incident response and disaster recovery capability**
- **Develop an effective governance structure and determine your risk appetite**
- **Have account management processes and limit the number of privileged accounts**
- **Removable media, USB sticks and laptops should have a policy**
- **Monitor systems and networks to make sure that data is not leaving the company; and,**
- **Know where all your kit is. Have an inventory so that lost items are identified very quickly.**

Cyber risk—2

Cyber insurance market grows up

Risk management and loss prevention should clearly be the top priority for any risk manager when they attempt to tackle a complex and fast-changing area such as cyber risk. But risk transfer is also an option and the insurance market to help carry out this transfer is building up a head of steam. Trevor Maynard reviewed the state of the market in the second part of his speech. ADRIAN LADBURY reports

ACE'S RECENT SURVEY OF SOME 606 EUROPEAN RISK MANAGERS found that some 38% believe that cyber risks are covered by their existing policies, but according to Trevor Maynard, the simple fact is that they generally are not covered under their standard insurance contracts. "Because this is such a niche business they will have exclusionary language," he explained.

ACE concluded in its report: "In practice, many traditional commercial property and casualty policies fall short of the cover needed for comprehensive protection."

The Lloyd's expert reported that some 20% of the respondents to ACE's survey knew that they didn't have cover although some said they were unsure.

Risk management and loss prevention should be top priority for any risk manager with such a fast evolving exposure.

PART OF THE SOLUTION

As the ACE report concluded: "Insurance should be seen as just one part of an appropriate approach to risk management." It added that the key need is to: "embed a risk culture that elevates these important risks out of the IT function and ensures that there is an enterprise-wide focus."

But insurance is important and the good news is that there is a growing cyber risk insurance market. This has been largely driven by regulation, particularly in the US, where data protection laws were adopted at an early stage.

As a result there is quite a vibrant and fast-growing cyber insurance market in the US and Mr Maynard said that he expects to see a similar growth in Europe, particularly when European data protection legislation is adopted.

Mr Maynard outlined the types of coverage forms that are already available in Europe, including Lloyd's.

There are policies that cover damage to digital data and systems and processes which basically pays to get them back up and running again.

Non-physical business interruption is available as an add-on to business interruption cover. But, as Mr Maynard pointed out, this cover is something that is separate to the standard BI policy and so is quite hard to underwrite and requires more information than normal.

Such cover will typically kick in following any interruption, degradation in service or failure of the insured's network.

It covers lost income, as well as interruption expenses incurred in the mitigation and investigation of the losses that were caused by the insured event during the indemnity period.

A monetary (usually in line with existing E&O policies) and time (usually 10/12 hours) deductible will apply, pointed out Mr Maynard.

Such cover is typically only sold as an endorsement, or in addition to a policy covering the third party liabilities, and where property and general liability (GL) covers do not respond to intangible property losses.

Customer care and reputational expense cover is also available, said Mr Maynard.

This includes notification expenses. Often the most expensive cost associated with a breach is the legal or regulatory requirement to notify any individuals affected.

For first party exposures, the insurer will pay for the legal, postage and advertising expenses that the first party incurs.

My Maynard pointed out that an increasing number of jurisdictions are making these actions mandatory.

There is also privacy assistance expense cover available which provides assistance to individuals whose privacy has been breached, including credit monitoring services and/or identity theft assistance.

Another coverage area is cyber extortion, which provides cover

THE FAST EVOLVING CYBER INSURANCE MARKET

- The Cyber risk insurance market is near to $1bn in annual premiums globally
- 65% of US public companies forego cyber insurance even though they identify cyber risk as their number one concern

(Source: Chubb Group, 2012)

- Average claim costs per breach in the US in 2011 was $3.7m

(Source: NetDiligence, 2012)

- US market expected to grow significantly, but growth in Australia, South Africa, Singapore, Europe and the Middle East is also expected, pending legislative developments

if a company with sensitive data is extorted for money through threat of damage to or restriction of their network.

Another exposure under this heading is the threat of the release of data obtained from the network with the intent to cause damage or to communicate with the insured's customer base under false pretences to obtain personal information.

This covers the extortion demand and pays necessary extortion monies rather than allowing them to follow through with their threats and cause further loss, explained Mr Maynard.

A further form of reputational and brand damage cover is that which covers damage that occurs as a result of a loss of income after a data protection breach has been reported, whether factually correct or not.

Under first party exposure, this covers loss of income as well as any increased costs of working and PR expenses.

Crisis management expenses related to costs incurred to protect or re-establish the insured's reputation or public image if it is damaged, by a privacy and/or security breach can also be included.

Under the heading of privacy regulation defence, Mr Maynard pointed out that if an insured is investigated by any regulator as a result of data loss or damage cover is available.

This covers investigation and defence costs, as well as any awards and fines where insurable.

He said that in a majority of countries, responsibility is on the data owner, rather than any data processor to which services are outsourced.

SECURITY AND PRIVACY LIABILITY

This cover is mainly available on a third party basis.

This is triggered if the insured suffers a breach to their network or happens to transmit any malicious code, or breaches any third party or employee privacy rights or confidentiality, explained Mr Maynard.

It provides cover for investigation and defence costs as well as any civil damages.

A failure of the network, its security, network interruption or data loss that may result in liability to third parties who rely on that network being in operation is also covered.

Mr Maynard pointed out that this may extend to firms that provide business applications, supply chain software or cloud computing (the shift of computing capacity, storage, platforms and software to the internet).

MULTI-MEDIA LIABILITY

This cover is triggered if a data breach results in the infringement of a third party's intellectual property rights (usually not patents), defames them, breaches their privacy or commits any negligence in the publication of any content in electronic or print media, explained Mr Maynard.

It will typically cover investigation and defence costs, as well as any civil damages.

BESPOKE SOLUTIONS

Beyond these solutions the insurance market has also developed a range of more bespoke solutions, said Mr Maynard. These include covers such as:

IDENTITY THEFT LIABILITY

This represents a standalone version of cover available on privacy liability policies, including credit monitoring, fraud and credit history remediation.

TRANSACTIONAL FRAUD COVER FOR ELECTRONIC PAYMENTS

Electronic and computer crime exposures which may be the reason for a security breach occurring are often only covered if this separate policy is also purchased, he said.

MERCHANT THEFT DATA

Coverage is tailored towards a retail merchant's third party liability to customers, banks and payment card companies as well as any first party lost sales caused by credit card fraud. The underwriting focus is on the security practices and other contractual obligations mandated by the payment card industry, explained Mr Maynard.

FUTURE CHALLENGES

Mr Maynard concluded by focusing on the challenges that insurers themselves face when they offer cyber insurance.

One of the big ones is the management of accumulations. He said that Lloyds is currently developing a kind of 'cyber hurricane' scenario to test out on the market to try and calculate the potential exposure.

One of the big challenges is that not everyone reports cyber attacks. "It's important to get more companies to anonymously report," he said.

To summarise, Mr Maynard said that Lloyd's regards cyber risk as a serious and growing threat which can come from many 'avenues of attack'.

"We think companies should actively manage the risk and it should be a board level issue. It shouldn't be just the IT department, it should be many different angles within the company," said Mr Maynard.

He stressed that traditional insurance does not cover cyber risk necessarily and so should not be relied upon as the only answer. As with all risks, the key is to structure a combination of risk management, loss prevention and transfer.

"You can get specialist policies and there are many solutions being developed. Hopefully taking the reasonable steps that they can and managing others through insurance gives a solution to this," concluded Mr Maynard.

Time for action

Ron Verhulsdonck, Country President for ACE in the Benelux region, opened the Benelux Risk Forum which focused upon emerging risks and solutions. ADRIAN LADBURY asked Mr Verhulsdonck about how ACE had fared in the tough operating environment of 2012, what he regards as the main emerging risks facing risk managers and how the insurer can help customers tackle these tricky exposures

ADRIAN LADBURY: How did ACE fare in the Benelux and elsewhere in 2012? Was it a particularly tough year because of the ongoing crisis in the eurozone?

RON VERHULSDONCK: ACE performed well in 2012, despite the continuing crisis. In the Benelux we delivered another year of growth and achieved a solid underwriting profit. In times of low interest rates it is even more important for insurance companies to produce underwriting profit in order to stay healthy and meet obligations to customers in the future.

AL: How can an insurer continue to make profits in such a difficult trading environment? What is the key?

RV: Today's crisis, like every crisis, has victims and survivors. Survivors usually come out of a crisis even stronger than they were before. I firmly believe that our geographic and product diversification will allow us to remain disciplined and selective. This in turn will make us stronger. We are well positioned to take advantage of the opportunities that will undoubtedly result from the turmoil.

Ron Verhulsdonck

AL: In what lines do you plan to grow, which are the most attractive and which are currently the least?

RV: We will continue to grow our specialty lines and are prepared to shrink portfolios where we are no longer able to make a margin. We will continue to focus on innovative products for emerging risks such as cyber and environmental risks and build on the expertise that we have in the group as a truly multinational company that writes the full range of key lines in P&C and A&H.

AL: What are the key emerging risks that your customers face and that you feel you need to focus your efforts on and help them tackle?

RV: ACE recently surveyed 600 companies across Europe about the risk landscape now and in the future. We spoke to risk managers but also to chief risk officers, CEOs and CFOs in the UK, France, Germany, Spain and Benelux. The results look at a broad range of risks and according to our results the top three most relevant risks to companies today are terrorism and political violence, environmental risk and multinational and export risk. We also asked how the level of business risk is expected to change over the next five years and the top three risks that were expected to increase in importance were environmental, multinational and export risk and business travel risk. The survey also revealed that the majority of companies rely on their brokers and insurers for advice on emerging risks. In the case of cyber risk, 82% of risk managers surveyed said that they want support from insurers and brokers to understand their exposures better. It is, of course, our hope that ACE can help the risk management community in the Benelux and worldwide understand their risks better and we look forward to working with them to do so.

A question on price

Rising protectionism among some nations is actually more of a threat to pricing and capacity than Solvency II, according to a discussion with delegates during Dr Thibeault's session

FOLLOWING DR THIBEAULT'S THOUGHT-PROVOKING presentation on the potential impact of Solvency II on pricing and capacity levels, one risk manager in the crowd not surprisingly asked for more.

"I have the impression that insurers will use Solvency II as an excuse to exaggerate and increase their price. So how could we, as a client, challenge this increase on price? Which are the arguments that we could use?"

Dr Thibeault replied: "I will give you the answer of a CEO from a big P&C insurance company in Canada, who recently said: 'I will give you the calculation of the right price but if I can charge more, I will do it.'"

The banker turned academic continued: "So you have to challenge them and push as much as possible to say 'if you don't give me a good price I will leave at some point'. In time you will reach some kind of an equilibrium."

Ron Verhulsdonck, Country President for ACE in the Benelux region, was then asked whether his company would solely base its pricing on Solvency II in future.

Mr Verhulsdonck clearly replied that this would not be the case as pricing depends upon a wider variety of factors.

But he did also say that ACE does not necessarily think that the new capital adequacy and reporting regime will necessarily lead to higher prices, in its case at least.

"I don't think we see Solvency II pushing its way down to the underwriting world. We do look at the capital that is required to operate insurance companies," he said.

"I can tell you that pricing actually is probably going to be impacted more by the cost of regulation and by the sort of 'balkanisation' that is occurring around the world by which regulators are all putting up barriers and defences in their own country," continued Mr Verhulsdonck.

He explained that it is ACE's view that the best diversification benefit is gained by concentrating its capital.

Efforts by international regulatory bodies to build a system by which home state regulation and capital management is recognised around the world are underway.

The problem is that, because of the financial crisis, there has been rising concern among some national regulators that companies might not have enough capital in their country and so expose policyholders.

"So they start to require more capital, say in Brazil or Argentina. If that occurs it reduces our return which then will impact longer-term what price we will charge, because we need to make a return on our business in order to make our return on assets, return on equity, because that is how investors judge us over time," said Mr Verhulsdonck.

"So I mean there is an effect but it is very distant from the day-to-day underwriting I would say," he concluded.

Multinational D&O: In need of expert advice

Suresh Krishnan is General Counsel for the ACE Group's Multinational Client Group. He is based in New York and has global legal oversight for matters connected with the company's North American and International multinational products and services. Mr Krishnan gave a presentation to risk managers at the ACE Benelux Risk Forum in which he shared his thoughts on challenges for companies facing global D&O risks, based on his 20-plus years of insurance industry experience. ADRIAN LADBURY interviewed Mr Krishnan after the event

Suresh Krishnan

ADRIAN LADBURY (AL): What, in a nutshell, do buyers of multinational insurance programmes want and expect from their D&O coverage?

SURESH KRISHNAN (SK): D&O insurance buyers basically expect their programme to perform when needed and the key test of this must be the ability for insurers to pay claims directly in jurisdictions where a loss has occurred. Not surprisingly, they also expect certainty. This includes compliance certainty in a complex global regulatory environment.

AL: And so what is the typical response from the insurance market to this demand?

SK: Insurers have historically responded by offering a single global insurance policy issued to the parent company in the parent's jurisdiction which insures both the parent's directors and officers as well as the directors and officers of its foreign subsidiaries, affiliates and joint ventures. A better alternative may often be to offer stand-alone local policies with appropriate local coverage grants and limits that insure the professional risks of local directors and officers. If needed, corporate indemnification payments may be supplemented with a 'master policy' ultimately insuring the parent company.

AL: That all sounds sensible and straightforward. Why is there so much discussion about this topic among the multinational risk management and insurance community?

SK: Structuring a compliant global D&O insurance programme means recognising that the D&O product has multiple coverage grants insuring separate risks—'Side B and C' insures the corporation for its indemnity obligations to the director or officer or to itself when it is sued and 'Side A' is personal liability protection when a director is not indemnified by the corporation. Taking this aspect of the D&O product and overlaying it with local regulation of unlicensed insurance adds another layer of analysis. Because of the nature of these insurance coverage grants in D&O insurance policies, execution certainty and managing the potential regulatory and tax consequences have to be assessed based on the types of coverage offered by the insurance programme and where the risks are located.

AL: So what are the main exposures that multinationals typically face when arranging D&O coverage across borders and why can it be so complex and in need of careful management by risk managers?

SK: Managing directors' and officers' legal exposure is a particular challenge for multinationals, because the extent of these individuals' duties and the range of potential claimants varies widely from one country to another. They can be sued for damages by the corporation itself, for example, where fraud or breach of fiduciary duty is alleged. They may also be exposed to claims by the liquidator or equivalent on the basis that, for example, they allowed the corporation to trade while insolvent. Some countries such as the US and Canada allow shareholders to bring derivative litigation alleging that these directors' and officers' actions damaged the corporation. Many countries in Europe—such as Germany, the UK and, in the

not so distant future, France—permit class action litigation. And in some countries, directors and officers are exposed to third parties, including regulators' investigations and civil or criminal proceedings. Where a corporation operates or trades in a number of countries, its directors and officers may be exposed to a range of different regulatory and liability regimes.

AL: So what are the forms of D&O cover available to tackle such exposures?

SK: A D&O policy is typically a bundle of different coverages that protect distinct parties against different types of liability. It generally offers three types of coverage. First, 'Side A' insurance that indemnifies individual directors and officers against their personal liability and defence costs in circumstances where a corporation is prohibited from indemnifying the director or officer, or unable to do so. This coverage is meant to provide critical personal asset protection to the directors and officers. Second, 'Side B' insurance covers the corporate entity where it can indemnify and defend its directors or officers. And third, 'Side C' insurance covers the corporate entity for its own exposure to securities litigation.

AL: So the critical thing is to customise the programme to maximise these covers and structure it correctly?

SK: Precisely. When these risks are identified and underwritten—especially across national borders—a multinational D&O programme, at best, should be specifically customised to manage each distinct obligation effectively. Critically, it must be recognised that distinct classes of insureds may compete for limited coverage. Commingling some or all of these obligations without clearly distinguishing how the programme will be implemented could lead to significant execution challenges—and potentially unintended and unwanted scrutiny from tax and regulatory authorities if the programme is not structured appropriately. Lack of a thoughtful solution tailored to specific needs could leave a director or officer exposed to big personal liabilities that could have been covered by 'Side A' insurance. Conversely, a poor solution could inadvertently provide coverage that is not permitted under local regulations. This would expose the insured, insurer and/or brokers to potential liability.

AL: Risk managers often tell me that their ultimate goal is to maximise capacity, minimise cost and maintain central control all at the same time. How is this possible?

SK: When developing a strategy to implement a global D&O insurance programme, multinational clients often try to balance these three core objectives. Multinationals, especially those in highly regulated industries, have a number of procedures and protocols to ensure appropriate control and oversight throughout their disparate operations, subsidiary business units and joint ventures. Sophisticated buyers design programmes to leverage their companies' central control of insurance terms and limits, consolidated loss information, consistent loss control procedures and corporate buying power. This can simplify placement and deliver more favourable risk transfer terms and pricing. Nevertheless, multinationals have to decide on a corporate philosophy of whom they intend to insure. Do they intend to insure only the main board or do they want to extend insurance to local boards? How should an independent director be insured versus an executive director—the same or differently? Have these responses been communicated transparently to all directors so that expectations have been managed? These are recommended steps that need to be addressed before the global D&O programme is implemented.

AL: So what are the core questions to consider?

SK: There are four basic elements. First, how the enterprise actually conducts the business of addressing its insurance purchasing needs, including how insurance proceeds ultimately may be paid and received by the appropriate parties in various jurisdictions. For example, along with the risk manager and broker, has the company involved its finance, treasury, tax and corporate legal specialists so that indemnification payments are effectively and efficiently managed? Second, whether the location of risk is matched with an insurer that is able to compliantly execute its obligations under the policy—can the insurer actually pay a claim in a jurisdiction where it is not licensed? Third, how the transaction of insurance is initiated, concluded and documented—are the terms and conditions of the various policies enforceable when and where they are needed? And, finally, the extent to which the course of conduct of the parties to the insurance programme and the accounting for cash (premiums, claims, etc.) are in conformity with the terms of the insurance policies that govern the multinational insurance programme—what are the implications when a claim payment is made in a jurisdiction that is separate from where the risk is located? Essentially, these four parameters should act as a general guide against which multinational enterprises may determine whether their global insurance programmes materially comply with all applicable laws.

AL: So what is your overall message for risk managers with multinational corporations who need to work out the best way to arrange their D&O covers?

SK: Once the corporate philosophy about for whom insurance will be purchased has been agreed and settled, buyers and brokers of any multinational programme should work with a global insurer and their financial and legal advisers to determine how corporate obligations, which may or may not be met, can be insured. Risk managers must anticipate

questions from local independent directors and prepare responses addressing the local directors' options when the corporation chooses not to indemnify them. Furthermore, multinational insurance buyers also need to understand the structure of their enterprise and the impact this structure has in connection with insurance protection. For example, where does the enterprise directly and indirectly conduct business? Where does the enterprise have (or intend to have) shares publicly traded? Where does the enterprise expect insurance protection? Is it for the main board only or does the enterprise expect insurance coverage to extend across the world? And, ultimately, where does the enterprise's debt and credit financing reside? Attention to these requirements and the need for documentation and supporting contractual arrangements should result in a compliant international D&O insurance programme that ultimately satisfies the collective objectives of the client, the broker and the insurance carrier in protecting directors and officers.

■ *For a more detailed description of the options available to risk managers when looking to purchase cross-border D&O cover go to http://www.acegroup.com/Media-Center/ACE-Perspectives/Multinational.html to access an in-depth report authored by Suresh Krishnan, Joshua R. Schwartz (general counsel and regional compliance officer for ACE Bermuda Insurance), Jeffrey Jabon (senior vice president and head of the professional lines department for ACE Bermuda Insurance), and Nigel Brook, who is a partner in Clyde & Co, an international law firm*