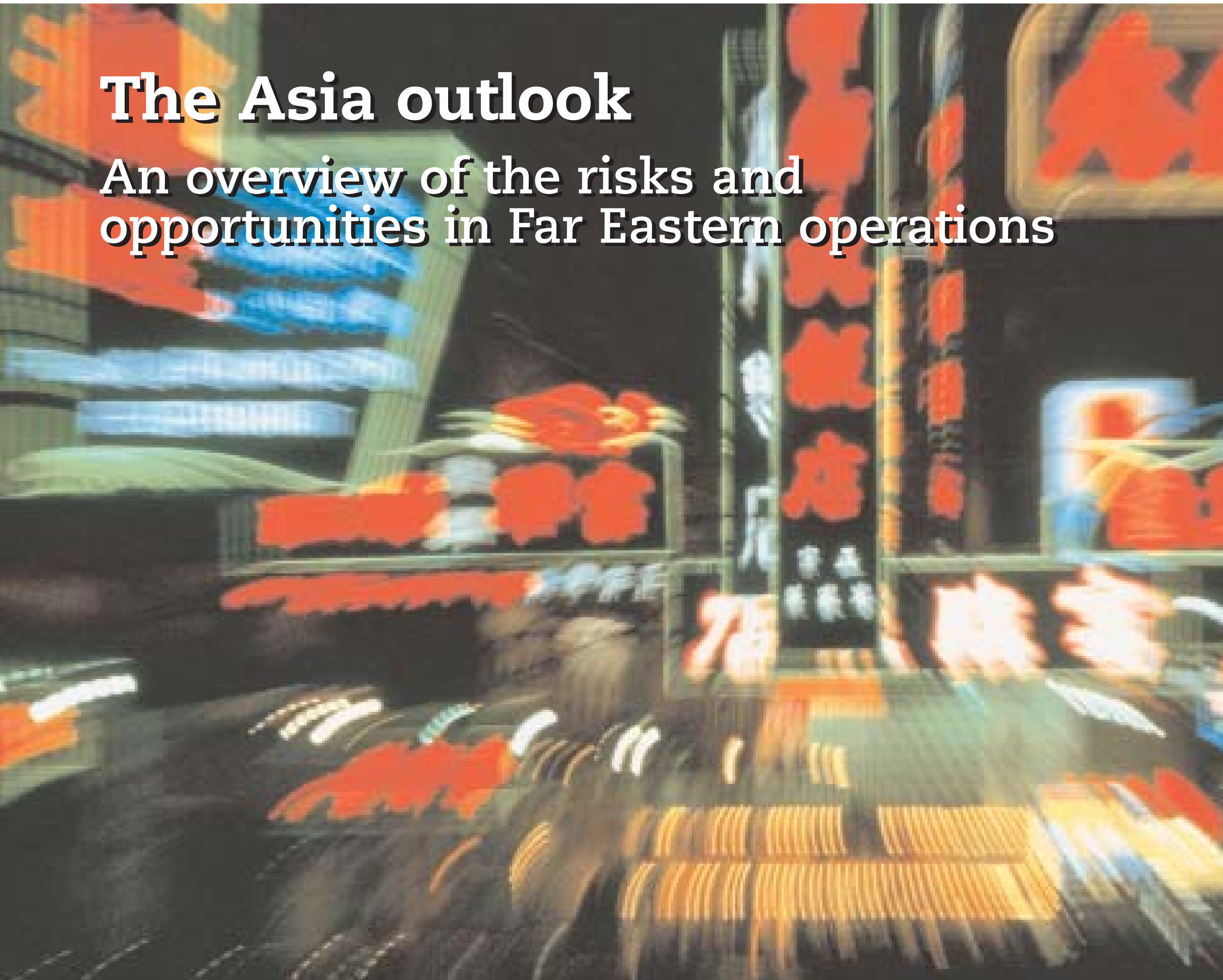
MARSH

The Asia outlook

An overview of the risks and opportunities in Far Eastern operations



Index

Introduction

In today's global business environment many companies are increasingly moving to outsourcing, joint ventures and supply relationships with firms located in regions throughout the world in order to cut costs and optimise efficiencies. However, such international supply chain dependencies present complex risk management challenges, particularly where these regions have very different attitudes and approaches to risk.

One of the prime destinations for outsourcing and joint ventures is Asia and in particular, China. Marsh has been researching the risks associated with Asian supply chain dependencies to obtain more detailed information about the nature of these risks and how best to manage them. Against this background we have produced a framework, with solutions, to understand and manage these risks more effectively.

A summary of our findings along with contributions from specialists in the field is now documented in the following pages.

The perception of risk in Asia

Andes Lam, Senior Vice President, Risk Consulting Practice, Marsh, presents the findings of Marsh's recent Asia Company perception survey.

With Asia accounting for 28.4% by value of the EU's total imports in 2005, many companies have a serious dependency on their Asian supply chains, which is still likely to increase further in the future.

In order to understand how Asian supply chain partners perceive risk, Marsh conducted a survey to help focus on the control of these risks to ensure supply chain integrity.

Our research has identified ten top risks that could adversely affect the supply chain and potentially pose a reputational risk for the client. In the survey, Asian senior managers were asked to rank these risks in terms of their expected impact and likelihood on their business, as well as the degree of management focus each area attracts.

Those surveyed were most concerned by the following three areas:

- Infrastructure e.g. failure of IT, communications, logistics or power supply
- Quality and counterfeiting of products
- Ethical risks e.g. damage to reputation from breach of health and safety, labour laws etc.

Risks arising from infrastructure failure, along with natural disasters and financial risks, were considered to be the most likely events affecting business on an annualised basis.

With under-developed infrastructure in much of Asia, many respondents expressed dissatisfaction with the capacity and resilience of local provisions. When asked how effective their back up and management plans were in maintaining business continuity in the event of failure, the results were:

- 56% answered positively in respect of power supply
- 68% answered positively in respect of communications and IT security

These results are encouraging. However, less than half (44%) considered they had effective plans for supply chain and logistics failure. If you then consider that those who believe they have an effective plan might not have, we can determine that Business Continuity Planning (BCP) is an urgent issue to be addressed. With Avian flu predicted as the most likely cause of the next world pandemic, so far most confirmed human cases have been located in Asia and the Middle East. Our survey revealed only 21% of respondents have a full BCP in place to respond to such a pandemic.

On the subject of product risk, quality and counterfeiting, after the launch of the General Product Safety Directive in 2004, the number of serious risk notifications in the EU almost doubled from 388 in 2004 to 701 in 2005. Half of these risk notifications were related to products from China.

The European Commission also reported that 71% of counterfeit goods originated from Asia in 2004. China accounted for 54% of this total.

Our survey revealed that measures for protecting intellectual property are weak in Asia. Ethical standards are also low compared with Europe – a particular concern in view of the severe damage to reputation and international standing that can result from suppliers' oversights. Infringements of regulations relating to minimum wage and working hours, and employment of under age workers, remain common. Some factories are even believed to be falsifying records and coaching workers on how to answer auditors' questions. On the subject of health and safety, China has a very poor record. Only 52% of the survey respondents said that they had dedicated resources to fully monitor and ensure compliance with all relevant legislation.

On examination of natural catastrophes and fatalities, Munich Re, Topics Geo 2005 reported that Asia experienced the greatest number of events compared with other world regions. However, our survey showed that only 28% of respondents have fully prepared for natural disasters. Similarly, although terrorist activities in the region are not uncommon, Asian businesses have done little to protect their key operations against direct or indirect terrorist attack. And while fraud and corruption are common in Asia, only a third of the businesses surveyed have fully operative procedures and/or conduct employee background screening to prevent such activities.

With the results of this survey in mind, companies need to understand the difference between Asia and Europe in terms of risk perceptions, risk management culture and appreciate where Asian companies' priorities lie. In considering outsourcing and joint ventures, do not assume that local suppliers are complying with laws and regulations and do not accept on face value the 'Asia way'. Equally, do not be dogmatic in adopting a completely western approach. Identify the risks, determine the solutions and be prepared to compromise.

UK Trade and investment

Ian Fletcher, UK Trade & Investment (UKTI), describes the UK government's role in respect of Asian markets.

The UKTI's role is to help UK-based businesses succeed internationally and to attract high quality inward investment. Given the disproportionately high benefits derived from entering emerging markets early and successfully there is an increasing remit from government to focus on China and India.

The UKTI operates through the Foreign & Commonwealth Office network, being represented not just in capital cities but in regional centres too. This breadth of international coverage means that it has local experts who can provide information, including market research, advice and support. It also offers political support, for example helping companies present their issues to local administrators.

The UKTI cannot, of course, remove the risks that UK-based companies face but it can help them employ strategies to mitigate these risks. In practice, this includes helping them overcome barriers, understand markets, find contacts and obtain payment.

Through the work of the UKTI a number of key issues in Asian markets have been identified. These include:

- Regulatory barriers (which remain important)
- Access to reliable commercial services
- Handling sub-national authorities
- Enforcement of intellectual property rights
- Agency costs – do local partners take more than they are paid?
- Workforce issues – cheap can prove to be expensive
- Reputational risks.

As to whether any of these issues have caused companies to pull out it is difficult to be categoric, as people do not like to talk about their failures. However, published research suggests that there are higher failure rates than companies are prepared to own up to.

To help companies address these issues the UKTI can provide support in building local relationships and by sharing information. An example of this is the UKTI's Asia Task Force. They not only conduct research but also publish the results along with other useful facts and information.

In addition you can always ask the UKTI about specific issues. Our global network is very knowledgeable and we will often be able to get this information from our representative in the area.

In summary, the UKTI can provide invaluable support for companies that are interested in trading in emerging markets. But by far the most effective way to increase the chance of survival and success is to learn as much as possible about the proposed trading environment before commitments are made. Due diligence is undoubtedly the most worthwhile exercise.

Intellectual property and counterfeiting risk in Asia

Dan Mead, Associate Managing Director, Intellectual Property (IP) EMEA, Kroll, presents some views on intellectual property and counterfeiting risk in Asia.

China's risk drivers are multiplying as a result of the country's 'primitive capitalism'.

These drivers include:

- An under-developed tax system and legal framework
- Arbitrary enforcement
- Large capital flows through enterprises
- Large local/foreign income disparities
- A transitional business culture.

China is party to a number of international conventions relating to intellectual property protection. However, the China United Intellectual Property Protection Centre, a private business representing some leading Western companies, says that counterfeiting has developed to the degree that there are regional centres specialising in producing particular types of counterfeit goods.

China has been on the US Priority Watch List for IP infringement since the list began. Although it has high standards of regulation, enforcement is weak and there is a lack of transparency and little public awareness of how seriously the western world views counterfeiting.

Infringers may often be former licensees or employees, producing the counterfeit products in a factory close to that manufacturing the genuine articles.

They may be using copies of the IP owner's manuals and blueprints, buying packaging from the same supplier and using the same distribution network. It is therefore important to address protection of trade secrets within the organisation.

Infringers are also becoming increasingly sophisticated. Labels and packaging are applied at the latest stage possible as goods are not deemed to be counterfeit before this. Often they now copy only the design, not the trademark, use small back street distributors that are hard to trace, or they export the goods.

In response to these threats, once a company has established what its IP is or will be, a comprehensive IP programme needs to be developed. The company must be prepared to invest in this programme and may consider it worthwhile to appoint an IP officer.

The programme should address:

- Invention and concept
- Research and development
- Packaging and supply channels
- Manufacturing
- Distribution channels
- Market and post-market place
- Litigation.

Specific strategies may include identifying who owns the IP (is ownership shared with someone such as an IT consultant?), confidentiality agreements, restricted access to key areas in the organisation, maintaining research and development security, educating employees on the company's commitment to prevent IP infringement, filing trademarks locally, periodically checking for vulnerabilities, and having a competent legal adviser.

It can also be valuable to seek assistance in protecting IP, including due diligence screening of potential joint venture partners and business intelligence.

Above all, the supply chain is integral to the level of commitment invested in the IP protection programme. Taking steps to implement protection of your IP is as important as establishing your systems of supply and distribution.

Managing for success

John Hurrell, Managing Director, Risk Consulting Practice, Marsh, outlines a process for managing supply chain risk in Asia.

Managing risk is complex and multifaceted and as such demands a process that can be managed in a robust, effective and comprehensive way. It needs to involve a minimum amount of cost and be implemented relatively quickly, but with measurable results to enable tracking of interventions.

In particular, a process must address the following questions:

- How can we prioritise our approach to managing our supply chain risks?
- How can we manage reputational risk arising from supply chain issues?
- How can we manage product recall risk through an extended supply chain?
- How can we increase our resilience to supply interruptions?
- How can we protect ourselves against IP infringements?

Marsh suggests a four-stage approach.

1. Risk exposure mapping – this critically evaluates the risks and dependencies associated with the supply chain and identifies key suppliers for prioritisation

2. Risk diagnostics – to identify and prioritise suppliers' major risk issues and design an appropriate risk management programme

3. In-depth analysis and risk management/transfer programme implementation

4. Monitoring and control – creating reporting and measurement processes and standards to ensure the approach remains up to date.

Not all suppliers are critical to the supply chain so it is important to identify and prioritise those that matter most to the business. This can be achieved by mapping supplier dependency in the context of key business processes and should consider those suppliers whose failure would have a significant financial or brand impact, such as sole and single source providers and those whose default could present key reputational issues with major clients.

Critical supply chain vendors (and potential candidates) require thorough evaluation of their risk exposures and preparedness/contingency planning in the event of an incident or an interruption. Risk diagnosis must consider a broad spectrum of exposures. Marsh has developed a proprietary diagnostic tool to assist clients in understanding and evaluating their Asian supply chain exposures as well as prioritising mitigation and management procedures. (See Marsh's diagnostic capability).

Risks posing the most significant threats, prioritised according to vulnerability and impact parameters, will attract immediate focus and require in-depth analysis and implementation of comprehensive management and mitigation strategies. In determining these strategies, provision needs to be made for support and assistance to help the supplier develop and implement a better risk management process.

Once processes are in place, they require agreed monitoring and performance benchmarks. Strategies at this stage include:

- Ongoing development, exercising and maintenance of agreed protocols
- Establishment of an appropriate monitoring and reporting regime
- Raising the risk awareness of crucial suppliers
- Formal training for key staff
- Agreed auditing standards and requirements
- Creation of annual programmes setting out schedules and responsibilities.

In conclusion, by managing supply chain risk in this way, organisations are able to make better business and financial decisions. They can understand their supply chain risk and its potential impact, and develop a better understanding of the key potential points of failure. This in turn enables them to provide recommendations to reduce key risk exposures and develop a roadmap for implementing and monitoring recommendations.

Closing comments

By the kind permission of The Rt. Hon The Lord Mayor, Alderman David Brewer CMG

As outlined at Marsh's Annual Market Address I believe there is great opportunity in the world's emerging markets for companies looking to invest outside of the UK. On my recent travels I have visited Mongolia, Hong Kong, Chongqing, Chengdu and Shenzhen.

Cities like Chongqing and Chengdu have a huge business potential and they want to do business with us here in the City of London. In particular, China's insurance industry is expanding fast.

Several of the cities that I have been visiting have ambitions to be or are becoming regional financial hubs, and they are all modelling themselves on the City of London. In a move both to promote the City of London and to provide local assistance, we are opening some City of London Corporation representations in key cities. We have already opened three in Beijing, Shanghai and Shenzhen.

I am encouraged by the wealth of information being made available to companies wishing to explore these opportunities and welcome the publication of The Asia outlook.

Marsh’s diagnostic capability

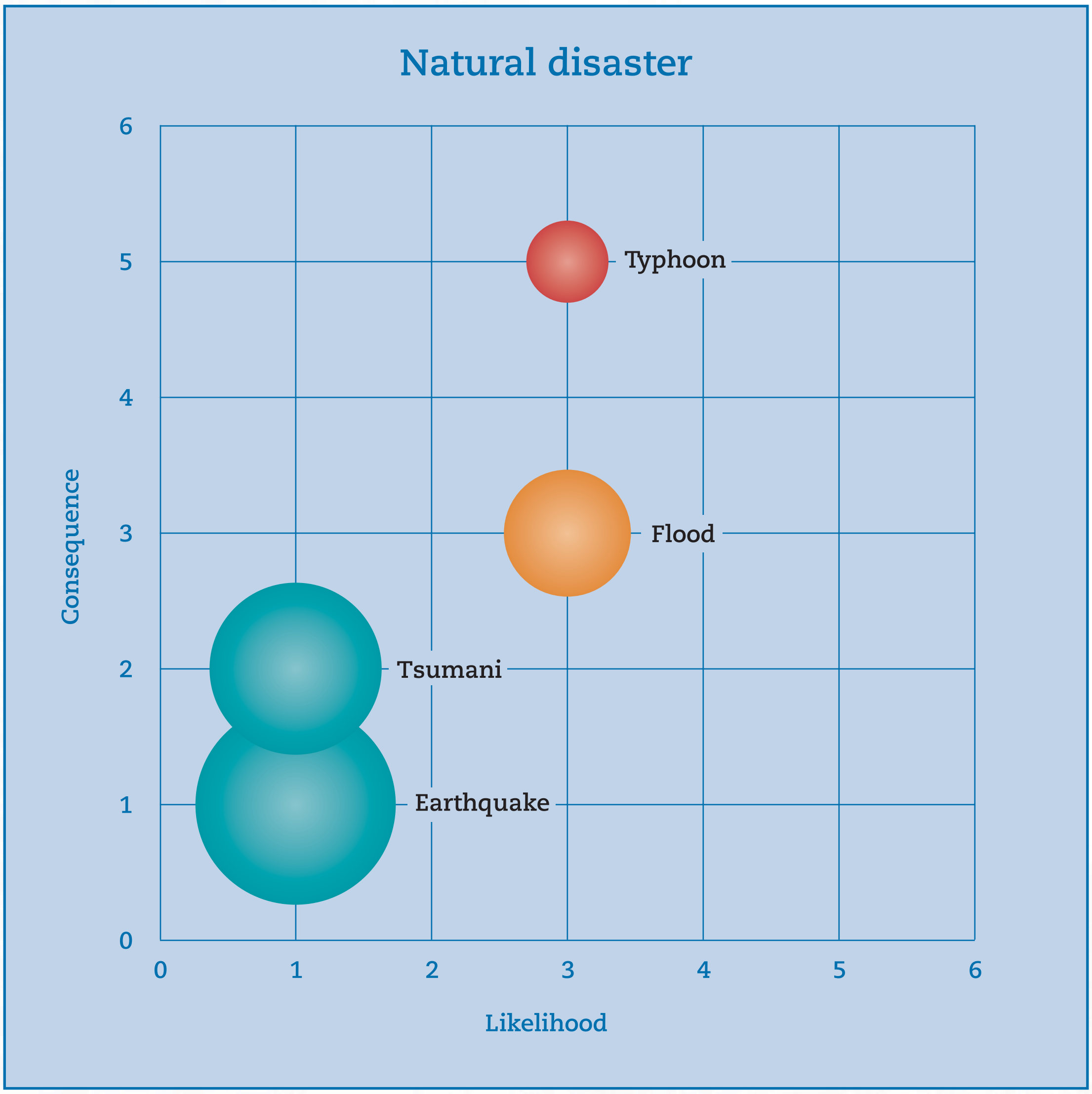
To assist clients in examining their suppliers’ risk exposure and the adequacy of management processes in place, Marsh has developed a diagnostic tool that pulls together our in depth knowldege and expertise of managing risk in Asia.

This tool covers a broad range of risk areas but can be made bespoke to particular issues, such as IP vulnerability or compliance with labour laws. The diagnostic process involves consultant led on site interviews with all relevant supplier management, held in the local language. It is complimented by a mixture of background research into the supplier and operational region, such as flood exposures at location and investigation of corporate and site history.

The output of the diagnostic provides clients with a comprehensive overview of suppliers’ risk exposures and control measures, prioritised in the context of the clients' own risk thresholds and parameters as required.

The results are consolidated and summarised in an analytical report including recommendations on the most appropriate next steps and processes required to improve the quality of risk management at the supplier and the resilience of the clients' supply chain.

Example output from the Marsh Asia supply chain risk diagnostic tool



Extreme risk	Should be brought to attention of directors and continuously monitored
High risk	Requires attention of managing director/ CEO and general managers
Moderate risk	Appropriately monitored by middle management
Low risk	Monitored at supervisory level

Size of bubble

The better the implementation of control measures, the smaller the bubble

Note: colour of bubble is not automatically changed in this version

Event	Likelihood	Consequence	Severity (Risk rating)	Control Measures
Earthquake	1	1	Low	Weak 0%
Tsunami	1	2	Low	Weak 14%
Typhoon	3	5	Extreme	Strong 86%
Flood	3	3	High	Moderate 45%

Contacts

For more information on how Marsh can support you in managing Asia supply chain risk please contact:

Matt Elkington
Tel: +44(0) 207357 5162
email: matthew.elkington@marsh.com

Andes Lam
Tel: 85223017000
email: andes.lam@marsh.com

Regional offices

China

Marsh
Suite 3518
35th Floor
China World Tower 1
No. 1 Jianguomenwai
Avenue
Beijing 100005
China
Tel: 861065058887

Marsh
B05-07
11/F
Center Plaza
161 Linhe Xi Road,
Tianhe District
Guangzhou 510620
China
Tel: 862038310200

Marsh
Suite 38
47F
Hong Kong New World
Tower
No. 300 Huai Hai Road (M)
Shanghai 200021
China
Tel: 862151162819

Marsh
Room 903
Aurora Plaza
No. 99 Fucheng Road
Pudong
Shanghai 200120
China
Tel: 862168873118

Hong Kong

Marsh
26th Floor
Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Kowloon
Tel: 85223017000

Korea

Marsh
17th floor
Hanmi Building
#39 Da-Dong, Chung-ku
Seoul, 100-180 Korea
Seoul
Korea
Tel: 82237880800

Marsh
18th floor
Jongno Tower
Jongno 2ga
Jongno-Gu
Seoul, 110-789
Korea
Tel: 82221982140

Singapore

Marsh
18 Cross Street
Singapore 048423
Singapore
Tel: 6562208141

Taiwan

Marsh
3F
No. 2
Sec. 3
Minquan East Road
Taipei
Tawan (104)
Tel: 886225189998

MARSH

MMC Marsh & McLennan Companies