ACE European Risk Briefing

Emerging risks, global challenges

Emerging risks are bringing the world to the boardroom door

ACE risk research

95%
of European firms have become more concerned about multinational risk over the past five years

50%
of businesses surveyed say they feel unprepared to manage multinational risk

The world economy has entered a new phase of globalisation. The upheaval caused by the Eurozone crisis and slow recovery in the US have only served to further stimulate a flight from the more mature markets as companies seek growth and profits in emerging regions.

Trade and investment flows are already shifting inexorably towards the new economic powerhouses in Latin America, the Middle East, China and India. Corporates are extending their global reach, keeping one eye on the investment opportunities and the other on protecting the balance sheet.

Navigating these new overseas threats has placed risk management firmly at the boardroom door and it continues to climb the corporate agenda. Our recent research with over 600 European businesses finds that an overwhelming 95% have become more concerned about multinational risk over the past five years. Natural catastrophe losses, the financial crises and a greater dependency on overseas earnings are driving these concerns, according to our research.

Mitigating risks

The scale of exposures has soared dramatically in the past decade. The exceptional number of natural disasters over the past two years – from New Jersey to New Zealand – has also tested the resilience of the global supply chain. The knock-on effects of an earthquake in Japan can now shut down or delay production lines in factories thousands of miles away.

The aftermath of superstorm Sandy has again highlighted the risk of business interruption. However, we are learning from these experiences. Lessons are now being put into practice from the Thai floods and the earthquakes in New Zealand and Japan.

Catastrophe models are being constantly refined and so are crisis preparations. Days before Sandy struck the eastern US seaboard, major contingency plans were put in place by state-run agencies to mitigate the risks. Many lives were saved because of these preventative actions.

Volatile society

Man-made catastrophes can be just as market-changing. Volatility in financial markets has led CFOs to review their exposure to all kinds of counterparty risk and 'systemic risk' has become part of the financial lexicon.

At the same time, however, the Costa Concordia tragedy in Italy has proved that – 100 years after the Titanic struck ice – man and his machines remain fallible. The Arab Spring and European riots have also heightened the awareness of unrest closer to home, while multinational companies with foreign assets must remain vigilant to attacks from extremists and cyber terrorists alike.

Unlike some other areas of the financial services industry, however, the insurance industry has shown resilience, reflected by the amount of capital still attracted to the sector. Despite record natural catastrophe losses, balance sheets remain robust and capacity remains available for clients. Business as usual has continued, largely uninterrupted by the financial crisis.

"It is essential for a company's board to have an oversight of its risk appetite, regularly audit its risk profile and consider emerging risks that could be on the horizon"

Robust solutions

In this increasingly turbulent operating environment, it is undoubtedly essential for a company's board to have an oversight of its risk appetite, to take clear responsibility for regularly auditing its risk profile, and to consider and discuss the 'black swans' and emerging risks that could be on the horizon. A risk culture can only be sustainable throughout a global organisation if it is engrained in the business from the very top downwards.

Compelling new evidence also highlights that a risk-aware culture is linked to secure long-term profitability. This was the message from recent research by FERMA, the leading European risk management association. They found that 28% of companies surveyed across 20 countries had reported 10% growth in EBITDA in the past five years after implementing advanced risk practices. It is unclear whether risk culture actually drives profitability, or whether both are simply the result of a well-run company. Nevertheless, the correlation is notable.

Finding the right insurance partners is also crucial to mitigating risk effectively. Insurers and brokers with a good mix of global capability, local knowledge, and an understanding of the emerging risk environment are increasingly valued in today's environment. I certainly believe the insurance industry can and will be a powerful partner in the development of answers to Europe's emerging risk problems and at ACE we are continually building out our capabilities and our risk expertise to make sure we are part of the solution.

Andrew Kendrick
Chairman, ACE European Group

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www.acegroup.com/eu
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The Arab Spring and unrest in Europe has led senior executives to feel more vulnerable to terrorism and societal risks. Without adequate protection, political violence can seriously disrupt business operations, says Matthew Shaw, president, ACE Global Markets.

Terrorism tops Europe's risk list

Political violence insurance policy wordings have always been broad and coverage is generally sold as part of a comprehensive programme. More than ever, it is important for European businesses to check and understand exactly what they are buying.

For example, the business interruption (BI) element of any cover may not be included, but can prove invaluable. In many cases clients suffer a very small property loss but because a whole business district has been shut down, the costs generated by BI claims are actually far higher than the property damage.

Multinationals should be careful that they are purchasing the right policy for their business. This means understanding the differences between political violence cover and a terrorism policy.

A common misconception is that companies believe they are covered for political violence by an existing terrorism policy. In most cases they are not, however, and any gaps in protection are only exposed if and when a claim is made.

The Thai demonstrations in 2010 highlighted the issue. Strikes and riots in Bangkok were deemed to be civil commotion, despite high profile legal cases that attempted to have them labelled as terrorism. By making the distinction, people were unable to claim on their terrorism policies – political violence cover was needed too.

There are no one-size-fits-all solutions. Each terrorism attack and outbreak of political violence exposes new threats. Understanding the local territory and being adaptable to any crisis is imperative for global businesses working in the modern geopolitical landscape.

32% of European companies surveyed by ACE believe terrorism and political violence is an important risk to their own business

> **"Social unrest is becoming a global phenomenon and recent events have forced clients to reassess their approach to the threat of terrorism and politically-motivated civil unrest"**
>
> Piers Gregory, ACE terrorism underwriting manager

Business interruption

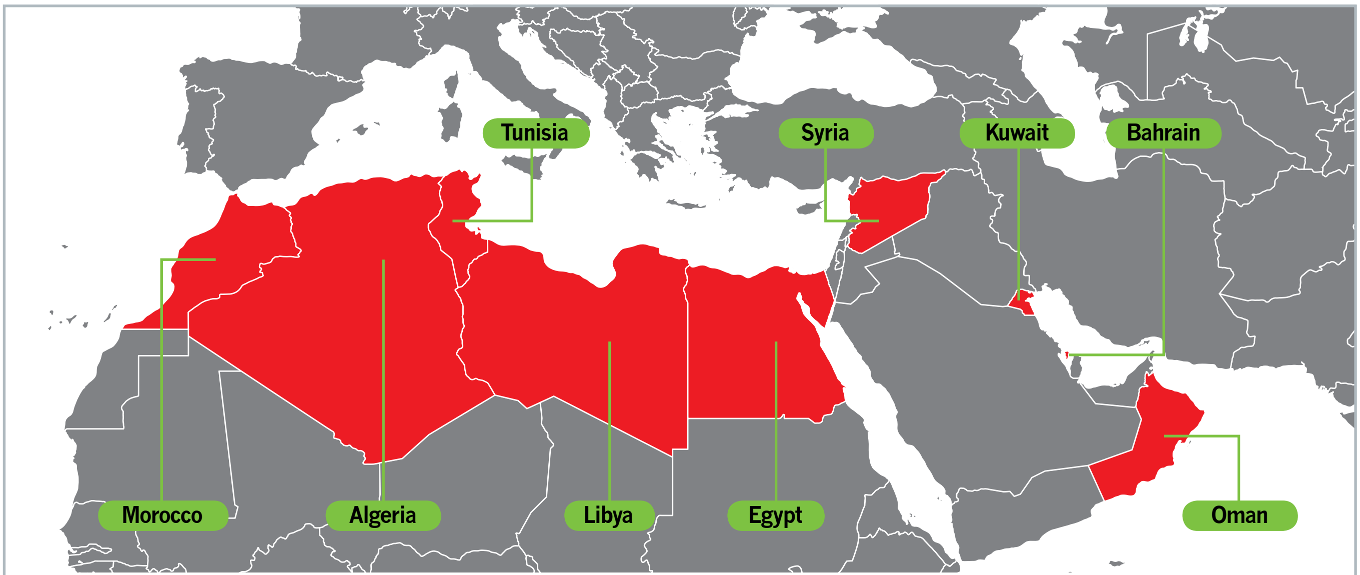
Companies with operations that have suffered only a small property loss may find a whole business district has been shut down, causing huge business interruption losses...

1. Business interruption may not be insured in the absence of property damage

2. Unrest can mean services and supply and distribution do not work

3. Customers may stay away even if the premises are undamaged

4. Staff and delivery vehicles may be unable to reach the premises



Of the ten states with the fastest increasing political risk profiles, nine are located in the Arab world, reflecting the political upheaval and unrest taking place in the region

Source: Maplecroft Political Risk Atlas, 2012

Buyers of terrorism insurance can consider four main coverage options:

- ✔ terrorism only
- ✔ terrorism and strikes, riots and civil commotion
- ✔ political violence, excluding war and civil war
- ✔ comprehensive political violence.

Political violence vs civil commotion – two separate risks, usually covered by separate insurance policies

Thailand – Strikes and riots in Bangkok in 2010 were classified by insurers as civil commotion, despite attempts to take the matter to court and have them labelled as terrorism. By making the distinction, people were unable to claim on their terrorism policies – they needed political violence cover too.

44% of European firms say terrorism and political violence will become a greater threat in the next five years

Environmental risks are no longer only a concern for the traditional polluting industries. Companies of all types are increasingly seeing the cost of reputational damage affecting their balance sheets just as seriously as the environmental loss itself.

Changing environment will bring new exposures

> **Firms are increasingly seeing the cost of reputational damage affect balance sheets**

In October 2012, oil giant BP was finally restored to fifth place in the league table of global oil companies.[1]

Yet back in 2010, as the international media beamed images of the Deepwater Horizon disaster and the subsequent ecological devastation to the natural habitat, the company's share price had nose-dived by 40% and its global ranking plunged overnight to 118th in the world.

Under the constant glare of media scrutiny, management paid the ultimate personal price for the disaster. Meanwhile, the overall cost of the clean-up of environmental damage has been estimated at $7.8 billion and it is taking time rather than money to re-establish the company's brand integrity.

"Business interruption and reputational damage resulting from environmental exposures can have a devastating impact on the balance sheet of any company," says Tom Hillier, environmental manager for UK & Ireland at ACE, "and businesses need to protect themselves against the full range of risks."

No sector should ignore the risks

ACE's research in Europe confirms that environmental issues are climbing the corporate risk agenda, with sectors outside the 'traditional polluting industries' becoming more aware of these new liabilities. Environmental risk is now the number two emerging issue (after terrorism and political violence). In fact it is the top emerging concern for companies in the UK (38%), France (33%) and mid-sized companies across Europe generally (35%) – it's not just a worry for the largest corporations any more.

Over the past decade, society's attitudes, coupled with major legislative changes, have pushed the issue firmly into the boardroom. Despite this growing awareness, barely half the companies participating in the ACE research feel prepared to deal with the growing number of environmental risks – and one quarter believe they are totally unprepared.

Legislation has had a major impact. Today, it is estimated that there are over 250 separate pieces of legislation that have a direct impact on the UK alone. There are more than 3,460 new environmental regulations awaiting attention from legislators and regulators around the globe.[2] The European Liability Directive (ELD), in particular, has significantly changed the exposure of European companies, especially for those in central and eastern Europe, which had faced less stringent requirements in the past.

This all creates a major challenge for a company operating in Europe. A recent survey by FERMA, the leading European risk management association, found that many companies are unaware of how the ELD will affect them in the countries where they operate. Only 56% said they knew how the ELD had been transposed into law within each EU state.

Take the right steps

For European corporates, plugging these gaps can be a bureaucratic and legal challenge. Though awareness is now improving, there is a need for more robust solutions to ensure that the financial repercussions of transgressing new environmental rules are successfully mitigated.

"An important first step is to conduct an environmental risk audit," advises Dorothée Prunier, environmental manager for Continental Europe at ACE, "to understand where exposures lie and pinpoint where action is needed to cover the gaps. One of these may be in the area of insurance, where claims can fall outside the scope of a standard property or liability policy. With a third of European companies lacking or unsure about environmental insurance cover, our research suggests that the insurance market needs to do more to raise awareness of the risks and the solutions available."

ACE risk research

55% of European companies expect the level of environmental risk to increase over the next five years

52% have crisis management procedures in place to deal with an environmental incident

Sources: [1]Platts [2]Enhesa

Travel is an integral part of most managers' jobs and, as European companies seek revenue growth outside their misfiring home economies, the destinations are becoming increasingly exotic. An ACE research study confirms business travel to be among the most important risks.

Taking care of core assets

The majority of European companies believe that the level of business travel risk their company faces will grow over the next five years, with a quarter thinking it will increase significantly, according to ACE's research study in Europe.

In particular, many European companies are concerned about the compliance implications of international business travel. Overall, 71% of mid-sized companies and 65% of larger companies say they are worried about the regulatory and tax consequences, in line with an increasingly proactive approach to compliance on the part of many national supervisors and enforcement authorities.

This research is published at a time when travel industry experts forecast that spending on business travel in Europe is set to pick up again in 2013.[1] The number of 'global nomads' – employees who move from country to country on multiple assignments – is also reported to be on the rise.[2]

The research also shows that new business travel 'claims hotspots' are developing as European companies build their overseas revenues. Over half of European companies identify either 'Asia and Australasia' (27%) or 'South America' (27%) as the region most likely to generate an insurance claim from their own experience. By comparison, western Europe is rated a claims hotspot by fewer than 5% of companies. "With the shift to emerging markets gathering pace, we expect this trend to continue," says Jeff Dowling, chief underwriting officer, Accident & Health for UK and Ireland at ACE.

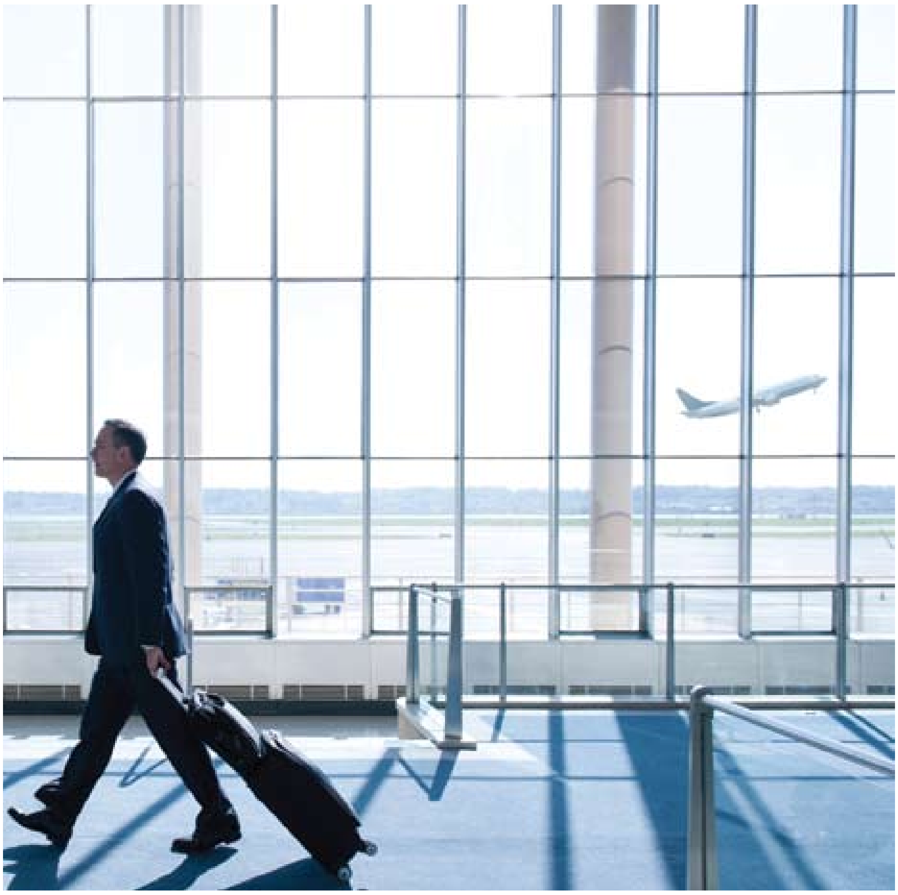
Wide variations

Currently, 67% of European companies surveyed say that they are satisfied with the way their business travel claims are handed by their insurer. However, the level of satisfaction varies widely by country. In the UK, almost 90% of respondents say that they are happy with the claims process, but this proportion falls to 58% in Germany and 52% in France.

"Traditionally, companies have tended to put in place one single insurance policy to cover their business travel globally," says Dowling. However, this might not always be the best or most compliant approach today, he believes. "Whether or not a claim for medical expenses can be paid to a European employee who falls ill in an emerging market where the insurer is unlicensed, for example, will depend on local laws."

ACE has recently seen increased interest from companies in developing comprehensive multinational insurance programmes that reflect their specific exposures, says Dowling and these "give reassurance that the policy will perform when their employees most need it".

> **"A single insurance policy to cover business travel globally, might not always be the best or most compliant approach today"**



Sources: [1] Global Business Travel Association, 12 June 2012
[2] Mercer Consulting, 31 July 2012

The global financial crisis has dramatically increased the severity of risks that individual directors and officers face. European businesses need to understand how to protect senior executives in today's corporate environment, says Suresh Krishnan, general counsel, multinational client group, ACE Group.

When risk gets personal: protecting your directors and officers across borders

Europe's companies believe that the personal liabilities their senior people face are growing.

In research completed by ACE with 600 businesses across the region, nearly 70% say that managing liability risk is an increasingly important issue for every 21st century company director.

This is a belief supported by recent regulatory and legal developments. It is now a year since the UK Bribery Act came into force. Significantly, while the Act made it a criminal offence to give or receive a bribe, it also introduced a corporate offence of failing to prevent bribery.

The potential for culpability to reach beyond a director's or officer's own actions to those of others is also under the spotlight. Recent allegations against a large global retailer headquartered in the US, for example, have focused on whether its managers in Mexico made 'improper payments' to secure the company's presence in the country and have led to accusations of a 'cover up' implicating the company's own board of directors.

A more litigious world

In an increasingly interconnected and arguably more litigious world, understanding the personal exposures of directors and officers presents a particular challenge for multinational companies. After all, the extent of these individuals' duties, the range of potential lawsuits and the regulatory landscape varies widely from country to country.

How can multinationals navigate the increasingly complex web of requirements? First, it is important to understand that a typical insurance policy for directors and officers (D&O insurance) is actually a bundle of different coverages protecting distinct parties against different types of liability.

The first and most established type of cover is a form of balance sheet protection that provides insurance to a company when it is required to indemnify its directors and officers for claims made against them. Most corporations agree to indemnify these individuals (where permissible) to the fullest extent legally allowed. But make no mistake, this type of protection (known in market speak as 'Side B insurance') is intended for the company, not its people.

In the 1990s, the insurance markets introduced a new type of coverage for a company's exposure to securities litigation. This is now also a standard part of most D&O policies, known as 'Side C insurance'. But this is really another form of balance sheet protection. An individual need not even be named in the litigation to trigger the claim.

What happens, then, in circumstances where a corporation is unable or unwilling to indemnify its individual directors and officers against their personal liability and defence costs?

One example might be a claim made against an individual when a corporation is insolvent or in bankruptcy proceedings and not permitted to pay legal expenses or indemnify claim payments incurred by its directors or officers. Another could be where a corporation is forbidden by law from indemnifying its directors – which is often the case with shareholder derivative litigation. This type of claim may occur less frequently than a Side B or C claim. But it certainly has the potential for catastrophic personal liability.

ACE risk research

70% of European firms say managing liability risk is important for every company director

This is where all-important 'Side A insurance' comes in, designed to provide individual directors and officers with a safety net against financial loss from personal liability. Indeed, many directors and officers see this as the most valuable D&O insurance because of the personal asset protection it provides.

Multinationals need compliant programmes

But in the case of multinational companies, structuring a compliant programme to manage its global D&O risk is never simple. And if a D&O programme is not designed thoughtfully, two main areas of risk begin to emerge for a company and its directors – ultimately threatening the security of their personal assets. These are execution and compliance risk.

The key to mitigating both risks is to ensure that the programme is carefully customised to manage each of the three sides of D&O insurance effectively by clearly distinguishing how the programme will work in practice. This means looking closely at how the three types of D&O coverage operate in connection with where the risks are actually located.

By focusing on these two themes, companies may ensure that their directors

Directors in the dock: executives face greater litigation in overseas territories

and officers are appropriately protected and mitigate unintended (and unwanted) scrutiny from tax and regulatory authorities.

Traditionally, many insurers have tended to issue a single global insurance policy to the parent company in the parent's jurisdiction. This is designed to insure the parent's directors and officers as well as those of its foreign subsidiaries, affiliates and joint ventures.

However, certain countries, including the BRIC economies and Mexico, Japan and Switzerland, either impose strict conditions on foreign companies or persons operating within their borders – or prohibit the purchase of coverage for local risks from insurers not licensed there. In such cases, the company can mitigate this compliance risk by purchasing local policies covering all three areas of D&O risk in addition to a master parent policy.

But this does not eliminate the execution risk. Distinct classes of insureds may actually be competing for a finite amount of Side A insurance capacity and individual directors could be left with no coverage at all for these claims. This is because claims made under Side B and Side C insurance will typically begin to exhaust the cover before the Side A claims start to materialise.

To effectively address this problem, a company may opt to include a provision in the master policy that it will respond in the event of more restrictive local conditions. Where overseas affiliates are allowed to arrange cover with non-admitted foreign insurers, they too can have comprehensive insurance under the master policy. Where this is not permitted, the master policy should expressly exclude coverage of these local affiliates. The master policy can still provide Side B and Side C insurance to the parent in respect of its insurable interests in its local affiliates. The critical Side A coverage may then be purchased separately and locally, in accordance with local regulations.

Conversely, a poorly structured programme could inadvertently provide coverage that is not actually permitted under local regulations. This exposes the company, its insurer and broker alike to potential liability.

If the mechanics sound complicated, risk managers should not despair. The principles of good risk management can be summarised by two thoughts. First, it's as 'easy as ABC' – multinationals simply need to understand the three sides of D&O coverage and how they interact. Second, what matters is 'location, location, location' when it comes to managing local compliance risk.

The bottom line is this: in today's increasingly complex business environment, the traditional, single 'packaged' protection of various standard D&O policies may be subject to challenge – either from a company's directors or officers who understandably expect certainty or from local regulators who demand compliance. It is only by separating the respective elements and understanding their interplay that a multinational company can protect itself and its people adequately.

> **"The range of potential lawsuits and the regulatory landscape varies widely from country to country"**

Prevention is key

In short, although the challenges can initially appear daunting, they can be overcome with forethought, consultation and expertise. With multinational insurance there are no simple solutions to complex problems, but there are concrete steps an enterprise can (and should) take to implement a materially compliant insurance programme.

The stakes of getting it wrong are undoubtedly high. At worst, a multinational D&O programme not tailored to specific needs could leave a director or officer exposed to substantial personal liabilities that could have otherwise been covered by Side A insurance.

Addressing the myriad challenges facing the 21st century boardroom means placing a risk management culture at the heart of the business.

Always prepare for the unexpected

The financial crisis exposed crippling deficiencies in many companies' risk management practices. Many continue to struggle to find the right risk management model.

According to ACE research, the CEO or COO has a formal role and responsibility for managing risk at slightly more than half of the European companies participating.

This could be viewed as surprisingly low. Although senior management may not be involved in the day-to-day intricacies of managing risk, it is essential for them to have the oversight of where risk lies in the organisation and the company's risk appetite. Boards should also have an understanding of potential new and emerging threats, including political, environmental, social and technological risks.

> **“A high profile incident can cause intense media scrutiny...effective communication is essential during any crisis”**

Disaster planning for any crisis

The worldwide upheaval brought by the Arab Spring caught many companies unaware. Suddenly, entrenched regimes were overthrown and the social unrest that quickly swept the region destabilised many multinationals' operations and supply chains. The worst case scenarios that keep executives awake at night were realised.

When a major disaster strikes, the priority of any company is the health and safety of staff and, in particular if they are abroad, getting them to a safe haven. Jeff Dowling, chief underwriting officer, Accident & Health for UK and Ireland at ACE, says: “Assistance should work 24/7 and must be incredibly flexible, working under whatever constraints clients face, whether that is a riot or the resulting transport disruption.”

He explains that during the Arab Spring, one client had a number of people stranded in Port Said in Egypt who faced a life-threatening situation. Ferries and flights were cancelled and violence was escalating, so all the stranded travellers were taken to one hotel and contact was maintained while problems with transport arrangements and travel documents were resolved. As flying out of Port Said was impossible, the decision was made to travel by road to Cairo with a trained escort, where a chartered plane was waiting for them. “Insurance provided cover for them every step of the way and allowed us to bring in the security experts needed,” says Dowling.

ACE risk research

>50% of European companies surveyed felt unprepared for most of the key risk categories

Good communication is good management

Effective communication is essential during any crisis. A high-profile incident can generate intense media scrutiny, and any mistake can be costly. Indeed, the reputational cost of many disasters may be hard to quantify objectively but is often higher than that of the physical event itself.

The vagaries of the modern world can inflict catastrophic pain on a corporate's long-term profitability for the most obtuse

reasons. If an employee decides to let off steam against a colleague or senior manager via Facebook or Twitter, this can suddenly 'go viral' and be splashed across newspaper headlines. Increasing attacks by the growing number of anti-capitalist groups (or hacktivists) is causing cyber liability to become a major concern, especially if the companies rely on outsourced suppliers to maintain and hold sensitive data.

Furthermore, shareholders are becoming less patient: if a company does not have an effective PR machine behind it to smooth out any embarrassing stories or manage a disaster, then they may demand change.

Pick the right partner

Preparation is an integral part of the overall risk management process. Gaps in the overall provision, whether relating to physical support, media management or brand reputation, can be covered, potentially saving a business from financial ruin. Working with experts who can develop a bespoke global programme to a client's specific needs will help mitigate the overall claims costs post event. Proactive risk management allows a corporate to react quickly because, in the middle of crisis, senior executives have plenty of other things to be thinking about.

Building a multinational insurance programme

Multinationals trading across multiple borders need comprehensive and compliant solutions to protect their assets in today's more aggressive tax and regulatory environment.

"The financial crisis and the resultant focus on corporate governance has highlighted the need for organisations to purchase compliant programmes," says Suresh Krishnan, general counsel at ACE's multinational client group. "From a fiscal perspective, based on recent tax and regulatory scrutiny in India, Brazil and the USA, there is a greater incentive to consider how cross-border insurance is procured, and to plan how to manage the performance of the insurance across national borders," he adds.

Insurance buyers are under increasing pressure to ensure that their multinational programmes are properly constructed. A complex array of laws and regulations means that multinational programmes will often rely on a master policy to ensure there are no gaps in the coverage or limits within the local policies.

Local knowledge gives global understanding

Krishnan says a local presence needs to be combined with good management and communication across a network. "A presence with local teams, and if necessary local counsel, gives clients feedback and information that is relevant and timely. Questions coming from London or Paris about a programme placed in India or Brazil, for example, can be promptly referred back to the teams in that country."

Multinationals should carefully consider exactly what they want the policy to respond to while the programme is being designed and constructed at the pre-inception stage, rather than wait for the consequences of a major event.

Key questions for risk managers to answer when considering a multinational programme

- ✔ Is the local coverage adequate?
- ✔ Is the local limit adequate?
- ✔ What is the client's preference for claims settlement (local or central)?
- ✔ Will the insurer/broker be able to supply insurance certificates in all territories?
- ✔ If Difference in Conditions (DIC) / Difference in Limits (DIL) is needed, may an unlicensed insurer pay a claim in a local jurisdiction?
- ✔ If yes, where are DIC/DIL premium taxes due and who will remit such taxes?
- ✔ If no, how may DIC/DIL be compliantly structured to meet expectations?
- ✔ Are related party agreements (such as transfer pricing agreements) addressing potential income tax or other fiscal issues, if any, agreed and in place before binding insurance?

In Europe, ACE insures progress

At ACE, it's our people who really distinguish our service - from designing the insurance programme that's right for your business to handling your claim when the unexpected happens. In Europe and across the world, our clients trust us to take on the responsibility of their risks so that they can take on the responsibility of making things happen. We call this *insuring progress*. Find out how our people can work for you at acegroup.com/eu

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