Navigating risk in a time of change: control and reduction

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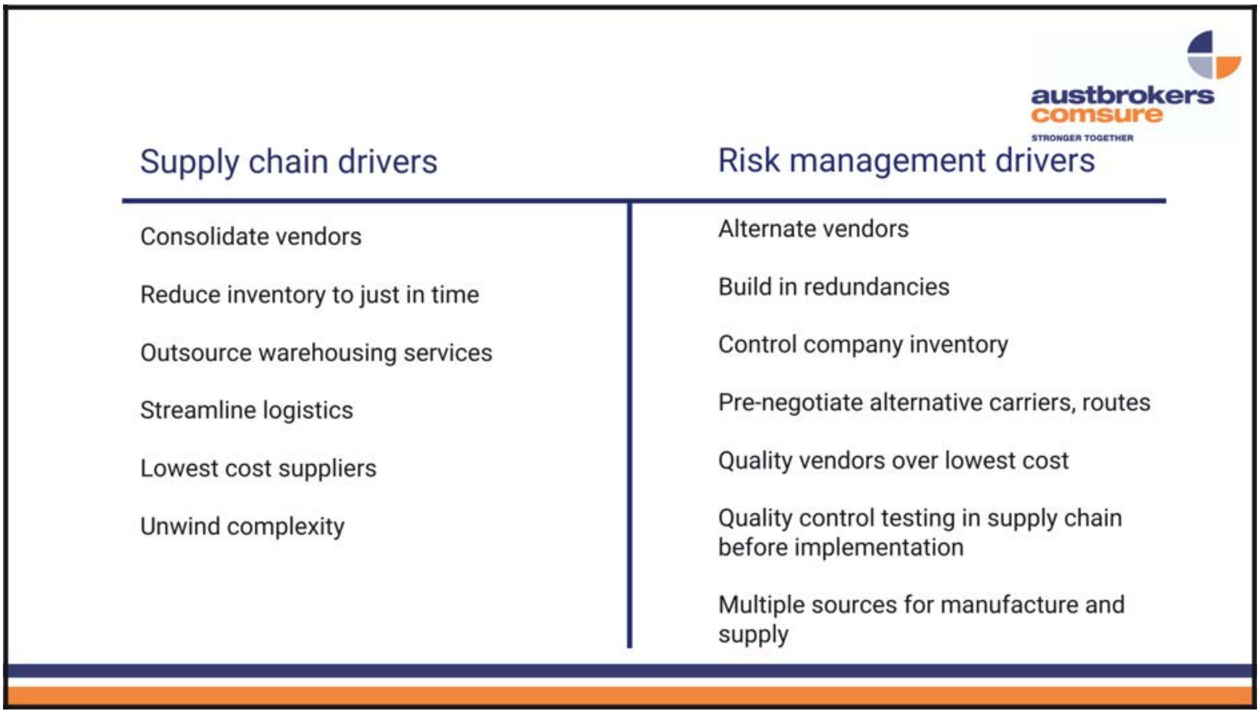
Navigating risk in a time of change is a question insurance brokers ponder daily.

The pandemic, the insurance market, climate change, and global supply chain hazards alter clients' risk appetites. So brokers must help clients through the changing matrix to implement effective risk management and source appropriate insurance coverage.

To understand the navigation required, let's examine some of the challenges facing the business environment.



To say the world is in an unprecedented time of upheaval is not true. There has been much more turmoil in living memory: world wars, other pandemics, credit crunches, and global weather catastrophes.

The difference between now and other times of challenge is the interconnectivity between financial markets and people's global mobility.

The speed of data and funds transfers around the world mean the nature of the hazard has changed from previous significant world events.

The impact and velocity of change is faster and harder than a gradual swell of change when there was no cyber "real time" connectivity.

COVID-19's impact has shocked the world, but there was already much pandemic planning in progress.

John Badgery, now Manager, Emergency Management & Biosecurity at South Australia's Department of Primary Industries and Regions, delivered a paper to the Risk Management Institute of Australasia in 2007 that outlined what all of us have been experiencing in the past 10 months. You'll recognise some of the terms he used: social distancing, travel restrictions, contact tracing, and supply chain disruption.

While much of the population may think this is all new ground, it is not. The approach taken by governments around Australia has been considered and planned.

So what is a pandemic and how is it different to an epidemic?

An epidemic is a disease that affects a large number of people within a community, population or region, but a pandemic is larger – it's spread over multiple countries or continents.

There might be differences, but all these terms relate to a disease that is captured by the Biosecurity Act of 2015.

The Covid-19 pandemic has seen Australia incur more than 27,600 cases and 907 deaths (at 6/11/20). While people's mobility and the speed with which they travel around the globe may have initially exacerbated the spread, the disaster does not discriminate on quality of health care systems or first world versus third world sanitation or standards of living. Nor does it discriminate based on genetics.

With global manufacturing markets and supply chains under extreme pressure, it is crucial for Australian businesses to understand their exposure and reliance on international markets when discussing business continuity planning.

We can no longer rely on a suppliers and customers extension on business interruption cover: companies need to understand the pressure points in the manufacturing process.

When discussing clients' supply chain and risk management drivers, insurance brokers need to replicate language the client uses internally so they understand "the context".

If a client cannot understand the language their broker is using and how it applies to their situation, the message and the solution will fall flat.

Some supply chain drivers should and will be reconsidered by many businesses in a post-Covid-19 world. This could include changing end customers' expectations, and may revolve around the timeliness of supply.

Some of the main business hazards, risk and perils pre-2020 were:

- Brand and reputation
- IT security, cyber risks
- Global warming/climate change
- Economic risks, financial risks – D&O, PI
- Industrial catastrophes
- Nat cats
- Terrorism
- Environmental risks, pollution
- Employers' liability
- Asset price collapse
- Financial investment risks, capital market volatility
- Pandemics, epidemics

Before 2020, we had a focus on the environment, and Swedish activist Greta Thunberg was giving significant airplay to climate-related risk and its impacts on business.

In late 2019 and early 2020, there were numerous natural catastrophes in Australia alone that had significant impact, including bushfires, hail storms, cyclones and floods.

The pandemic and financial impacts of an economy in lockdown did not rate a mention in this climate-focused environment.

But, during the last 10 months of global upheaval, we have had a reshuffle of the attention and importance of some of these corporate risks.

> "The pandemic and financial impacts of an economy in lockdown did not rate a mention in the pre-2020 climate-focused environment."

The Australian business community has now shifted the importance of some of these risks and put a greater focus on those hazards highlighted below in red.

While the global warming focus still exists, business and community expectations are now primarily on health, cyber, economic and employment-related perils.

Access to capital and economic markets is still important to clients, but the importance placed on the immediate environment rather than the global reach has forced businesses to rethink how they price supply chain risk.

Supply chain drivers of the past may not necessarily be the same moving forward when we factor in pandemic and cyber impacts. For example, in May 2020, transport giant Toll Holdings was forced into its second cyber shutdown.

And post Covid-19, what does the risk landscape look like moving forward? What tools do brokers need and what changes do they need to make to clients' programs?

Here's how another realignment of the priorities will likely look.

So, will the same level of global elasticity exist post-Covid-19 and what are the current challenges?

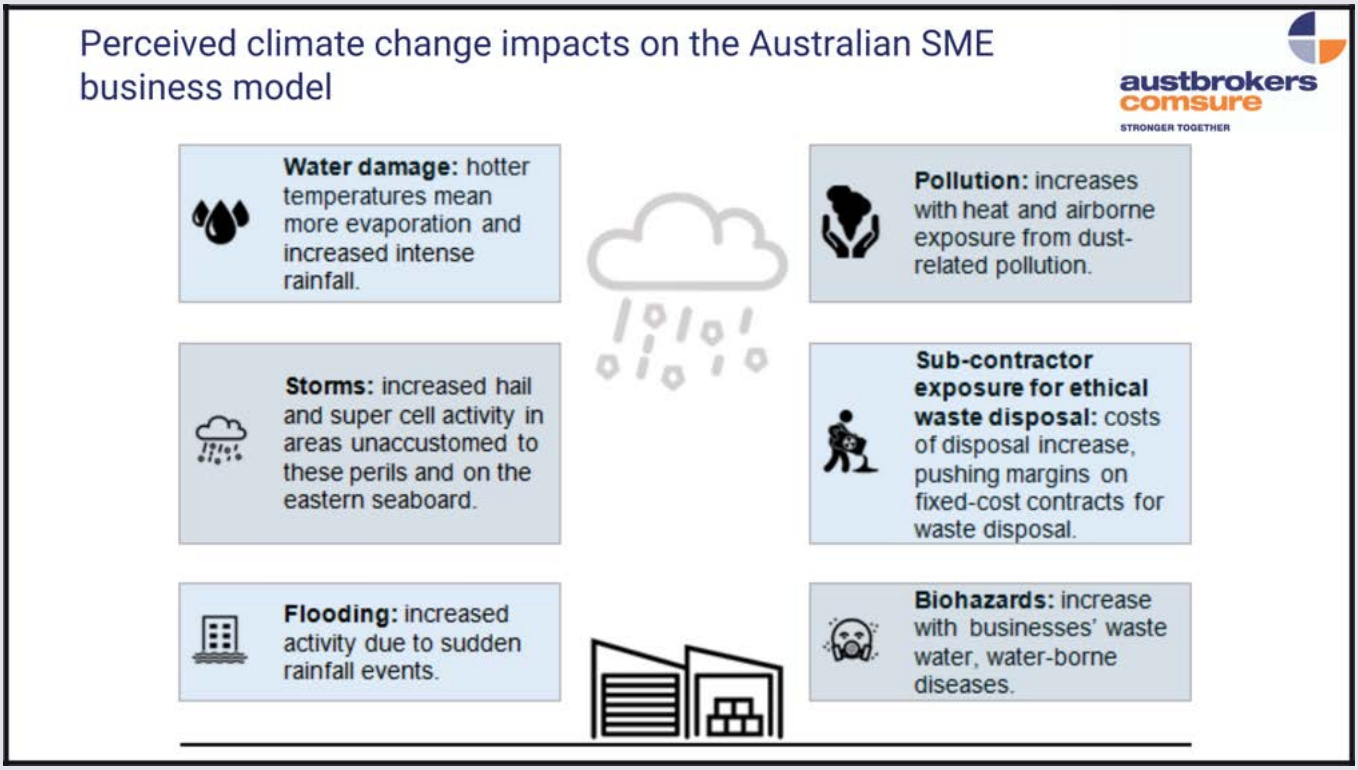
The availability of capital will be key to business expansion moving forward, and financiers will factor in sustainable supply chains in lending criteria.

That means many previous global options may be replaced with onshore options as a more reliable source of raw material.

Business will want a predictive capability and accurate pricing of risk in business decisions. As cyber crime and social engineering become the new forms of highway robbery and piracy, it is essential to underpin confidence in the supply chain and future proof cyber-trading platforms.

Once the pandemic risk is managed, we will rethink our short-term view on disease-based exposures. Many practices of physical distancing and border control will revert back to pre-2020 days.

The focus may revert more strongly to climate change risks. The diagram below shows climate change and environmental exposures and their potential impacts on the Australian SME business model.



The changing environment is also redefining insurers' risk appetites and acceptances.

Fire risk assessments conducted by insurers are now more closely scrutinised for loads, impacts, and responses by public authorities.

An insurance catastrophe is the intersection of a naturally occurring event with insurable assets. The severity and frequency of those intersections determine the ability to provide cover and the pricing.

While SME clients cannot manage climate change, brokers need to provide advice on managing the effect of the intersection between climate change and company assets.

The upcoming Australian summer for 2020/21 appears to be a La Nina or a wetter, more disruptive weather pattern which may well involve cyclones and floods.

The climate change risks on the horizon are potential hazard disrupters to any insurance program.

Businesses that rely heavily on water and power, or whose operations are subject to environmental impacts of weather and pollution exposures, will experience rating and coverage pressure in the global insurance market.

Increased pressure to comply with acceptable waste removal and handling practices will see contractors that are ill equipped to deal with these pressures face increased litigation.

For example, waste company Bio Recycle on 18 September 2020 was fined $300,000 for dumping 274,000 tonnes of waste above its allowable limit.

Sadly this is not an isolated case. The same applies to many companies unable to adequately deal with waste and that ignore the impacts of climate change on their business model.

In August 2017, a class action was lodged against the Commonwealth Bank board for failing to address climate change in the 2016 Annual Report. The 2017 Annual Report subsequently considered the issue, albeit in a limited fashion.

The action against the CBA is likely the start of more scrutiny on boards to tackle these exposures.

The lesson for Australian business is that hazards and impacts like climate change will not only impact on property losses in the future but potentially in boardrooms as well.

So what does all this mean for clients that want to control their risks in the current environment?

What tools and methods can brokers use to help clients understand the perils in this time of change?

Brokers generally have A, B and C class clients. The As get the best service and attention, the Bs usually have an annual review, and C class clients are generally buying a commodity line, like single liability, and get a standard letter and an invoice.

While brokers owe a duty of care to all their clients, realistically the in-depth risk analysis process can be used only for A and B clientele.

The insurance renewal review process usually involves a needs analysis and is a tick a box with basic information collection.

However, brokers need to expand their language and thinking to include open-ended questions. Rather than asking “Do you need cyber crime cover?” perhaps brokers should ask “How have the ramifications of Covid-19 changed how you deal with your customer base?”

“The lesson for Australian business is that hazards and impacts like climate change will not only impact on property losses in the future but potentially in boardrooms as well.”

Here are some possible client answers and broker responses:

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Possible client answer	Which means
Great, now we have the website upgraded, most over-the-counter sales are now online.	Review cargo coverage and terms of trade with customers and suppliers. Review company cash holding as this may have disappeared with a cashless society.
However, we have problems getting product out of Asia due to factory shutdowns.	Review BI exposure and discuss public utilities extension on BI coverage, suppliers and customers. Is EEQ incl BI cover required? Is inventory all held at the location you have in the schedule? Does the client have an IT exposure for online sales and collection of client data, or increased PI exposure for any blog on product use not in conjunction with the sale of its goods?

So once the broker develops questions suitable for the type of client and fleshes out the information that gives them insight into potential exposures clients face from the emerging global and domestic situations, the skill is identifying what is important to the client. It is usually linked back to a monetary exposure.

This is “establishing the context”. Once the broker has established if there is an exposure, they need to bring it back to a dollar amount of risk.

In doing so, they must discuss and consider several issues.

- **The level of risk tolerance:** Is the client a SME or a mature business with balance sheet to match? Can they absorb $1,000, or $10,000 or even $100,000?

- **The likelihood:** Insurance broking professionals consider the various aspects that affect claims, the frequency of events, and the nature of the hazard. For example: Are we talking about an earthquake in regional South Australia or an earthquake in Sydney’s CBD?

- **The consequence of the risk:** Is it total devastation or only a potential partial loss? What does some form of risk mitigation do to the risk? For example: what happens if you don’t rely on just one supplier for raw materials but two and in different regions? How does that change the overall consequence?

- **Velocity:** How hard and how fast will this risk hit? Can you change course to avoid it or the opportunity to see it coming and take advantage of it?

So, after a discussion with the client, the broker has established the context of what may be an evolving change to the client’s risk profile for existing and emerging risks.

Brokers need to get clients thinking about their risk tolerance, question why they buy certain classes of insurance, and consider how risk mitigation could alter the impact of the peril.

Does the client expect their insurance program to be a maintenance policy? All brokers have clients who are professional claimants – what is the broker’s advice to them in a market with an upswing?

Unless brokers can educate clients, the professional claimant client's strategy is flawed in a rising insurance market cycle. They will face greater scrutiny on coverage, conditions and pricing.

The client will soon have a substantial rating increase and will likely put their broker to tender unless they can change the client's attitude to insurance.

Consider the dilemma if a client suffers a downturn in the economy and margins are squeezed. Their risk tolerance is lower and there are smaller cash reserves in working capital to absorb uninsured or under-deductible losses.The cost of insurance coverage is going up, excess conditions are rising, and terms are under scrutiny.

There are new and emerging risks that are largely uncapped exposures, including increasing sums insured due to reinstatement values going up.

What is the broker's advice to clients?

The broker must ask: "What can I do with my client's premium dollar to protect their business and prevent myself being attacked by another broker or direct marketer purely on price?"

It is important for brokers to engage with clients on a new approach – advice rather than price. Many clients may not feel a part of the process. Some brokers are good at dictating to clients what they think they should have without engaging with them.

Brokers can start the conversation with SMEs by having them decide what the hazard and exposure to their business is.

Using a basic heat map, client and broker can set the parameters. That provides client buy-in to the process and identifies risk management that can be implemented.

The example below shows how broker and client can determine the dollar parameters, then plot the risks. For example, the client is an SME in manufacturing. Risk ratings are:

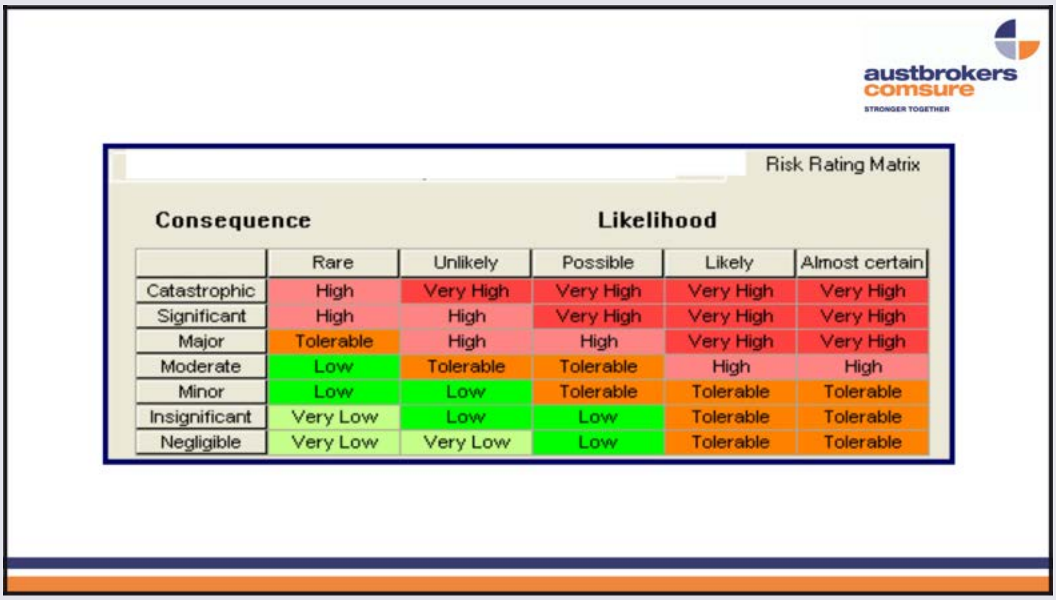
Light green: less than $1k

Green: up to $5k

Orange: $5k-$20k

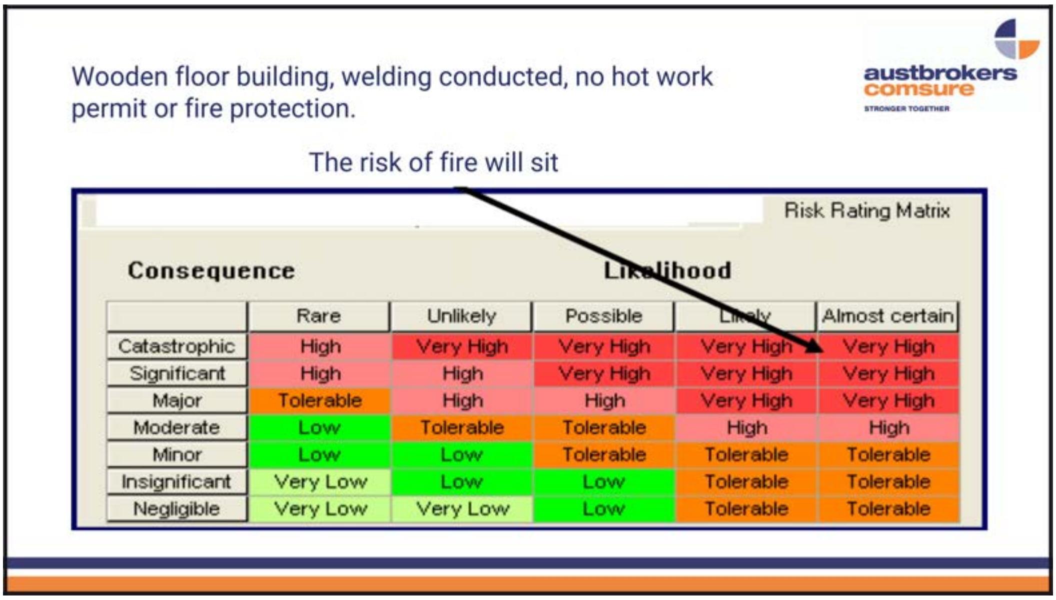
Pink: $20k-$50k

Red: more than $50k



	Rare	Unlikely	Possible	Likely	Almost certain
Catastrophic	High	Very High	Very High	Very High	Very High
Significant	High	High	Very High	Very High	Very High
Major	Tolerable	High	High	Very High	Very High
Moderate	Low	Tolerable	Tolerable	High	High
Minor	Low	Low	Tolerable	Tolerable	Tolerable
Insignificant	Very Low	Low	Low	Tolerable	Tolerable
Negligible	Very Low	Very Low	Low	Tolerable	Tolerable

Using a basic fire peril on a scenario, you can see the insurance implication is either uninsurable or the rate is circa 2% depending on loss history and capacity.



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Minor	Low	Low	Tolerable	Tolerable	Tolerable
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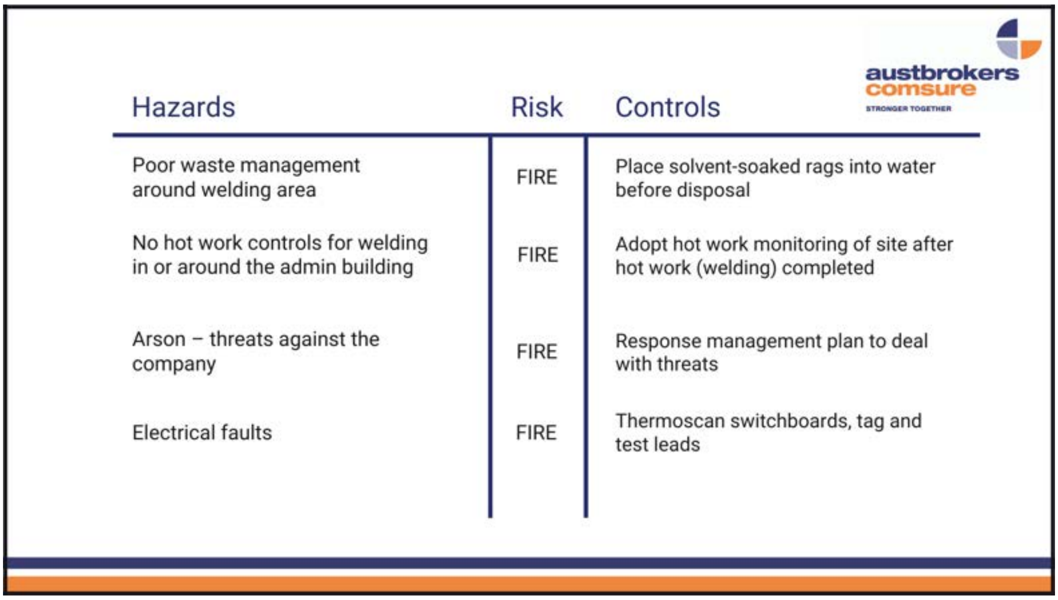
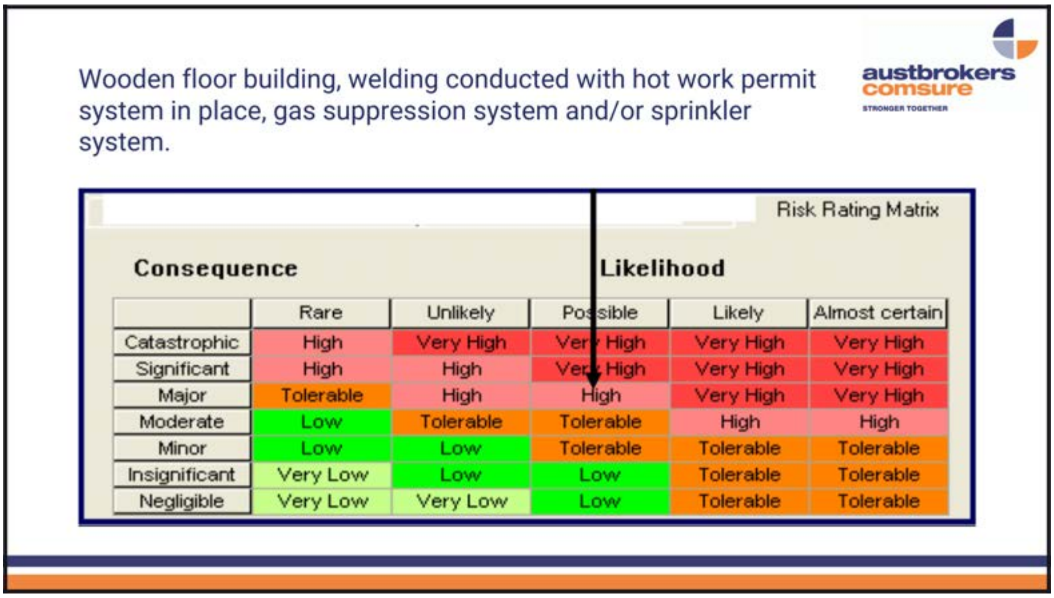
Now let's look at some of the potential risk controls.



Hazards	Risk	Controls
Poor waste management around welding area	FIRE	Place solvent-soaked rags into water before disposal
No hot work controls for welding in or around the admin building	FIRE	Adopt hot work monitoring of site after hot work (welding) completed
Arson – threats against the company	FIRE	Response management plan to deal with threats
Electrical faults	FIRE	Thermoscan switchboards, tag and test leads

Changing the risk mitigation to include these hazard controls brings both the likelihood and the consequence down.



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We move from an almost-certain catastrophe to a better managed risk that reduces the potential loss.

The insurer's approach changes from uninsurable to insurable and the premium rate lowers to circa 1% on asset value.

Remember however, this is a risk we know about and for which we can take aversive action.

This is a basic example but the principle applies to many risks and the same can be said for some emerging risks, such as cyber crime and IT perils.

What are the hazards with emerging risks we cannot control? Is uncapped, uncontrolled risk more hazardous than risks we can quantify?

Unless brokers engage in dialogue their clients, clients cannot ascertain their own exposure and get buy in.

Brokers also have the opportunity to provide additional coverage to the insured's portfolio.

It is important to recognise with clients that not all risk is insurable and brokers cannot ignore or shy away from that fact.

However, what may be a risk can be modelled and managed. The next step in the process is to review the risks and develop a list of the client's top 10 risks. This is a risk register.

In more complex models, the register identifies who owns the risk within the business, when it should be reviewed, what mitigation is in place, and what its ranking is.

On an SME level, if an owner can simply identify the top five to 10 perils is significant enough. They may not all be insurable, and may differ totally to what the insurance program reflects.

There is a range of methods to capture risk data, depending on the industry, but one that works well is FMEA, a failure mode and effects analysis, which is qualitative and can extend to quantitative analysis, that is, a method based on system reliability.

This is particularly useful for manufacturing environments.

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Failure Modes and Effects Analysis

Item	Failure Mode	Failure Effects	SEV	Causes	OCC	Controls	DET	RPN
A	B	C	D	E	F	G	H	I

The risks could include:

- Management liability implications of Covid-19 related losses that underwriters do not wish to cover.
- Business interruption reviews for profit centres that may have altered the model or closed.
- Supply contracts – contractual conditions that are onerous, or have tight time frames with no extension of time relief or adequate *force majeure* clause, will be dangerous in the post Covid-19 environment.
- Asset value reviews – have stock levels shrunk considerably or inflated post Covid-19?
- Technology liability – the world's interconnectivity is as much a threat as an opportunity and business needs to come to grips with supply chain disruption.

By examining these points, brokers can build a fence around their client, increase the client's coverage, manage the risk profile, and concurrently protect their own professional indemnity.

Broker and client need to break the manufacturing process down into components and identify the ones they want to analyse. It starts with a "top event", which is the initiating failure.

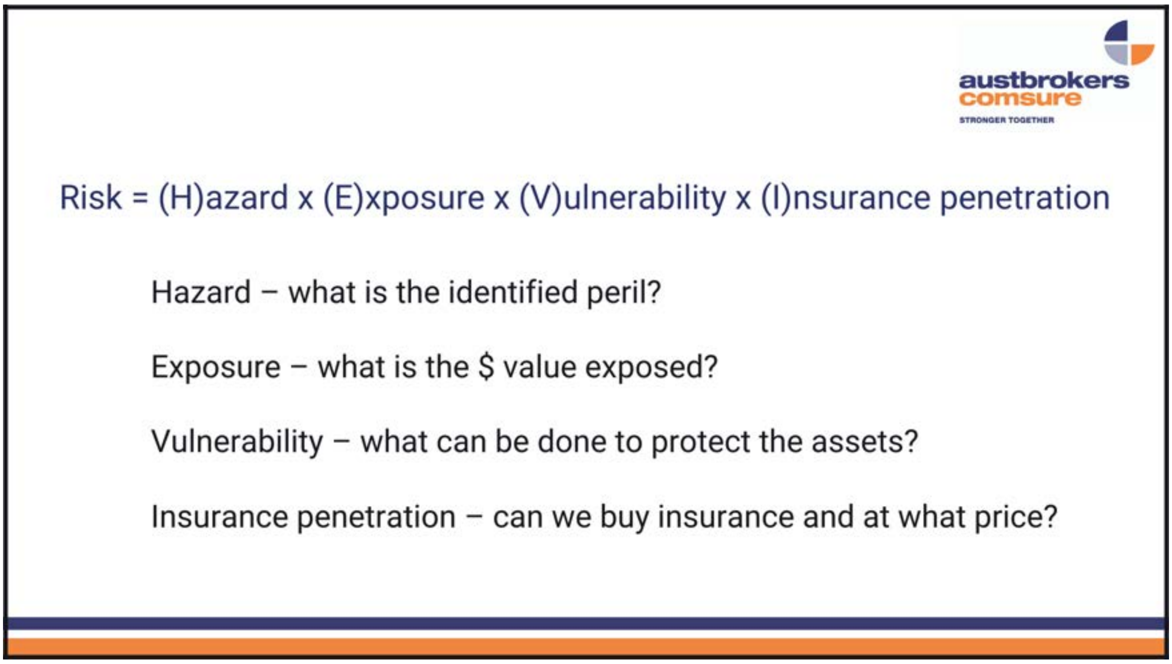
The broker lists the functions of the components and then, using language the client understands, describes the hazard. For example, consider fuel line assembly and removing residue from fuel lines. List the failure modes that may occur and rank them into severity of the consequence.

In many SME businesses, going through a version of FMEA will assist in understanding some of the weak points in the manufacturing process and the supply chain.

It will provide a methodology to deal with exposures the client considers are important enough to transfer to an insurer.

Brokers need to move the focus from price to advice in a rising market. In doing so and by pointing out the emerging risks, brokers will discuss a few important points with their clients.

> "Brokers need to move the focus from price to advice in a rising market."



If the broker examines the main risk management models that can map the consequence of actions, they can then understand:

- the velocity – how fast is the peril going to hit?
- the client's budget
- the appetite for transfer and ability to change.

Key issues for brokers are to:

- Determine what data collection methods and risk management models can be used
- Ask open-ended questions and listen to clients' responses so they know how the business model has changed.

About the author

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Steve Hamill is a licensed insurance broker with more than 30 years' experience at national and international broking firms. Steve is a Qualified Practising Insurance Broker, holds post graduate qualifications in risk management, and is a Certified Practising Risk Manager, accredited by the Risk Management Institute of Australasia. Steve is a Director of AB Comsure, a Director of AIMS (Austbrokers Insurance Marketing Services), and a Non-Executive Director of the Procare Group.