GEOPOLITICAL THREATS TO GLOBAL TRADE

www.russell.co.uk

GEOPOLITICAL THREATS TO GLOBAL TRADE IN A CONNECTED WORLD

The Rapid Growth of Casualty Insurance: A Familiar Phenomenon?

"The rapid growth of the casualty business is a familiar phenomenon. We are informed upon competent authority that from 1890 to 1926, the net premium income of casualty companies in the United States grew from less than $8,000,000 to more than $800,000,000." The Position of the Reinsurance Company in the Casualty Business by Winfield W. Green

The above quote belongs to an archaic and no doubt revered reinsurance tome on the subject of the casualty class of business. While the literary style of the author is flowery, his area of expertise remains relevant to the discerning underwriter today. (Re)insurance is a deceptively simple business but it would be interesting to see how Winfield W. Green would respond if a time machine were to transport him to today's world of traditional and emerging risks. Once thing is for sure, the pace of casualty insurance growth has not slowed since 1926!

Man-made Interconnected Exposures

In previous eras, a large proportion of the major risks facing corporate risk managers and the global P/C (re)insurance industry were environmental and natural catastrophe in nature but today's largest interconnected exposures are man-made. Both geo politics and disruptive technology are challenging the status quo while a new era of liability is ushering in a new range of risk drivers such as cyber, business interruption, supply chain and credit & surety.

There is no doubt that the winds of change are in the air. The run-off market is always a useful harbinger of risk related things to come in the live market. Run-off specialists have predicted that legacy transactions will reach ground-breaking heights in 2017 as current market trends and pressures drive the sector's growth.

2016 has been labelled an unprecedented year for run-off, both in number of transactions and volume and this year will bring further growth with continental Europe leading the way. Non-life run-off deals last year totalled about €4.4 billion, and this figure is expected to double to more than €8 billion in 2017.

This €8 billion+ prediction is due in part to Europe's biggest insurers all simultaneously entering the run-off market. While companies have been gearing up run-offs for some time, they had been holding back until Solvency II regulations were complete, but will now be implementing their new legacy strategies.

Social, technological, and economic trends place (re)insurers on the cusp of a major change, with run-offs being seen to fit hand in hand with these developments.

Modelling Emerging Risks

Meanwhile, the new emerging risks – yet to hit the run-off phase of the insurance cycle! -are opaque and the new perils they present are hard to model, like 21st Century geopolitical exposures. Today's world is more complex at every level whether you are an individual running multiple smart devices that require different passwords in a connected home or a Fortune 100 company managing offices across the globe.

Last year's opinion polls failed to predict either Brexit or Trump's win. While a Le Pen Presidency remains unlikely in France, the situation is increasingly volatile and it would be foolish to discount the possibility of a win there. Even if there are no further upsets, both Brexit and Trump alone provide a significant challenge to corporate resilience.

This is because conventionally siloed geopolitical risks such as terrorism, kidnap and ransom, cyber, political and trade credit, are becoming increasingly blurred.

In our interconnected world, the era of extreme politics – like extreme connectivity - brings all these exposures together to create a complex and unstable risk landscape that pretty much no one foresaw. Populist politicians are challenging not only globalisation and free trade but the very institutions - NATO and the UN – that the world has come to rely on to mediate and manage geopolitical conflict.

Even the EU appears to have less than 100% support from the new U.S. administration. The fusion of political and cyber risk is particularly alarming. Cyber is a risk that didn't even exist 20 years ago and already takes many forms – economic espionage, denial of service, extortion, social engineering.

Developing a Cyber Risk Framework

The national and economic security of nation states, for example, depends on the reliable functioning of critical infrastructure. According to the National Institute of Standards and Technology (NIST) Framework:

"Cybersecurity threats exploit the increased complexity and connectivity of critical infrastructure systems, placing the Nation's security, economy, and public safety and health at risk. Similar to financial and reputational risk, cybersecurity risk affects a company's bottom line. It can drive up costs and impact revenue. It can harm an organization's ability to innovate and to gain and maintain customers."

To better address these risks, the then President Obama issued Executive Order 13636, "Improving Critical Infrastructure Cybersecurity," on February 12, 2013, which established that "it is the Policy of the United States to enhance the security and resilience of the Nation's critical infrastructure and to maintain a cyber environment that encourages efficiency, innovation, and economic prosperity while promoting safety, security, business confidentiality, privacy, and civil liberties."

The Executive Order also requires that the Framework include a methodology to protect individual privacy and civil liberties when critical infrastructure organizations conduct cybersecurity activities. While processes and existing needs will differ, the Framework can assist organizations in incorporating privacy and civil liberties as part of a comprehensive cybersecurity programme.

Worst-case Scenario Catastrophe

Modelling for a corporate cyber disruption, DOS or even a large-scale attack on critical infrastructure is difficult enough but how would the world's insurance markets respond in a worst-case scenario catastrophe? A recent White Paper published provided a unique industry-led 'dry run' simulation of a never before seen US$200bn catastrophic loss event.

A consortium of leading London insurance market organisations and associated entities tested the resilience of the Lloyd's insurance market to a major loss event.

Led by Hiscox, the exercise tested two very different fictional loss events happening in quick succession. The events chosen reflected the changing nature of risk; a highly destructive hurricane, an unprecedented cyber event, one of the largest stock market declines, and a major (re)insurer default with consequent delays in reinsurance payments.

These simulated events resulted in extraordinary global insurance losses of approximately US$200 billion. This amount would be the largest loss ever seen; more than twice the size of losses caused by Hurricane Katrina and at least four times larger than the World Trade Centre insured loss.

Cyber Simulation

Following the conclusion of the exercise, participants considered that they would have access to sufficient practical and financial resources to cope with the losses that would result from such an event. However, it was found that the loss could strip insurers of up to 120 percent of their net capital base.

Insurers in the tests lost between 30 and 120 percent of their capital, and sought replacement

capital from their parent company or bond or equity markets. Chris Moulder, director for general insurance at the Prudential Regulation Authority, said access to capital or reinsurance might not be as easy as insurers think in the event of a genuine catastrophe.

Moulder believes it is important for firms "to consider what they might do if the level of uncertainty is high, or the actions being taken across the market as a whole affect an individual firm's ability to act in the way it might have originally planned."

Raising New Capital

The Hiscox report was critical of the regulators rather than the (re)insurers. The focus of the regulators is on solvency. Their primary responsibility is to ensure that claims are paid, not necessarily fighting for the insurance industry.

This is hugely important because speed and flexibility are essential in a catastrophe. Firms have days rather than weeks to raise new capital when disaster strikes.

In 2001, the regulators were prepared to tell them to go for it without first demanding lengthy reviews and modelling.

But even then, the market was left standing by Bermuda, which attracted roughly 10 times more new money than Lloyd's of London. This pattern has been repeated after every disaster since. So, the big question for next time is whether the regulator will be sufficiently switched on and nimble.

According to the Financial Services commentator Anthony Hilton: "The test showed how some underwriters and companies were not properly organised internally to cope with multiple disasters but it showed up the PRA even more. The regulator appears quite shaken by the number of people it needed to call here and in America, and how fast it was expected to move.

"Communication and understanding are clearly inadequate at the moment; the test will be whether the report provides a sufficient spur for the needed improvements. Even then, it may not be enough."

Stressed Out?

As Hilton points out, the other thing that will be crucial, but which the stress test could not probe, was the attitude of foreign jurisdictions. This is key because insurance is a truly international business, but global regulation tends to become very local in a crisis.

Most businesses, jurisdictions, regulators, politicians tend to look after their own, and care little about helping out with problems elsewhere. For example, at the time of 9/11, the UK Government effectively informed the insurance industry to do whatever it took to get aircraft up in the air again.

The industry delivered on its promise but was then mortified to be instructed by the EU competition authorities to launch an inquiry into collusion in the aircraft insurance market. Even more difficult for the London market was the attitude of the American authorities.

London was looking for co-operation to help navigate through the chaos, but the focus of U.S. officials was relentlessly domestic. They made it clear almost as soon as the British got off the plane at Kennedy Airport that they really did not care what happened in London or whether its insurance market survived or not.

Connected Liabilities

Compliance, regulation and how best to manage risks across jurisdiction and territories are indeed a growing challenge. Connected liabilities from the same event are rising in today's new era of liability, whilst liabilities that are currently uninsured are also on the rise. In past papers we have referred to this unknown risk as dark risk matter!

Corporate risk managers are complaining that their insurers don't offer products that address their growing liability need. Meanwhile the insurance carriers are saying we can offer these products but the risk managers are not outlining the requirement. There is disconnect, which needs to be addressed and which means there is a role to play connecting insurers with their clients.

It is also evident that the re/insurance market needs to change to address disconnect between insurers and reinsurers and even disconnects within single insurance entities that have a global footprint. Russell Group research has come across numerous examples of disconnect between underwriters working for the same company but operating out of different jurisdictions and territories.

Understanding Underlying Exposures

It is common for underwriting units operating the same class but in different regions within the same (re)insurer to write a line on the same underlying risk. Then there is overlap when underwriters in the same company but in different classes might put down a line on the same risk, for example, a War and Terror specialist underwriting an aviation risk.

Ultimately, we need to go back to first principles which all comes down to an understanding of the underlying risk. A thoughtful article in the Financial

Times some years ago mused on the causes of the so-called "LMX spiral" – whereby Lloyd's syndicates reinsured each other rather than laying off risks elsewhere.

The FT author writes: "The LMX spiral brought that venerable insurance market close to collapse. The reinsurance contract is almost as old as insurance itself. The insurer cedes part of the premium in return for an agreement to bear losses in excess of an agreed sum. The modern innovation was to reinsure not just a single contract but a package, or even the total losses of an underwriting syndicate or an investor. These losses might themselves include claims on similar policies. As such structures proliferated, it became increasingly hard to understand the nature of the underlying risk.

"Lloyd's was, I came to realise, a microcosm of what was happening in other financial markets. If trading was motivated not by differences in attitudes and preferences but by differences in information and understanding, risk would gravitate not to those best able to bear it but to those least able to comprehend it."

Emerging Risks are Mutating

More worryingly, emerging risks in geopolitics are mutating far beyond the confines of Lloyd's. Social media acted as a catalyst during the Arab spring to overturn autocratic regimes. Now those same methods are being employed by groups of people that are hostile to democracy. When the world's richest country is unable to prevent a foreign power from influencing its Presidential election it becomes virtually impossible to predict accurately how a political situation can unfold.

We live in a new post truth age of fake news and alternative facts. So, these changes to the status quo are very significant challenges for corporate risk managers and our own (re)insurance industry. In a world where global trade has risen five-fold in 15 years, companies are exposed to a wider range of geopolitical risks from supply chains to workforce to customers to capital - and sometimes to all four.

Consider, for example, the fact that two thirds of the world's container traffic passes through ports owned in whole or in part by China. If the fragile flower of global trade is nipped in the bud then the potential negative impact on global economic trade, for business and for living standards and supply chains could be significant. The supply chain is a major concern.

Supply Chain Instability

At the end of 2016, a Chartered Institute of Procurement & Supply (CIPS) Risk index revealed that global supply chain risk increased to a level of 80.8 in the 2nd quarter of 2016. That is not good. The Index outlines a trend of rising risk that has become more obvious over the past decade. Weak oil and commodity prices, political uncertainty, economic instability, the impact of terrorism and the unclear fallout from Brexit have all contributed to high risk figures.

For most supply chain professionals, this is no major surprise: risk and threats encompass global supply chain operations across the specialty classes. The pharmaceutical industry, for example, must constantly control its supply chain for counterfeit medications. In a July 2016 report, the Drug Enforcement Agency discovered hundreds of counterfeit pills being introduced illegally to the U.S. every year. For consumers, this means the safest path to legitimate medication is through closed and completely secure drug supply chains.

At the same time, Bloomberg reports that cargo theft is increasing in Europe. It is reported that food, alcohol and clothing are now being more targeted than high-value electronic goods. Recent thefts have included over $105,000 worth of salmon in Norway, 80 cases of whisky near London, and $2.12 million worth of Champagne!

Including the Middle East and Africa, the Transport Asset Protection Association shows cargo theft has increased almost three times in five years. Meanwhile, in the U.S., the retailer Chipotle made headlines with a declining stock price and decreasing earnings resulting from a supply chain incident that revolted customers last year.

Tumbling Stock Price

Chipotle reportedly built its brand on quality ingredients, ethical treatment of animals, and local sourcing in its Supply Chain. But in a series of developments that sent the chain's stock price tumbling, the diversity of supplier base and Supply Chain complexity apparently opened the business to food safety risks – and various restaurant locations have been linked to outbreaks of E. coli and Norovirus.

Chipotle now faces a sales shortfall, and stock sell-off, as a result of a Supply Chain risk. It appears that Chipotle had for years operated without systematic item scanning at supplier, distribution or restaurant facilities. Consequently, Chipotle has indicated that improved supply chain visibility is now a key priority. Visibility and transparency, of course, are hugely important to the mitigation of risk and nowhere is this more obvious than in the Credit and Surety risks arena.

Current supply chain threats and complexities create extreme levels of risk that can impact operational performance, customer satisfaction

and, ultimately, a company's bottom line. Global trade risks will continue in 2017 and require a comprehensive approach that includes the right skills, processes and software technology to avoid serious harm to a company's brand and reputation.

Credit and Surety Risks

It is increasingly difficult to keep up with the pace of geo-political events as they evolve in real time and impact on credit and surety risks. We live in a time of Presidency by tweet. Brexit and the new U.S. administration seem to garner all the headlines but the rest of the trading world is no less interesting.

In 2016 we observed a failed coup in Turkey, Spain learnt that it is increasingly difficult to elect an operational government, the elected President of Brazil was impeached by senate just a few days after the summer Olympics in Rio, while the world was riveted by the intriguing election battle between Ms. Clinton and Mr. Trump in the US.

Political activity has been completely paralyzed in Venezuela for months with no end in sight, and a new and worrying tone emanates from the Philippine government. There are more examples of political unrest in other countries such as Argentina and Thailand where the much-loved King died. Nobody who is interested in politics can really complain that we are not living in interesting times, but what does all this has to do with the credit and surety business?

The answer is that governments are often the main initiators of business, a guarantor that makes things happen and they also compose the framework for sureties such as, for example, the general contracting laws that are under review now in some countries such as Italy or Brazil.

Business and Politics is Connected

According to Roberto Castillo Chair of the Surety Committee Company at Hannover Re: "The public administration is the main generator of infrastructure projects which is still the largest business source for sureties in most countries. But it is not only the public budget that has substantial effect on our line of business, also soft factors such as the payment behaviour and/or the negotiation attitude to solve arising problems can differ from one government to another and these can be decisive factors for being successful or not."

Business and politics is inextricably linked. Where political volatility increases, however, the result is that: "Instability in political matters always results in downsized business," according to Group Head at Euler Hermes Group, Martin Faber.

But it is a mixed picture globally. According to Faber, writing in the ICISA Insider, any region or country that invests in infrastructure is a promising environment for sureties. Faber writes: "If you take the so-called Juncker plan for the EU with a 3 years investment volume of €240bn we expect business opportunities in particular in energy, transport or broadband. But still, Asia-Pacific is the region with an extremely high need for infrastructure."

Faber believes that risk managers and (re)insurers need to pay high attention to country risks in a broader way, paying particular attention to the business environment in a specific country or to which extent its public finances depend on commodity revenues. The surety industry over the next five to ten years faces a variety of challenges, but there are also opportunities, reckons Faber.

The (Re)insurance Opportunity

How we as an industry help corporate risk managers to respond to these challenges and opportunities will define the future of (re) insurance. The first point, self-evidently, is that change and uncertainty are an opportunity for the wider (re)insurance industry and the way it responds to the needs of increasingly over exposed risk managers. The specific risks may have changed but helping clients understand, manage and mitigate risks is what we have been doing for centuries as an industry.

In a world where companies can be made or broken on the back of a tweet from a politician we need to help clients build their resilience against all eventualities. It might be changes to the Dodd Frank bill or changes to the tax treatment of Bermuda that in fact affect our own industry so we need to work with clients extensively by scenario planning the full range of risks so they understand and mitigate them.

Increasing Automation

It won't be long before we see more business to business platforms vying to chip away at our market share, and our margins with these automated platforms.

In North America there are already 700 insure-tech firms trying to disrupt the market. These new players aren't frightened of failing or of taking big risks. They are agile and they enjoy less intensive capital requirements than London, for example. Insure-tech start-ups are moving at an incredible pace. It will not take too many to succeed to inflict very significant pain on the established business models of insurers and reinsurers.

So how should underwriters respond to the threat to their business models? And what impact might such a response have on the world of corporate risk management best practice?

Harnessing Data

(Re)insurers can harness data and advanced analytical techniques to broaden their risk toolkits. By combining analytics and experience, the sector, aided by experienced technology and analytics partners, can give clients a multi-dimensional view of the risks and where they can add value to their business and improve their resilience.

As geo-politics and disruptive technologies challenge the status quo, the question is how quickly can we adapt to help clients improve their business models and become more resilient?

We need to build a more robust risk management framework that can be extended to underwriting for new forms of liability risk. In this report, we've identified the impacts of the new era of liability.

With these insights, we believe that a marriage of C-suite sponsored investment in new forms of liability modelling and data-led bottom up underwriting can benefit companies.

The ultimate prize will be an enterprise risk management approach to help businesses identify vulnerabilities in their organization whether that be a Fortune 100 corporate or its re/insurance partners.

Russell Group is a leading risk management software and service company that provides a truly integrated risk management platform for corporate risk managers and (re)insurance clients operating in an increasingly connected world.

Connected risk refers to the growth in companies which are increasingly integrating across industrial sectors and geographies, and creating greater levels of risk. This exposes corporates and (re) insurers to a broader range of inter-related perils, which requires a risk management approach built upon deep business intelligence and analytics.

Russell through its trusted ALPS solution enables clients whether they are risk managers or underwriters to quantify exposure, manage risk and deliver superior return on equity.

If you would like to learn more about Russell Group Limited and its risk management solutions, please contact sbasi@russell.co.uk or rborg@russell.co.uk