MARSH

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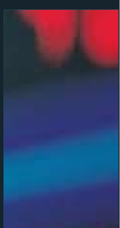
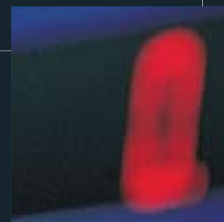
Managing through the downturn:

Using risk and insurance management to build resilient businesses in a difficult and uncertain economy





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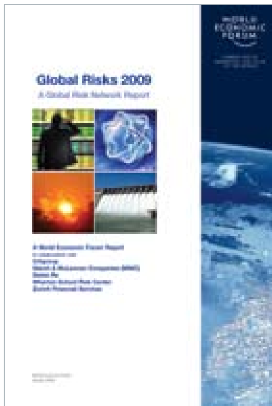
Preface

It's been called the perfect storm, and in my experience - having worked through economic downturns in the 1970s and '90s - the current situation is unprecedented. We are witnessing a welcome degree of cooperation among the world's governments, reinforcing the message that this is a global crisis needing international solutions. Legislation and governance which would scarcely have been conceived of a few months ago are now the norm. The challenge, as always for business leaders, is to respond quickly and positively to this new environment.

At Marsh, my management priorities are focussed around our core activities: making sure we are pro-active in providing appropriate products, services and solutions matched to our clients' particular needs and that our own risk management procedures are robust and strictly adhered to.

The global credit crunch and deteriorating global economic conditions have understandably dominated the headlines, but there are other dynamics carrying just as significant consequences for European business. They include such risk issues as terrorism, climate change, energy volatility, and the emergence of the BRIC countries (Brazil, Russia, India, China) and other parts of Asia and the Middle East as the world's future economic powerhouses.



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Countries comprising the G-20 group of nations, for instance, will account for an increasing share of global output. As they approach western European economies in terms of size, output and ownership, there will be far reaching implications for home grown businesses. This shift in economic power will have important consequences for labour and skills, sociopolitical pressures, and global supply chains and trade. These and other critical risk issues are discussed in *Global Risks 2009*, the World Economic Forum's annual risk report, prepared by MMC and other world class business and research organisations.

The topics addressed in this report provide guidance and advice in the management of risk. While preparing their companies for the coming twelve months, prudent leaders will be taking action around risk mitigation to strengthen their firm's ability to succeed in this volatile global environment. As the world's leading insurance broker and risk adviser, Marsh is proud to work with companies across the globe in helping them meet their insurance needs. We hope the guidance in these pages will provide help and insight into building resilience and supporting a successful future for your organisation.

David Batchelor
CEO, Marsh Europe, Middle East and Africa
January 2009

Introduction

The global economy is slowing down rapidly.

This is undoubtedly bad news for companies that carry too much debt and have weak business models, as evidenced by the recent bankruptcy of hundreds of companies across Europe. But what impact will the recession have on well-managed companies with sound finances? Can they remain resilient, and emerge from the downturn with their human and capital resources in place to enable growth in the future?

Most will seek to ride out the storm by reducing costs to protect their bottom line. This response is sound, but it would be wise to avoid rushing into decisions about where and when to make cuts. This paper offers advice on how to take stock of the risks to your organisation in three key areas – financial, liability and trade. It also suggests ways to manage and mitigate these risks to reduce overall costs while maximising potential business opportunity. No business can be made totally recession-proof, but the approaches outlined here will undoubtedly help.

Summary of contents

Section one: Money and risk

Insurance is a proven instrument for protecting organisations against the effects of risk, but it is neither the only option nor always the most cost-effective. By analysing your risks carefully and determining your 'appetite' for them, you can arrive at a considered strategy for managing risk, which may include a greater element of risk retention. Get your sums right, and the overall cost of risk will likely be lower – even allowing for greater retained losses. Consider alternatives such as a captive insurance company. Captives are much more than a clever financial vehicle. Properly used, they can free up capital for investment in revenue-earning activities of the parent.

Trade credit insurance can protect against the risk of debtors becoming insolvent, but cover may be hard to find and increasingly expensive. Companies that can demonstrate a thorough understanding of their risks and have effective strategies to manage them, are likely to secure the best terms on trade credit insurance and other vehicles – such as contract surety – to protect payments.

Section two: Liability and risk

When people and organisations wish to apportion blame for the adverse effects of the downturn, directors and officers will be in the firing line; we anticipate increased litigation against company executives across Europe. In such an environment, the need for directors and officers (D&O) insurance is obvious.

Concerning corporate liability, some commentators are predicting 'waves of litigation' around the demise of prominent financial institutions. A liability 'food chain' may occur, with litigants moving down from banks to the organisations and individuals that advised them, as shareholders, investors and employees seek to recoup losses.

Establish the correct limits of liability for your organisation; buy too much insurance and you waste valuable capital; buy too little and you could be hit by uninsured losses. Advanced modelling tools help you get the right balance. Take particular care when calculating liability in some overseas markets, where insurance regulations may be ambiguous or difficult to interpret. Also beware of falling foul of local premium tax laws.

Section three: Trading and risk

The massive complexity of today's global trading networks magnifies overall risk for many companies during a downturn. Risk may exist at any point in the value chain, and could be located anywhere in the world or, as is increasingly the case, in cyberspace. Organisations can protect themselves by analysing their value chains from end to end and identifying their key points of vulnerability.

Business resilience is the outcome of effectively executed management decisions based on robust management information. The old adage – the better the inputs, the better the outputs – should be a guiding principle for those with responsibility for managing corporate risk. By getting it "right", companies will benefit from:

- increased working capital for the business to pursue its growth strategies
- better governance and business processes to demonstrate why specific decisions were made
- favourable access to insurance markets and products at competitive prices.

Section one:
Money and risk

A question of balance – optimising spend on risk financing

This is a tough time for chief financial officers (CFOs). As the global economy deteriorates, so the pressure increases to develop strategies for making the best use of capital, and reducing the potential impact of volatile markets.
It's impossible to forecast precisely how significant a role insurance and risk financing will play in helping companies manage through the downturn. However, a strategic approach to risk financing is likely to provide valuable additional capital for many businesses. Such an approach should be based on the cost of capital, any expected losses, the quality of internal controls, the strength of the balance sheet and a company's predicted cash flow.

An alternative to insurance

When not employed optimally, insurance can be a drain on capital. It's also only one of several options to help companies manage and finance their exposure to risk. When an insurance premium is paid, the capital is effectively written off by the insured. Even if the company experiences few or no losses over the following year, it cannot get that capital back to help grow the business. On the other hand, if the company chooses to retain an element of that risk rather than subcontract it to an insurer, and experiences a similar year of low losses, the capital is still available to the business.

Many CFOs may reject the latter approach, contending that – for all the turmoil in the financial markets – insurance has remained relatively inexpensive and provides good value at a time when there are other significant pressures on the balance sheet. But this overlooks two issues. Firstly, the cost of insurance will not remain at the same level forever and no business with a three-to-five year outlook should assume that it can accurately predict the future cost of insurance cover. Uncertainty in capital markets, including the capital adequacy of some insurers, means that future 'spiky' periods of increased rates and restricted capacity are likely, at least in certain lines.

Secondly, and more tellingly, by focusing only on the cost of insurance, companies ignore the opportunity to strike the right balance between transferring risk to an insurer and financing a degree of risk themselves.
At Marsh, we call this Risk Transfer Optimisation.

The process of identifying the optimal risk financing solution will often result in three sets of information: financial, leadership and insurance. It's the blend of these considerations or factors that will provide the optimal risk finance design.

Through the use of analytics, the business will have a view on the financial aspects of risk - the financial optimal view. Senior leaders in the business will have a perspective on the on/off strategy risk mixture. Conclusions driven by these perspectives can be called leadership optimal. The third broad piece of data required in the blend is insurance market pricing - insurance optimal.

Exploring risk appetite

The extent to which a business feels comfortable in retaining risk is commonly known as risk appetite. This is bound to be affected by the general state of the economy and the availability and cost of capital. However, these will not necessarily be decisive factors.

Most companies will accept a degree of deviation (or volatility) from their planned trading performance in any given period. These "on-strategy" risks are taken in pursuit of shareholder value and growth. Such risks could be an acquisition, or the development and launch of a new product, or the risks of moving into a new geography. However, companies must also consider the potential adverse impact of unexpected volatility, or 'off-strategy risk', which may require additional financial protection. Off-strategy risks are those risks that attach to the business as a consequence of normal business operations. Companies do not willingly take these risks to grow value. Off-strategy risks include employee injury, auto-accident, or supply chain disruption. In our experience, companies generally have a much lower tolerance to off-strategy risk than to on-strategy risk.

Understanding these two types of risk will be a key consideration in determining a company's risk appetite, as will be the strength of its balance sheet and cash flow. Other factors will include the use of capital in the business, its rate of growth, company culture, past performance and peer group experience, perceived strength of management systems and controls, and simple 'gut instinct'.

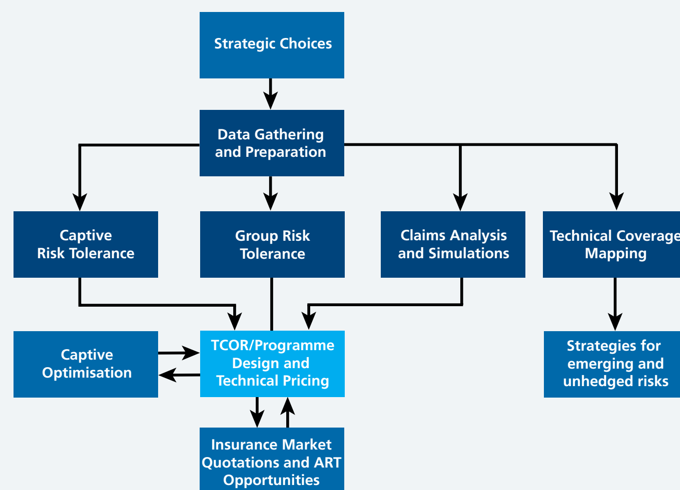
Risk appetite is more a measure of how much risk a company is willing to retain, rather than how much it can financially retain – which is usually referred to as risk tolerance. Business leaders should determine whether their current risk appetite is appropriate for the changing economic conditions, and as a result make any necessary changes to their arrangements for financing risk.

What is the optimal risk financing programme?

Financial, leadership and insurance optimal results are all necessary considerations in their own right, but they are not individually sufficient. By blending these three different decision-making tools a business is able to design its optimal risk finance programme.

A valuable by-product of this process will be a very strong governance framework. A board can demonstrate to shareholders why they buy the insurance limits they buy, what's behind the decision on deductibles and why they have chosen the insurance carriers for those risks. The various component parts of the process are shown in figure 1.

Figure 1: The typical component parts of risk transfer optimisation



Risk managers following this process can usually demonstrate a reduction in the total cost of risk (TCOR), enabling their firms to release capital back to the business. And not just in year one, but ongoing, helping the company reduce volatility in its total cost of risk. Part of the solution may come from a captive, or simply from a different programme design. Companies should therefore examine where capital is being used inefficiently and look for solutions to help them release that cash back to the business.

A managed approach to risk

Consider two hypothetical companies. Both plan around three-year cycles, employ the same number of staff, operate in similar locations, and have similar loss histories. Company A decides to fully insure, at a cost of €10 million.

Company B takes a more strategic approach to its risk financing.

1. Senior management decides that, even in the current economic climate, the company can afford to be less risk averse and depend less on insurance to protect the business. It verifies this through a risk tolerance exercise, which looks at its current and future risk profile, the strength of its management controls, and its loss experience and how this compares with similar companies. This helps it to determine at what point it would be prepared to start paying for future losses – and at what point it would want to stop. This is called the 'materiality threshold'.

2. It checks its existing insurance against its risk profile to ensure that there are no major exposures left unprotected. If there are, it agrees an alternative management strategy to insurance.

3. It makes improvements to its risk control environment – putting fire sprinklers in all warehouses and refining its business continuity arrangements – which significantly reduce its exposure to business interruption.

4. Using risk modelling techniques, it develops a series of programme structure options, each of which reflects a different approach to retaining or transferring risk, and takes account of the varying cost of capital. It considers alternative risk financing, such as a captive insurance company.

5. Finally, it arrives at an optimum risk financing programme. It secures preferential terms for the risk it places in the insurance markets by demonstrating improvements in its risk control environment.

The total cost of risk for Company B is €8 million. This takes into account the cost of retained losses, of capital and of external risk transfer. Although insurance may initially have appeared the least expensive option, the company has managed to reduce its total investment in risk by optimising the balance between insurance, retention and control. It has confidence in its retention decisions as it has made improvements to its risk management, and – because it is buying lower levels of insurance – it will be less exposed to the insurance cycle should rates rise in subsequent years. It has also released €2 million of capital, which would previously have been written off, to invest in growing the business.

Decisions around risk-financing strategy and arrangements are rarely clear-cut. However, if your business is not following a similar approach to that of Company B, it probably is not optimising its return on capital employed on risk transfer.

Captives – an alternative approach to insurance

Captive insurance companies are wholly owned by non-insurance parent companies, which use them to self-insure some, or all, of their risk. While still referred to as an alternative risk-financing mechanism, captives have existed for over 50 years, and today there are more than 5,000 worldwide. In many firms they have become the main vehicle through which risk financing and insurance are purchased.

During an economic downturn, companies should review carefully the amount of insurable risk they retain. Indeed, risk control and careful management of expense are now vital as insurance costs rise and insurer security is questioned. Over the past year or so, Marsh has fielded a marked increase in enquiries about captives from large companies. This is understandable: a well designed programme gives companies greater control over risk financing and in the longer term, can significantly alter the way in which a company buys insurance, leading to a reduction in the total cost of risk.

Reacting to market swings

The incorporation of captives into a well structured strategy for retaining the optimal level of risk can provide a company with lower insurance costs and lead to accounting and tax benefits. Further, this strategy can adapt to market cycles, enabling a company to fine tune the amount of risk it retains. For instance, in a hardening market, insurers typically increase the amount of excess payable on policies, so it may be cost-effective for the company to retain more risk.
The use of a captive will increase both a company's control over this process and its ability to react quickly to market swings, thereby lessening their impact on the business.

Use of a captive can improve information flow because, by its very nature, a captive provides more and better quality claims data. This can be used in turn to enhance decision making in risk-retention analysis and identifying trends and prioritising expenditure on risk management. Moreover, as a licensed insurance company, a captive can access the reinsurance market and secure a wider choice, both in terms of markets available and competitiveness of cover. It may also provide greater options for cover structure – for instance multi-year periods and policy triggers.

A long-established captive may have capital available immediately to fund the retention of additional risk by its parent. However, with the current restrictions in the commercial paper market – exacerbating companies' difficulties in taking on short-term unsecured debt – CFOs will be focusing on ensuring that all available funds are deployed in the parent's core business. It is, therefore, vital that any additional risk assumed is beneficial to the company's bottom line, so as to reduce the temptation to divert spare capital away from the captive for use in other areas of the business.

Companies should also consider their position in relation to historical business that has been underwritten. Utilising lines of credit to support insurable risk written three or four years ago is likely to be subject to a new level of scrutiny. Not only has the benefit of avoiding ‘pound swapping’ with the insurance market been enjoyed, but the firm is left with volatile risk. Mechanisms to eliminate such gyrations can have a double benefit in today’s environment by reducing both volatility in reported results and releasing capital to enhance the cash flow of the parent. We expect to see significant development in this area as prior investment in the capital markets migrates to the insurance market.

Innovative investments

Companies without a captive may experience difficulties in obtaining cash to capitalise one. Consequently, it is essential that any company considering the retention of additional risk establish a clear business case both for the short and medium term. Once a captive has been created, its funds need to be invested innovatively so as to reduce the overall impact of reallocating capital away from the core business. In 2008, Marsh undertook an assessment of the performance of captives worldwide. Figure 2 shows that while almost half of the captives surveyed achieved a return on capital of over 10%, almost one quarter achieved no return at all.

Figure 2: Return on capital employed in captive insurance vehicles

Source: Marsh’s research report ‘Next Generation Captives, 2008’.

Marsh has developed a solution which is particularly appropriate during an economic downturn. It involves a structure that enhances the company’s cash flow by using the captive’s assets to purchase the receivables of the parent. By not lending funds from the captive directly back to the parent company, it can help to avoid potential tax exposures.

Companies considering a captive should also identify and develop appropriate adaptation and exit strategies. They should ask how they will match their investment strategies with long-term patterns of expenditure, and whether investments will generate sufficient returns to offset the ultimate cost of losses. And they should consider how the changing regulatory environment, such as the Controlled Companies legislation, may impact on the effectiveness of vehicles such as captives.

Captives can help companies navigate their way through the current economic downturn and beyond. However, their utility is maximized when they are aligned with and calibrated to a company's strategy and appetite for risk. As with all financial tools, companies must use captives appropriately, factoring in any new dynamics, volatility or changed appetite for risk.

Trade credit insurance – a buffer against tough times ahead

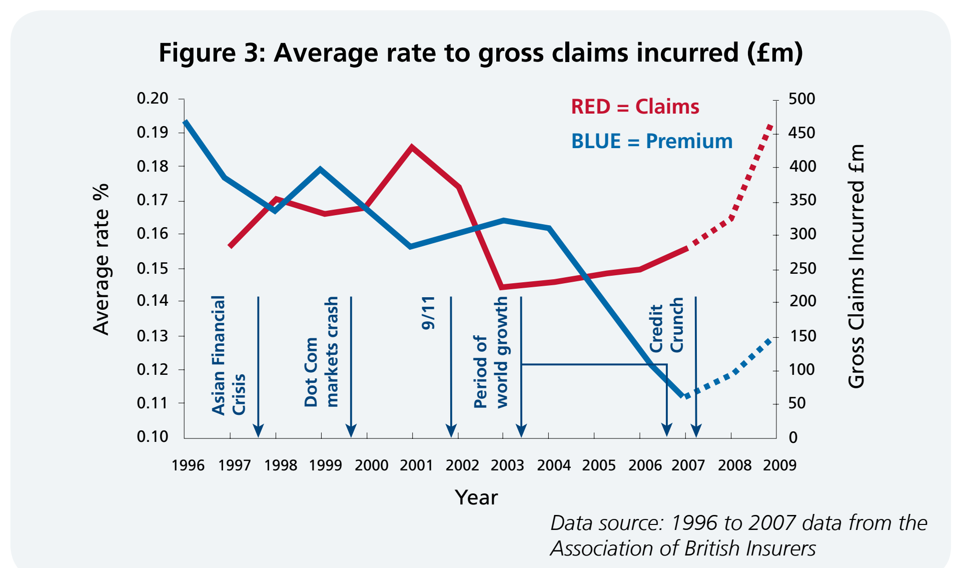
Companies should look to use trade credit insurance to protect themselves against the impact of bad debt or late payment by their customers. While the current climate has made underwriters more cautious about insuring such risk, the good news is that at the end of 2008 credit insurance was still available for good, well-run businesses.

In the past underwriters would generally vet only the credit ratings of the client's more risky customers, while relying on the client to advise which customers were good risks. Today underwriters are becoming more cautious, demanding more information and transparency to enable them to assess more thoroughly the financial status of even the better risks.

The lessons of history

So what have underwriters learnt about managing the trade credit insurance markets from past crises? Firstly, as global growth slows, incidents of non-payment increase. Over the past five years, loss ratios – the difference between premiums taken and claims paid out – of between 40% and 50% have been normal. However, by November 2008 the loss ratio had already exceeded 70% and is projected to continue to rise. Figure 3 shows how changes in the global economic outlook have influenced the volume of trade credit claims, and the cost of the insurance.

Figure 3: Average rate to gross claims incurred (£m)



Data source: 1996 to 2007 data from the Association of British Insurers

Secondly, history has shown that in times of economic difficulty underwriter capacities have tended to decrease. However, during 2008 the number of

enquiries for trade credit insurance increased, enabling underwriters to be more selective about the business they accept and to demand more information and transparency from each potential purchaser. While some underwriters are being cautious, preferring to contain the element of risk they currently hold and not grow too quickly, or even by withdrawing from the market, others are seeing rapid growth and have increased capacities since the start of 2008.
These underwriters have undoubtedly selected the risks they underwrite carefully, and are managing their exposure to poor risks. Even so, their overall business appears to be expanding and they are treating the current economic climate as an opportunity.

Despite examples of rapid growth, more than 80% of UK and European companies still have no trade credit insurance. This is surprising, because financial institutions tend to view such insurance as a suitable guarantee or security to support funding, overdraft facilities and re-financing packages. And in our experience, banks increasingly ask for a credit insurance policy to be in place before they will lend to a small, or even a mid-sized, corporate business.
Before they can access these insurance products, companies trading in a downturn need to demonstrate that they are particularly attentive to risk management.

Risk control sends out the right signals

A key factor in the success of a new enquiry is how well a company can evaluate, audit and review its credit limit exposures. Most insurers now insist on access to that information before they accept any future product. As a further safeguard, most insurers like to 'embed' a company's credit-management procedures within their policies. This ensures that the policy takes account of the company's day-to-day protocols and procedures, while minimising the potential administrative burden for both insurer and insured.

The primary products for trade credit insurance are 'whole turnover' or a 'catastrophic approach'. Whole turnover covers a company's total order book against default or insolvency, and is favoured by traditional trade credit insurers. It has low self-insurance levels and is produced around a company's current environment and administration. The catastrophic approach covers a much wider range of credit problems, but usually includes a greater element of self-insurance. For a catastrophe portfolio, underwriters require much more consultation with the customer and fuller auditing of the primary risks.

Even in the current downturn, with underwriters reviewing some credit limits, we have seen an increase in credit insurers' exposure levels since early 2008; clearly the credit insurance market is still open. Over the past few years, the trade credit insurance market has differentiated largely on price, but as claims and losses rise, that approach will no longer be sustainable. Insurers are interested in talking to well-run and well risk-managed organisations.
Those that can accurately assess, review and understand their exposures across all corporate lines are likely to have a competitive advantage when trading both at home and overseas.

An alternative approach: surety bond solutions

With continuing difficulties in the banking and credit markets, and the uncertainty around bank capacity and pricing, alternative surety and guarantee relationships should be established and developed now to ensure a company's existing working capital facilities are maximised.

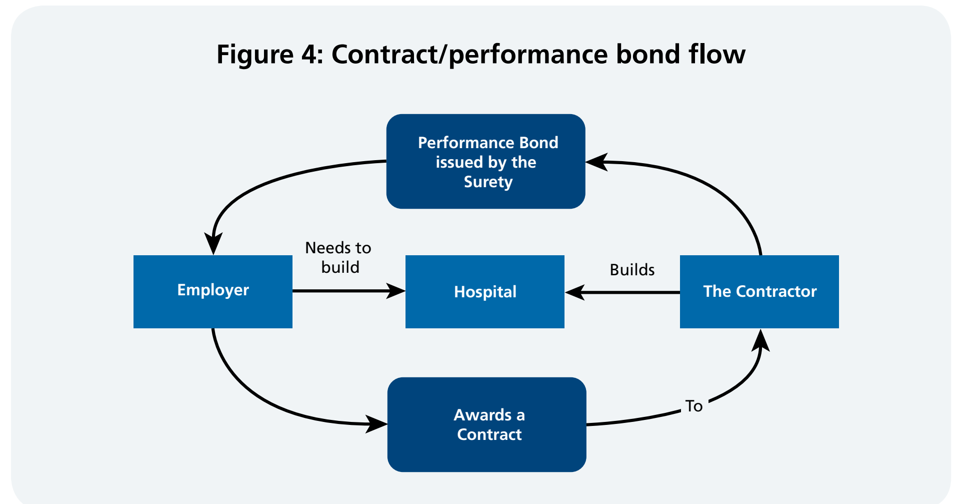
Banks have been forced to reassess how they use their capital, as a shortage of wholesale funds continues. This has led to a change in their appetite for risk and their need for profitable return has intensified. European banks are reducing the availability of bank guarantee facilities in favour of promoting 'cash' working capital facilities.

In spite of the lower Central Bank interest rates, some clients have reported the cost of bank guarantees is becoming more expensive, as the banking trend to widen the interest rate 'spread' between deposits and lending continues, in spite of government pressures.

In such circumstances those companies for whom bonds and guarantees are critical synthetic balance sheet capital, the alternatives are limited. Often a parent company guarantee (PCG) may be an alternative, but the risks of providing an unlimited direct guarantee (subject to contract limitations) are clear.
More often both a bond and PCG are requested as corporate insolvency rates are rising daily.

A surety bond solution delivered through the specialist insurance markets is today an increasingly viable way to respond to both performance and cash flow related risks. They help companies that are concerned about a supplier's ability to withstand the recession. If a supplier can give its client a surety bond, it can provide a timely confirmation that a third party guarantor is prepared to countenance its reputation.

Depicted in figure 4, a surety bond can protect both contractors and employers (the beneficiary).



To the bonded contractor, it can provide protection to the underlying contract conditions in the event of dispute, rather than the on-demand exposure of a bank guarantee. Typically, surety bonds are off-balance sheet liabilities and classed as a contingent liability and as a result tend not to aggregate against bank facility limits.

To the beneficiary, there is a commercial assessment by the surety underwriter that the bonded contractor has the ability and creditworthiness to perform the contract. But even if the contractor does default, the surety bond gives the beneficiary protection against contractual losses suffered as a result.

Companies that have prepared for an increase in economic risk and the demands placed upon their balance sheets will be better placed to manage the downturn. There are opportunities to minimise the financial impact of an unstable banking sector and when circumstances are appropriate, investigating surety bond solutions should be a priority.

Section two:
Liability and risk

D&O insurance – peace of mind for directors and officers

In a recession, there is increased risk that claims will be made against company directors and officers (D&Os). If a company becomes insolvent, any indemnities that it may have given to senior employees may be virtually worthless. We expect D&O insurance to continue to provide an effective source of cover and directors and officers should not feel hamstrung by concerns about personal liabilities.

Financial pitfalls multiply during a downturn. Companies that miss their earnings projections, or that have trouble meeting loan obligations, might find themselves the subject of D&O lawsuits. Enhanced scrutiny from regulators, who are collaborating across borders, has also increased the risks to senior personnel.

In the US, class action litigation is rising rapidly. A study by Marsh's sister MMC company, NERA Economic Consulting, projects that filings will shortly be at their highest level since 2002 and more than double the 133 filings made in 2007. We anticipate an increase in litigation against company executives in the UK and throughout Europe. This will occur across a broad range of sectors and include more litigation from disgruntled employees as well as shareholders and regulators. To enable directors to feel comfortable around making decisions, possibly tough ones regarding the running of a business, they need to feel they are protected personally against the financial consequences of litigation. D&O insurance can provide protection to directors for claims made against them from a range of claimants.

How are companies responding?

The turmoil in the financial markets has also raised directors' concerns about the solvency of insurers. A common response has been to reduce their exposure to any one insurer and to carefully consider the insurers utilised.

Insurers have experienced a greater demand for 'Side A DIC' (difference in conditions) cover. Side A DIC policies have fewer exclusions and operate only when a company does not indemnify its directors. They provide an additional limit of indemnity, or will reimburse directors and executive officers when legal actions lead to some events that are not covered by underlying insurance policies.

Such events could include the insolvency of the insurer of the underlying D&O policy, or the wrongful refusal to pay a claim by the underlying insurer. Side A also provides coverage for directors where companies do not indemnify them. Examples include where the company is insolvent and therefore unable to honour the indemnities it had previously granted to senior employees, or where the company wrongfully refuses to provide indemnity.

D&O insurance cover is not yet becoming expensive: rates for most sectors continue to decline as insurers vie for business. But D&O rates for all sectors may increase in the face of recession-related exposures and a shortage of viable insurance and reinsurance capital.

Managing D&O premiums

Directors' risk of liability increases significantly when their company raises capital or issues debt publicly. In addition, recent changes to UK companies' law has increased the ability of shareholders to bring derivative claims, which force the company to sue directors. The likely impact of this is unclear, but it does represent a significant change.

As D&O premiums increase in some sectors, companies should demonstrate that they are taking a proactive approach to managing this risk. In doing so they will be able to take maximum advantage of the more competitive strain in the D&O market and to minimise the cost of cover.

In particular, companies should carefully study the terms and conditions of any cover, and ensure they are appropriate to its particular circumstances.
Policies differ, which is why large companies seek expert advice on which policy most effectively meets their needs.

Insurers look more favourably on companies that actively engage with them and are seen to be proactively managing risk. A good recent example was a Marsh client which had an increased cost of credit when renegotiating its debt facilities. By disclosing all necessary information to its insurer, the company allowed underwriters to understand the situation fully and to work with it to ensure that this did not result in a large premium increase.

In tough economic times, companies look to reduce costs wherever they can.
But protecting the company's directors and officers is one area where businesses should carry on investing.

Litigation – the calm before the storm?

Undoubtedly the credit crisis will affect the legal world. But how and by how much? Some commentators suggest that more claims will reach the courts as the backlash of the slowing global economy begins to be felt.

Marsh is already seeing an increase in the number of claims by financial institutions as a result of significant shareholder and borrower disputes. In addition, at least two leading City law firms have reported numerous pre-litigation enquiries, although these have yet to become legal actions. There must surely be implications from the sheer number of major mergers, acquisitions and nationalisations now taking place in record time – a matter of days – whereas previously they would have taken weeks to complete.

A contrary view is that while there may be an increase in fraud, corporate restructuring and insolvency work, excessive litigation may be constrained by, as one commentator has put it, "an inability to pay the bills". Whatever happens, parties who seek redress will still need an effective forum for the resolution of their disputes. Given that the litigants may themselves be short of funds, this could lead to an increased use of Alternative Dispute Resolution (ADR). ADR takes various forms, filling the space between formal court proceedings and informal commercial settlements.

Two forms of ADR – arbitration and expert determination – bear the hallmarks of traditional litigation, with formal processes and binding decisions. In contrast, mediation and out-of-court settlement discussions take a more commercial and practical approach. Although there are hidden costs to ADR, fees are unlikely to reach the heights of full-blown litigation. Nonetheless, some matters will still need to be dealt with by the courts, because of their complexity or the desire to set a precedent for future claims.

The 'liability food chain'

Although the volume and location of claims will not become clear for some time, it is likely that claimants will give more thought to the identity (and solvency) of the defendants against whom they bring claims.

At the top of what could be described as the 'liability food chain' are the financial institutions. If these lack the resources to pay claims, litigants may move on to what they perceive to be the next strongest targets – professional advisory companies, such as auditors or accountants. Even companies outside the financial sector are starting to feel pressure, and this may result in the hunt for liability turning to individuals.

In difficult economic times, those closest to the bottom of the 'liability food chain' are more likely to be targeted – as the only place where cash may be available. To ride the storm, individuals will be looking for robust directors' and officers' insurance or will need unimpaired personal wealth. Lord Goldsmith, a prominent UK Law Lord, expects people to "jostle for a position in the queue for

assets" of failed entities, and that they will move "quite quickly to the search for defendants with insurance or deep pockets able to pick up the loss." [1]

Legal and regulatory responses

Notwithstanding recent actions to nationalise some financial institutions, it is still too early to predict exactly how legislators and regulators will respond to the credit crisis in the longer term. The global nature of the crisis impedes immediate action, as national governments will need to coordinate their responses to ensure coherence and consistency. However, when action is announced it will be strictly enforced, with an even greater emphasis on supervision and transparency.

In the UK, the Financial Services Authority (FSA) has made clear that its "touch will be heavier," as well as "intelligent and focused."[2] In the US, The International Association of Insurance Supervisors has also moved regulation to the top of its agenda.

The signs of a new approach are already apparent. The FSA temporarily banned the practice of short-selling of stocks in many financial services companies. The British government has waived competition law to allow the merger between two large banks Lloyds TSB and HBOS and has commenced with legal action against the Icelandic government. These actions would have been inconceivable at the beginning of 2008.

Survival of the fittest?

Companies which are proactive in responding to regulatory developments are likely to be those that survive and prosper. This report contains a range of practical and innovative approaches companies should actively consider in face of a more complex and demanding legislative regulatory environment.
"As has already happened with many of the major banks, companies may look to merge, or acquire ailing companies "on the cheap". This may result in fewer large companies dominating areas of industry."

Nor will the legal sector be immune. Law firm mergers are expected to rise sharply, with more deals predicted in the next year than in the past 25.
The consequences of such activity could have a dramatic impact upon business, as competition and consumer choice are reduced.

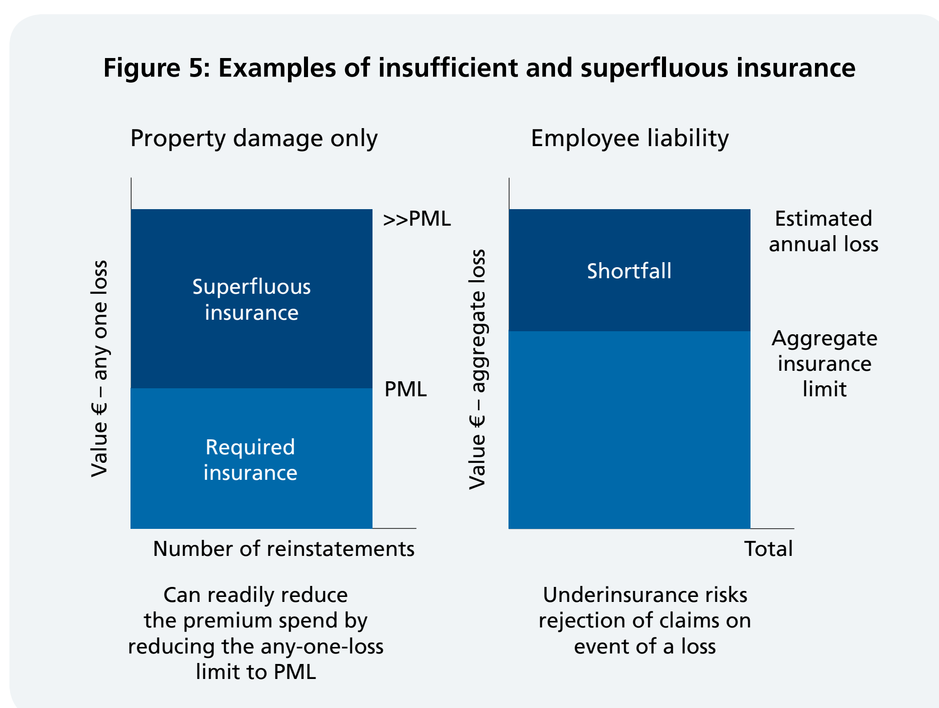
[1] Lord Goldsmith quoted in *Legal Week*, 7 October 2008

[2] Comments taken from an interview with the *Guardian*, published on 17 October 2008

Liability and risk – setting the correct limit of liability

Serious financial consequences can be the result of incorrectly setting your company's level of insurance cover wrong – particularly during an economic downturn. Buy too much, and you divert much needed capital away from your revenue-earning business. Buy too little, and your company could end up with uninsured losses. Figure 5 depicts both scenarios. The left hand bar shows excessive insurance purchase – where the limits are far above the maximum loss possible (described by the probable maximum loss, or PML). The bar on the right depicts insufficient insurance where the aggregate limit is below expected levels.

Figure 5: Examples of insufficient and superfluous insurance



By striking the right balance between insurance and retained risk – what we call Risk Transfer Optimisation – risk and insurance managers can ensure optimum financial efficiency for their organisations. Moreover, they will achieve a better understanding of how to manage the risks inherent in their business, which could well result in better governance and processes.

In both instances in the chart above – over and under-insurance – the organisation's capital was inefficiently deployed. Capital was neither invested in business to generate a return nor used to provide an appropriate level of insurance. These same principles apply for all classes of risk.

So how much is too much, how little is insufficient and how are both assessed?

There are many approaches to assessing appropriate insurance limits. For some companies the process will be straightforward, but others will require a sophisticated approach tailored to the specific needs of their business. The common requirement in all cases is to understand fully the volatility and uncertainty of the risks the company faces.

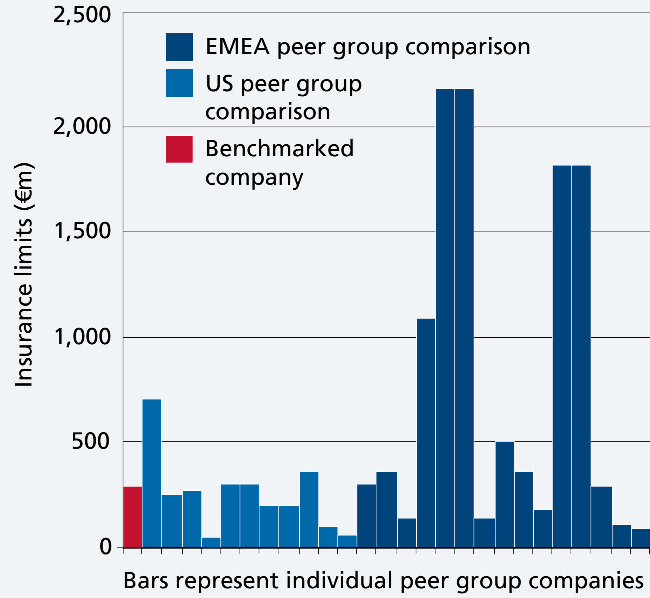
Assessment of limits in an economic downturn

During an economic downturn, companies should have certain key considerations front of mind. For instance:

- Economic volatility may cause changes in a company's asset values and inventory, directly affecting its risk exposure.
- Its liability values may also change. For example, the higher likelihood (and value) of credit default may increase its risk for credit insurance.
- The correlation and dependencies of risks are especially important as an incidence may give rise to claims for different insurances.
- An insurer's ability to pay claims relates to its creditworthiness, which may be affected by economic conditions.
- An insurer's financial performance – and the relationship between liquidity and solvency – will be impacted.
- Claim payments may be delayed, or challenged, as insurers tighten their claims procedures so as to control claims costs.

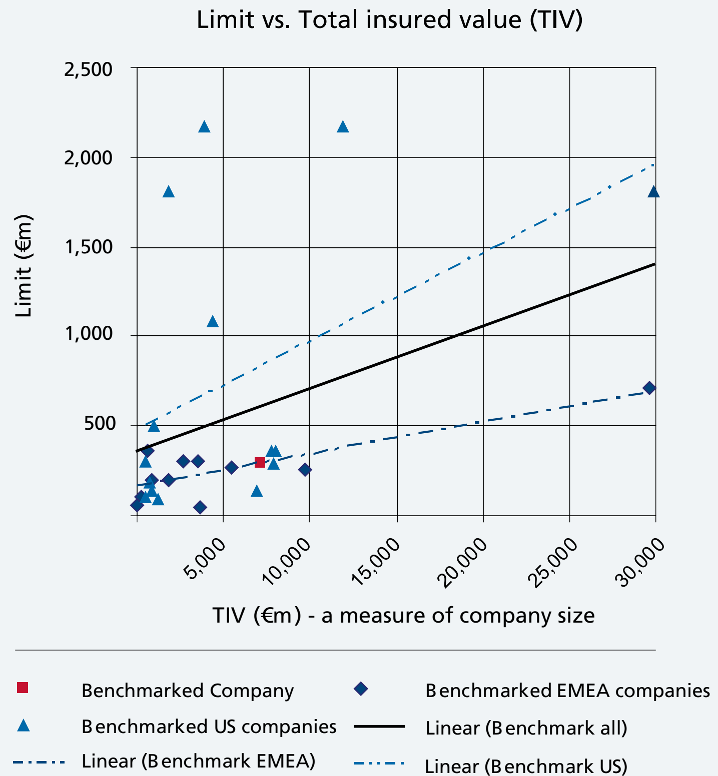
It is essential for organisations to understand these issues, because it will help them determine the appropriate insurance limit to purchase.

Figure 6: Benchmarking programme limits in Euros (M)



The charts above and below show an organisation's insurance programme limits in comparison to its peer group. Figure 6 simply shows absolute limits without regard to underlying exposure. Figure 7 shows the change in limits as exposure changes, allowing for more meaningful review.

Figure 7: Examples of benchmark analyses



Figures 6 and 7 are Illustrative only

Benchmark analysis

Organisations typically focus on the insurance purchasing habits of their industry peers. Marsh holds up-to-date details of the insurance limits purchased by companies of various sizes in specific industries (published by Marsh annually as *Limits of Liability*). This is particularly helpful for organisations that require benchmarks to enable them to stay within the market norm.

As shown in figures 6 and 7, cover can be analysed by total peer group, or be split by region. However, the minimum 'standard' comparator in figure 6 does not indicate underlying exposure, measured either by company size or (where appropriate) total insured values. The more detailed analysis in figure 7 does this.

Benchmark analysis is a quick and straightforward way for organisations to compare their own position with that of similar companies. However, it has its limitations. The limits indicated will not relate directly to the organisation's own risk, exposures and specific circumstances. In fact, they may simply represent the insurance market's appetite for risk at any given time, and may not be relevant to the current economic, regulatory and social environment.

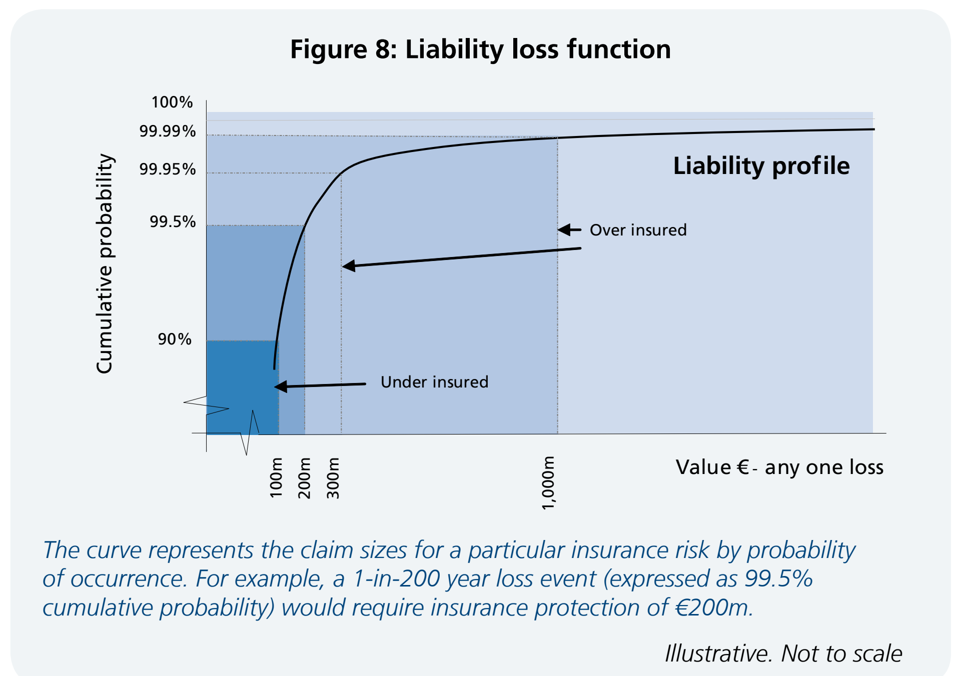
Modelling liability limits

A more advanced approach than benchmarking is required if an organisation is to benefit from insurance tailored to its specific circumstances and needs. This approach is based on modelling techniques, and must be underpinned by a company's accurate understanding of its risk and its appetite for risk. This will be based on both the historical experience of the organisation, and the likely future business environment it will operate in, and the risks this will bring. This process will help the organisation to avoid over or under insuring, and to determine the appropriate price for the risk it purchases.

The limit of insurance sets the upper threshold of protection, so organisations must understand the characteristics of risk in extreme scenarios and ask the right questions. For example, what is the likelihood of the limit being breached? How would this affect the organisation's own capital?

Figure 8 sets out the potential insurance loss profile for a particular liability class, in the form of a cumulative loss distribution. It shows that the cover required to protect the organisation against a 1-in-10-year event (90% level) is £100 million. However, it may be argued that the likelihood of a loss exceeding this amount is too high, so it would be reasonable to purchase more cover. Using the tenets of Solvency II as a guide, the organisation may conclude that protection from a 1-in-200-year event (99.5%) is reasonably prudent, but not excessively so. This suggests that a cover limit of £200 million would be appropriate.

Figure 8: Liability loss function



The curve represents the claim sizes for a particular insurance risk by probability of occurrence. For example, a 1-in-200 year loss event (expressed as 99.5% cumulative probability) would require insurance protection of €200m.

Illustrative. Not to scale

Cover for protection from a 1-in-2,000-year event (99.95%) or indeed cover for protection from a 1-in-10,000-year event (99.99%) would clearly be overly prudent, and would leave the organisation over-insured.

The exact level of protection depends on the risk appetite and risk tolerance of the organisation – as well as the availability and cost of contingent capital. However, the process of modelling the profile of the insured risk is key to determining the appropriate level of cover, and ensuring the efficient use of capital.

Modelling considerations

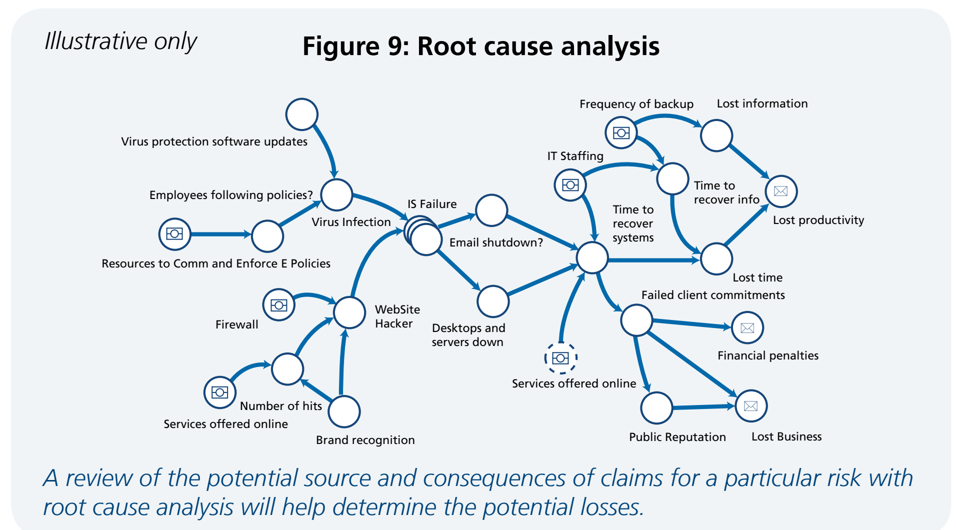
Understanding the underlying source, or cause, of losses can be achieved either by analysing an organisation's own data, reviewing industry-specific information, or a mix of the two. For example, pharmaceutical or nuclear liability losses are relatively rare, but the potential impact of both can be substantial, so detailed industry-specific analysis is important to determine the risk of companies in these sectors.

An organisation may not itself have experienced a representative range of loss events, particularly when new legislation has introduced potential new liabilities. In these cases, it is imperative to use the documented experience of industry peers to gain a thorough understanding of the underlying drivers of the events, and the potential impact on the risk profile of legal and economic changes. This is essential to achieving an accurate understanding of the risk to the organisation, and to building the liability loss function, as illustrated in figure 8.

When considering insurance limits, organisations need to understand the correlation and dependencies of the various risks they face. These interdependencies are well illustrated in figure 9. A ‘root cause analysis’ can be used to determine the overall scale of a potential loss.

Illustrative only

Figure 9: Root cause analysis



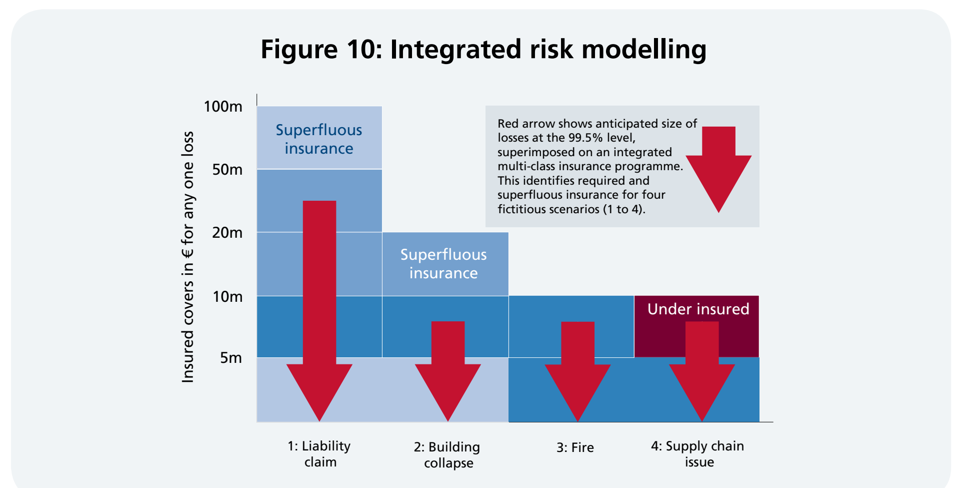
A review of the potential source and consequences of claims for a particular risk with root cause analysis will help determine the potential losses.

They should also consider the resulting profile of aggregated risks, especially if there is an umbrella or aggregate limit across all insurance programmes.

Knowing your insurance is knowing your risk

The process of acquiring an accurate profile of risk will provide an organisation with invaluable information about its optimal insurance programme and insurance limit. As figure 10 shows, organisations must relate the efficiency of cost of capital to their insurance structures. The probable maximum loss - depicted as a red arrow - should be aligned with the insurance cover purchased. In the case illustrated below, only scenario 3 is set correctly.

Figure 10: Integrated risk modelling



Navigating the risks and complexities of global insurance

In an environment of growing regulation worldwide, multinational companies are increasingly concerned about insurance regulation and tax compliance. This is particularly the case for those that have expanded their operations into countries such as Brazil, Russia, India and China (BRIC), where compliance challenges are most acute.

Given the increased emphasis on compliance, multinational companies are demanding global insurers achieve greater compliance from both regulatory and tax perspectives. Consequently a number of global insurers have modified their approach to participation in global insurance programmes. This is good news for the market as a whole as successful, cost-efficient compliant programmes reassure investors and analysts that a company takes its global insurable risks seriously.

Regulatory dilemma and time for change

Marsh works with many multinational companies, helping to ensure their insurance arrangement complies with local regulations wherever they trade. This is not always straightforward because regulations in some countries are either ambiguous or obscure.

This is a particular problem in countries that strictly prohibit non-admitted insurance, and require risks located in their territory to be covered by locally licensed insurers. In these cases, companies with very large global exposures sometimes find it difficult to buy local cover that satisfies policy wording or limits of cover. This places them at risk, especially in a period of economic downturn.

Insurance regulations are usually designed to protect local interests, but in many jurisdictions they are outdated and fail to cater for the business needs of modern international business. Insurance regulators should consider modifying these regulations, to align them with the business models of multinational companies. This could be possible without compromising their local objectives.

Insurance regulators and perhaps the International Association of Insurance Supervisors should play a significant role in addressing the regulatory challenges faced by multinational companies. Our proposed framework on page 27 could be a suitable starting point to address the needs of local regulators, insurance markets, tax authorities and multinational companies.

Proposed framework for international insurance governance

EXCESS/GLOBAL/DIC/DIL* POLICIES PLACED WITH CREDIBLE GLOBAL INSURERS WORLDWIDE TO COVER LOCAL AND INTERNATIONAL RISKS

LOCAL REGULATOR PROVIDES FORMAL APPROVAL FOR SUCH A STRUCTURE ON APPLICATION AND THEREFORE MAINTAINS SUPERVISORY CONTROL

LOCAL ADMITTED POLICY TO THE LIMITS REQUIRED BY THE LOCAL REGULATOR OR NEEDED BY THE MULTINATIONAL COMPANY FOR ITS LOCAL EXPOSURE

* Difference in conditions/difference in limits

This simple framework could result in positive outcomes for all parties. It would enable the local insured to pay its portion of the premium for cover provided by the global overseas insurer; obtain premium deductibility, and pay local premium tax and parafiscal charges on those premiums.

It would also enable the overseas insurer to pay claims for a loss incurred by the local entity of the multinational company. This would protect the local economy as well as the local interests of the company.

Such a framework would provide flexibility and certainty for companies, without compromising the objectives of the local regulator and the status of the local insurance market. The willingness of supervisory authorities to adapt their respective regulations to the changing economic and regulatory environment would engender greater confidence and encourage investment from multinational companies in local economies.

Premium allocation and taxes

If a company's insurance programme is structured to meet local insurance regulations, it should become easier to comply with the local premium-related tax rules – both insurance premium tax and parafiscal charges, such as supervisory and terrorism levies and fire brigade charges.

From a premium tax perspective, premiums relating to global insurance programmes should be allocated by reference to the location of risk. Unfortunately, rules governing the location of risk vary, and depend on the class of risk in question. For instance, property risk is located in the country in which it is physically situated. However, there is often uncertainty over risks related to product liability or directors' and officers' liability. In such cases, the risk is generally regarded as being located in the country where the entity to which the policy relates is established.

As there is no specific rule for allocating premiums, the tax authorities generally expect the allocation methodology to be just and reasonable, and consistent with the underwriting principles. Therefore, the amount allocated would form the basis for determining the tax liability payable in each country by either the insurer or the insured.

Any failure to comply with the local premium tax laws could give rise to interest and penalties in addition to any unpaid tax, for the current period and retrospectively.

Governments around the world are lending to troubled financial institutions. These extra funds have to be sourced from somewhere, so tax authorities are likely to be required to assist by generating higher tax revenues. A significant portion of these revenues will probably be the collection of unpaid insurance premium taxes (plus interest on overdue tax and, where appropriate, penalties).

For instance, in Canada, Korea and parts of the European Union, tax authorities are aggressively targeting multinational companies, requiring them to audit global insurance programmes to recover unpaid premium taxes, interest and penalties. This practice is likely to escalate in all major territories.

What should multinational companies do?

To reduce avoidable costs, such as interest on overdue tax and penalties, multinational companies should adopt a more analytical approach.

- Where is our insurable risk located and can it be covered by a preferred global insurer either on an admitted or non-admitted basis?
- What is the potential maximum exposure in that locality and could the risk be covered by a global insurer at reasonable cost?
- What are the insurance needs locally from a commercial perspective?
- What are the local insurance regulations, and are there any exemptions or dispensations?
- Can the preferred global insurer(s) pay for any losses in that jurisdiction?
- If not, what is the status of any other local insurer and the country in which it is located?
- Would that local insurer be able to provide local limits required and settle claims efficiently?

If the answer to any of these questions is ‘no’ or ‘don’t know’, the multinational should consider alternative strategies, to either overcome some of the regulatory barriers or to minimise the risk to the group. It should also conduct a cost-benefit analysis of the various options to find an optimal solution.

The multinational company should consider the decision tree in figure 11 when deciding on the appropriate structure of its global insurance programme.

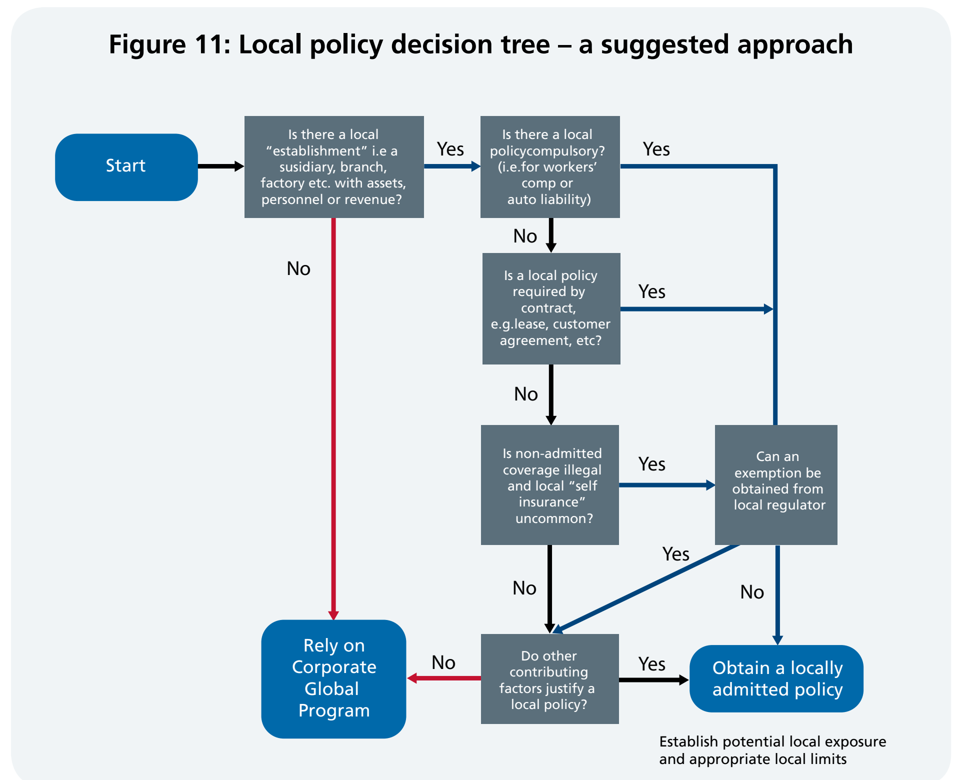


Figure 11: Local policy decision tree – a suggested approach

Typical questions to ask when considering local policies include:

- Is local representation important for legal issues, claims adjusting or risk management consulting?
- Are there important coverage extensions on local policies not available through the corporate programme?
- Can coverage be obtained more efficiently in other ways, e.g. as a good corporate citizen?
- Do you know the insurers' approach to mitigate regulatory and tax risks?
- Is the local establishment a joint venture with capital injection requirements?
- Will the local establishment disregard corporate instuctions and independently purchase local policies?
- Are limits required by contract higher than the local market customary limits or available capacity, which may then require a local admitted policy and excess non admitted (corporate programme) on top of it?

Main issues to consider when setting local policy include:

- evaluate where the risks are located and the potential loss exposure
- determine what level of cover would be appropriate
- confirm where claims will be paid by the insurer and the implications of this (i.e. taxes, legality, etc)
- whether or not the insurers on the programme have the ability to issue a local policy.

Of course 100% compliance may not be possible, or economical. Reasons for this may include the lack of local credible and rated insurers, capacity and limits, and consistent wording. In this respect, multinational companies should ensure that the insurance programme is as compliant as possible – particularly in two scenarios: where the regulatory environment is generally more mature and where the multinational company has a significant activity.

A global insurance programme should achieve a delicate balance between the multinational company's approach to compliance, its insurance needs and the costs of cover. It should be commercial, realistic, practical and pragmatic without compromising the quality of cover required.

Section three:
Trading and risk

Protecting your value chain

Most companies have a 'value chain' which they rely on to provide goods and services for their customers. While it includes conventional supply-chain elements – raw material, vehicles, warehouses and distributors – it is much broader than this, encompassing all the partner contributions, suppliers and systems needed to trade effectively and profitably.

There are always risks associated with a company's value chain, and Marsh advocates a proactive approach to managing them because, even during periods of economic growth, business interruption can severely damage a company. A study by academics Kevin Hendricks and Vinod Singhal analysed supply-chain disruptions at 800 publicly traded firms. They identified impacts that included:

- 114% drop in return on sales
- 107% drop in operating income
- 11% growth in cost
- 13.5% higher share price volatility

However, during an economic downturn old risks are magnified and new threats emerge, so the potential adverse impact increases. As markets contract and credit becomes scarce, key business partners may suddenly face threats to their viability, which could in turn threaten your own ability to trade. Therefore, it is essential to understand your company's key points of vulnerability within the value chain.

Business continuity management has traditionally focused on a company's internal systems, asking questions like 'what happens if our IT network goes down'? Where it has focused externally, it has tended to look mainly at immediate upstream dependencies, such as the manufacturer that supplies the parts used in the company's factory. These are certainly important, but the value chain must be examined from end to end – downstream as well as upstream. The key questions to answer are:

- Where are our points of vulnerability?
- What are the 'at risk' activities?
- How do threats differ across the supply chain?
- What will be their likely impact?
- What are our priorities based on cost/likelihood/risk reduction?

Coping with complexity

Today's global value chains are highly complex. They contain multiple dependencies and suppliers that may be located almost anywhere in the world or – in the case of companies that trade heavily online – in cyberspace. But whatever the nature of a company's markets, the priority is to understand fully your own position in the chain, and the conditions and factors that enable you to operate successfully within it.

The first task is to analyse the key activities that create value for your company, and without which you wouldn't have a business. If your key activity is selling paperclips, it will be essential to ensure a reliable supply of the product. This should not be too difficult, even in a downturn, because paperclips are a commodity, so alternative suppliers will be available even if your favoured manufacturer suddenly goes out of business. However, if you supply specialist products to a niche market, and rely on a single precision manufacturer for parts, your business could be vulnerable if that supplier ceases to trade.

You should also identify the critical relationships further up the value chain and look at the financial viability of your critical supplier's suppliers, because you need to understand how your business will be affected if one or more of these upstream partners goes out of business. It is equally important to understand the financial status of your main customers, because a small customer base can be a point of vulnerability for a company at any time, but particularly during a downturn.

Managing value chain risk

Once you have identified the key points of vulnerability in your value chain, you should develop a strategy for managing your risks and for ensuring your business can recover from adverse events. This is likely to include a business-continuity plan and an appropriately structured insurance plan. However, bear in mind that during an economic downturn the best approach may differ significantly from best practice during a period of growth – particularly in relation to financial risk.

For example, the natural reaction of your procurement team may be to protect the bottom line during a downturn by seeking to reduce the cost of procurement. They may do this by reducing the number of suppliers your company uses, and by negotiating new contracts that squeeze the remaining suppliers on price. Although this will reduce your costs in the short term, it will make it more difficult for your suppliers to trade profitability and will increase the risk of their going out of business. If this happens, and there is no ready alternative supplier, the impact on your company could be severe.

A more considered approach would take account of the financial health of your suppliers, and may extend to supporting one or more of them by paying their invoices sooner. While this may seem counter-intuitive at a time when your own cash flow is under pressure, it could be in your long-term interest if it enables a key supplier to continue trading. In the same way you need to consider

whether to encourage your own customers to pay you promptly, if necessary by tighter enforcement of their contractual terms and conditions, or help them by extending additional credit. With trade credit becoming increasingly difficult to obtain, prompt payment for the goods and services you provide is important.

The priority is to take all reasonable steps to protect the overall health of your value chain, and not just the financial health of your company. As part of this process, it is important to engage in dialogue with your suppliers and customers. By improving communication between members of the value chain, it is often possible to achieve synergies that are not possible simply by rigidly enforcing contractual terms and conditions, or by relying on insurance when things go wrong.

No one can predict how severe the present downturn will be, or how long it will last, so it is important that your value-chain analysis looks beyond the objective of simply ensuring 'business as usual'. It should also consider questions such as 'at what point might we need to reduce headcount?' and 'if we can no longer source sufficient raw materials, might there come a point when we need to mothball part of our production capacity?' If you decide that these are realistic scenarios, your strategy should include contingency plans to deal with them, and trigger points for implementation.

Any time you spend assessing the risks and points of vulnerability in your value chain will be worthwhile. The more rigour you apply to the process the better. Our recommended approach is a three phase programme to:

- map your value chain to identify your critical dependencies and risk
- audit critical suppliers, assessing their exposures and their management of risk
- create robust contingency and business-continuity plans for key activities.

By applying a level of rigour to an analysis of your whole value chain, you will give your company the best opportunity to survive the downturn with your critical dependencies and key partnerships intact.

Maintaining a resilient business

For many organisations, 'resilience' is about maintaining the status quo, and – when things go wrong – being in a position to replace like with like, usually through insurance. Historically, the concept has been closely associated with several key areas, including:

- the reliability of IT networks, particularly within banks and other financial services organisations, which require constant availability
- the ability of these networks to be recovered quickly, with little or no business interruption
- the vulnerability of public infrastructure – such as road, rail and air networks
- the measures required to protect them, and to repair infrastructure rapidly in the event of damage.

However, it is wise to avoid narrow definitions, because resilience can mean different things to different organisations, as in the cases of Companies A and B in the following example.

Company A is committed to manufacturing in the UK for the foreseeable future, and so has comprehensive insurance cover for its UK factory, which will replace old for new in the case of fire. Company B has long-term plans to move its manufacturing to the Far East, and so insures only for the immediate loss of plant and inventory in the UK. Furthermore, unlike Company A it does not invest in state-of-the art fire prevention measures, relying only on the minimum precautions to meet health and safety and insurance requirements. For Company B, 'resilience' in the event of a catastrophic fire would be the ability to transfer its production capability abroad, in line with its business goals.

As this example shows, careful thought needs to be given to precisely what 'resilience' means for your own organisation. In broad terms it clearly takes account of all the main risks facing an organisation, and how these relate to its strategic objectives. This holistic approach is particularly advisable in an economic downturn, because it will provide clarity in situations where senior managers are required to make difficult decisions under pressure.

Understanding your risks

Other sections in this document set out various approaches to analysing the risks and inter-dependencies within an organisation and its value chain, and to setting appropriate limits of liability. These approaches should underpin any decisions you take about what resilience means to your organisation. This might be a quicker process than you anticipate, because many companies will find they already have most of the analysis needed, although they might not have pulled it all together to gain a holistic view of risk.

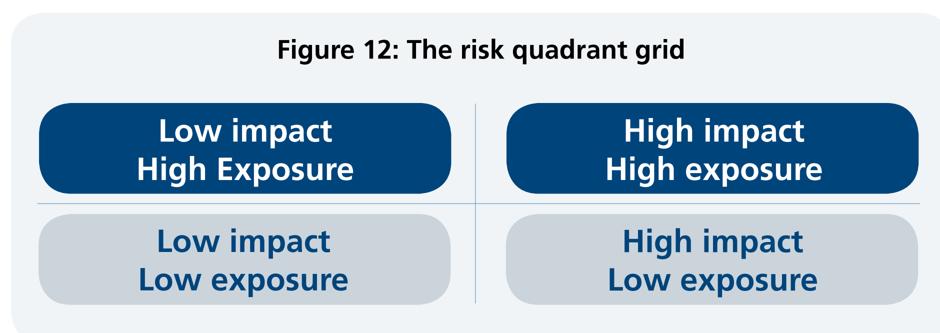
For example, Company A has historically assumed that resilience depends on its ability to ensure business continuity. It therefore invested heavily in ensuring it can swiftly recover plant, inventory, IT networks and other physical assets. It did not include financial risk within these plans, because it viewed finance as belonging to the treasury function and therefore outside the remit of the business-continuity team. However, during a credit crunch, finance might rapidly become a business continuity issue if Company A relies on the ready availability of cheap credit. This is particularly true for financial services companies, whose 'raw material' is cheap credit. It is a problem that arises particularly in organisations that see risks as existing in silos, and fail to indentify the interdependencies between areas such as finance, health and safety and operations.

The process of pulling together the necessary information about risk from different parts of the organisation will not necessarily be onerous. It is possible that a small group of key people might be able to make the right decisions by answering the following questions:

- Which activities and assets are crucial to our business?
- How exposed are they (are they at risk and how well are they protected)?
- What investments do we need to make to protect these things?
- What do we need to know to make informed investment decisions?
- Do we already know these things, and how much can we rely on this knowledge?

When setting priorities for ensuring resilience, we suggest asking an adaptation of the classic risk quadrant grid (figure 12) to consider the exposure of your activities and assets.

Figure 12: The risk quadrant grid



If your organisation has any risks in the top right-hand quadrant then it is usually best to address them immediately, before proceeding with any further analysis, because these are most likely to affect your business resilience. Once steps have been take to mitigate them, look next at your risks in the bottom right-hand quadrant. Events such as the Buncefield oil depot disaster in the UK fall into this category – extremely rare, but having a severe impact on many of the organisations directly affected.

This process of risk analysis and mitigation is fundamental to ensuring business resilience in terms that match your organisation's strategic goals, and may also result in other long-term benefits. These are described in other sections of this document, but they may include:

- more efficient investment in risk management
- lower overall cost of risk to the business
- optimised risk retention levels
- more appropriately structured insurance programmes
- being viewed as a 'good' insurance risk by underwriters
- being viewed as a 'good' credit risk by lenders.

Risk as opportunity

Organisations should scrutinise their business plans and identify any aspects that are no longer valid in the economic downturn, or have become too risky. As a result, they might find they have to shelve plans for investment and expansion. Some of these plans may already be well advanced, with people and resources in place ready to implement them.

Inevitably, hard decisions may need to be taken in the area of human capital. However, it is always worth considering how employees and resources, freed up by changed priorities, might contribute to the organisation's overall resilience. For example, Company B was planning to make a business acquisition, and so recruited a team to run the project and manage the new area of the business. Although the credit crunch caused the deal to fall through, Company B decided to redeploy its acquisition team to work on business continuity planning. It reasoned that this would reduce the cost of risk in other areas and increase the company's overall resilience during the downturn. Another consideration was the need to retain high-quality employees, putting the company in a stronger position to respond rapidly to renewed demand from customers when the downturn ends. This type of reasoning might apply to any resource freed up by changed priorities, including capital, plant and premises.

Conclusion

The priority is to determine what resilience means to your organisation, and to keep this front of mind as you review your risk analysis and business continuity plans in the light of the downturn. Then immediately deal with your high-impact, high-probability risks, because these are most likely to affect your resilience. Finally, focus on the potential impacts of your risks, and only consider the causes insofar as they help with mitigation. In short, don't worry about things you can't control. The global financial crisis and the resulting credit crunch are hugely complex issues that no one fully predicted. They only matter to your organisation as sources of risk. Beyond that, be prepared for uncertainty, because it might present unforeseen opportunities.

Prepare to seize opportunity

The articles in this report have identified a number of practical steps that could improve a company's resilience in the face of this period of economic downturn. These steps could easily improve a company's performance in the best of times, but in a recession they could have an impact on a company's ability to survive. Confident companies have already demonstrated that even in such hard financial markets, opportunities can be found – specifically in the acquisition of businesses that were not robust enough to withstand the economic shock waves.

The current economic crisis has highlighted interdependencies across many areas of global risk. For example, a decline in manufacturing has led to a downturn in demand for recycled materials. What impact will this have on efforts to manage environmental risk? And the collapse in oil prices, again partly in response to falling manufacturing requirements, and to a slowdown in emerging economies, could lead to an increase in geopolitical risks.

This final article revisits each of the risk areas highlighted in the previous sections, and provides a summary of the elements that constitute the risk, the response and the possible outcome. While the economic crisis is at the forefront of our attention now, the issues of climate change, environmental risk, terrorism and energy production and consumption have not gone away. The ideas and solutions presented here could be just as valuable in helping companies protect themselves against these, and other emerging risks.

Setting the correct risk financing strategy

When buying insurances, many companies either set their purchasing requirements on what they bought last year, or on what underwriters charge for their protection (the premium). In doing this, those companies are ignoring two critical aspects: no company's risk profile is the same year on year, and the cost of recovering from a risk-related incident is increasing.

A company might be buying too much insurance, and so wasting money on protecting itself against risks it may not have (or not insuring against risks it does have). Conversely, a company might reduce the level of protection it buys against certain risks, because that particular line has become more expensive. But the risk hasn't gone away, and a claim could end up being greater than the insurance limit purchased.

Both cases illustrate the need for an inspection of operations, an audit of external factors and a review of managerial 'appetite'. The most efficient use of capital for insurance and other risk management costs will result from an optimised understanding and response to these three areas. Organisations that have not already addressed this process will almost certainly benefit from an overall reduction in their total cost of risk if they were to optimise their approach.

Being pro-active with captives

A well designed captive insurance programme gives companies greater control over risk financing and, in the longer term, can significantly alter the way in which a company buys insurance. Risk and expense control are now vital as insurance costs rise and insurer security is questioned. Pro-active companies will be able to configure their captives to respond quickly to changing market conditions, lessening their impact on the business. A long-established captive may have capital available to use against additional risk. But in an environment where 'cash is king', those funds could be seized upon by the CFO who is focussed on ensuring that all available funds are used to support the parent's core business.

Companies without a captive may experience difficulties in obtaining cash to set one up. Should funds be available, it will be important to identify and develop appropriate adaptation and exit strategies. How will the changing regulatory environment impact on the effectiveness of captives?

Captives can help companies navigate their way through the current economic downturn and beyond. To do so, companies must use captives appropriately, factoring in any new dynamics, volatility or changed appetite for risk.

Insurance protection for credit

Trade credit insurance is available to protect firms against the impact of bad debt or late payment by their customers. In the past this has been a relatively easy line to access, but today underwriters are increasingly cautious, demanding more information and transparency to enable them to assess with greater rigour the financial status of all risks.

Accessing trade credit insurance today will be tough, but those firms who have been successful will have demonstrated a high degree of risk attentiveness and governance in their business. Financial institutions tend to view such insurance as a suitable guarantee or security to support funding, overdraft facilities and re-financing packages.

Despite the current economic climate, insurers are willing to engage with well-run and well risk-managed organisations, who can accurately assess, review and understand their exposures across all corporate lines.

Protecting directors and officers

During an economic downturn, directors and officers face an increased risk of claims being made against them. These could result from missed earnings projections, or difficulty in meeting loan obligations – in both circumstances directors and officers could find themselves the subject of lawsuits. Greater and more rigorous scrutiny from regulators also increases the risks to senior personnel. Directors' risk also increases significantly when their company raises capital or issues debt publicly. Directors' and officers' (D&O) insurance can provide some safeguards.

Those companies able to demonstrate a proactive approach to managing their D&O risk, will be better placed to minimise the cost of cover.

Monitoring for new litigation trends

Marsh is already seeing an increase in the number of claims by financial institutions as a result of significant shareholder and borrower disputes. As capital becomes scarce, it is likely that claimants will give more thought to the identity (and solvency) of the defendants against whom they bring claims. Financial institutions, once at the top of the 'liability food chain', may not be the 'attractive' target they once were. The hunt for liability may in the end turn to individuals, as the only place where cash may be available.

In time, national regulators around the world will announce their coordinated response to this financial crisis. Companies which are proactive in responding to these regulatory developments are likely to be those that survive and prosper.

Accurate liability limit setting removes waste

Setting an inappropriate level of insurance cover could result in either wasted capital or an uninsured loss. Although there are many approaches to assessing appropriate insurance limits, a common requirement in all cases is to understand fully the volatility and uncertainty of the risks.

Industry peer analysis is a good starting point to establish a probable spread of limits, but the limits indicated will not relate directly to the organisation's own risk, exposures and specific circumstances.

Modelling techniques can provide a more rigorous approach, but can only be effective if data about a company's understanding of its risk is accurate and complete. The process will help to avoid over or under-insuring, and determine an appropriate price for the risk being placed.

Considerations for international insurance

As regulators evolve local frameworks, multinational companies are increasingly interested in insurance regulation and tax compliance, particularly in emerging economies.

Insurance regulations are usually designed to protect local interests, but in many jurisdictions they are outdated and fail to cater for the business needs of modern international business. Rules governing the location of risk vary, and depend on the class of risk in question. This will have an impact on where a claim can be paid. In addition, a failure to comply with local premium tax laws could result in interest and penalties in addition to any unpaid tax.

A more analytical approach to programme design would help avoid any additional costs.

Protecting your value chain

During an economic downturn old risks are magnified and new threats emerge, so the potential adverse impact increases. Key business partners may suddenly face threats to their viability, which could in turn threaten your own ability to trade. A full audit of internal and external vulnerabilities will help to establish the weaknesses and aid preparation for managing points of failure.

This audit would take the form of a business-continuity plan and an appropriately structured insurance plan. The priority is to take all reasonable steps to protect the overall health of your value chain, and not just the financial health of your company. Counter-intuitive decision making could suddenly make sense.

By applying a level of rigour to analysing your whole value chain, you will give your company the best opportunity to survive the downturn with critical dependencies and key partnerships intact.

Remain resilient

Organisations first need to agree what 'resilience' means for them. Problems can arise for organisations that see risks as existing in silos, failing to identify the interdependencies between areas such as finance, health and safety and operations. Questions need to be asked to determine the activities and assets which are crucial to the business, how exposed are those assets and activities, and what investments do we need to make to protect them?

This process of risk analysis and mitigation is fundamental to ensuring business resilience in terms that match your organisation's strategic goals, and may also result in other long-term benefits. Focus on the potential impacts of your risks, and only consider the causes insofar as they help with mitigation.

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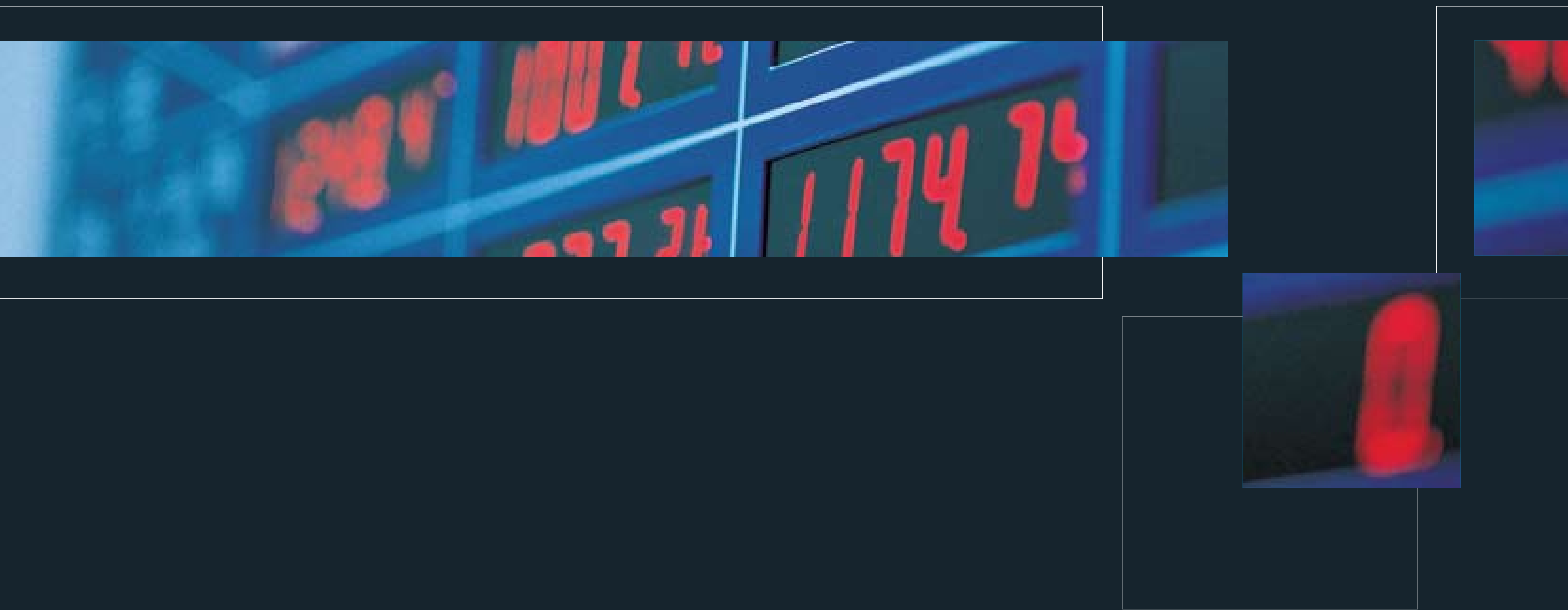

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