

360

DRIVING THE
DEBATE ON
EMERGING RISK

GLOBAL BUSINESS IN TREACHEROUS WATERS?

The risk environment is changing faster than ever before. In the second of two short reports, specialist insurance market Lloyd's asks how business leaders can plan and prepare for future emerging risks.

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DIRECTORS IN THE DOCK

As the fallout from the economic downturn continues, financial and professional services executives are more concerned than ever about the prospect of litigation. Is a liability culture now strangling innovation and entrepreneurship? Andrew Cave investigates

In the US, the FBI is probing the role of financial firms in an alleged mortgage fraud while shareholder activism gathers pace in the wake of the latest market developments. In the UK, business leaders are trying to get their heads around the impact of new legislation on corporate manslaughter, health and safety issues and environmental liability. Faced with these developments, fears about liability are certainly higher on the average executive's agenda, says Dr Roger Barker, Head of Corporate Governance at the Institute of Directors. "Many directors perceive that their

potential liabilities have increased in recent years," he says, citing not just new legislation but also high-profile cases such as Equitable Life, where individual directors were sued by an incoming board and the extradition to the US of the so-called "NatWest three".

Liability risk - an increasing drain on company resources

Dealing with liability risk now takes up more time and costs more than ever, according to research undertaken with over 150 global business leaders this year by Lloyd's and the

Economist Intelligence Unit. In the past three years alone, 58% of boards have increased their use of lawyers to manage litigation-related risks, and 28% have enlarged the size of their in-house legal departments.

But is this view of heightened risk justified? "This perception does not necessarily correspond with the reality of their actual liability," admits Dr Barker. "But there is a fear that the UK is edging towards a US-style liability environment."

Lloyd's research suggests that this isn't a worry which is confined to the UK. It found widespread agreement among CEOs worldwide that a US-style compensation culture is spreading. However, concern is highest in Europe, where two thirds of senior executives feel that the grip of compensation culture is tightening on their business.

European businesses need to plan and prepare for the prospect of greater litigation.

A particular worry for Europe?

There are two main concerns in Europe. First, as globalisation takes hold, companies outside the US are growing more willing to litigate generally. Second, US courts are becoming more willing to rule on cases that might have once been considered extraterritorial. Simply put, European businesses need to plan and prepare for the prospect of greater litigation – indeed more than two thirds of boards expect to devote yet more attention to this over the three years.

One fear is that, left unchecked, these trends will create a pervasive atmosphere of excessive caution. There is already growing evidence of this from Lloyd's research: one third of business leaders say that liability risk deters them from investing in certain markets, or from launching innovative products and services.

European companies could forego numerous and profitable business development opportunities, agrees Sean McGovern, Director and General Counsel at Lloyd's. "There is a very strong perception throughout the business world that we are seeing an environment in which it is increasingly difficult to develop and innovate," he says.

WHAT ACTION CAN BOARDS TAKE?

Encouragingly, the evidence suggests that boards are increasingly aware of their liability risks. However, there often appears to be a significant gap between this and the action eventually taken.

Developing the right culture

In attempting to close this gap, companies need to think first about whether their organisational culture is conducive to good liability risk management. Staff education is vital: many business leaders say that low staff awareness is a major obstacle to effective risk management and education is often needed to facilitate change across the whole organisation. Dr Barker also believes that better professional training for directors, for example through the Institute of Directors chartered director programme, is key to ensuring that directors understand their distinct role and responsibilities, and appreciate the importance of taking a proportionate approach that reflects the scale of the underlying risks but avoids bureaucracy.

Transparent decision-making

Sandy Purcell, Managing Director at Houlihan, Lokey, Howard & Zukin and co-head of the US investment bank's

European financial advisory services practice, also points to the need for strong and transparent processes. "The key is to be able to demonstrate that you have a clear and comprehensive process for your decision-making," he says. "The courts do not question whether decisions are right or wrong. They are interested in what processes you have used in making the decisions."

Dr Barker agrees. "Directors of smaller companies should not need to change their behaviour a great deal, assuming that they are already operating in a conscientious manner," he says. "The imperative in most areas of risk is to act honestly, competently and conscientiously. There is no expectation from the law of infallibility."

Anticipate tomorrow's risks, today

Lloyd's research highlights the need to give greater attention to anticipating tomorrow's risks. Advancing technology, environmental issues and corporate governance are the three emerging areas that most worry boards, according to the research. This is supported by data from elsewhere in the insurance market. For example, despite media, investor and regulatory scrutiny of businesses' performance on environmental risk, a recent study by the insurer ACE concludes that such risks have yet to become routine components of the main risk management agenda. Meanwhile, the broker Aon recently warned that cyber risks could be the next big trigger for lawsuits against directors.

Anticipating the future successfully means monitoring the risk environment in a more structured way. Most companies use lawyers to help identify and manage liability risk, but only a minority follow and record developments in the media, and less than a third adequately monitor government and regulatory developments. Companies can reap benefits by ensuring that such information filters through into all their broader commercial activities. For example, a company which conducts a thorough examination of liability issues early in the design phase of a new product can identify issues before they become the subject of litigation and help product development at the same time.

Finally, it may sound obvious, but companies need to be consistent in choosing the actions which will bring them the greatest benefit. While 77% feel that the adoption of formal policies and procedures for managing liability risk is valuable, only 57% follow their own advice. Similarly, too few take the time to formulate a long-term view. Lobbying for legislative change is another approach which

companies think could be valuable, yet most admit they are not taking action.

In the coming months, we can expect to see even greater pressure upon boards.

Advancing technology, environmental issues and corporate governance are the three emerging areas that most worry boards.

The public and political backlash against perceived excesses in the financial markets, and the inequity of taxpayers once more having to bail out apparently profligate banks, makes it likely that the lexicon of financial regulation will include "strict", "tough" and "pre-emptive" as key watchwords.

In such a climate, liability risk is no longer something that should be left solely to lawyers. Instead, it should be viewed and managed as part of a broader enterprise risk management framework, with clear engagement and leadership from the board. Abraham Lincoln once said, "Discourage litigation. Persuade your neighbours to compromise whenever you can. Point out to them how the nominal winner is often a real loser - in fees, expenses and waste of time." Litigation is with us to stay. But Lincoln's words are as relevant for modern business leaders as they were in his day. By taking risk management seriously and embedding a stronger culture and better processes within the organisation, boards can minimise their liabilities and at the same time feel more confident about taking the risks they need to in order to grow and develop the business.

Andrew Cave has written about business and The City for 17 years. He now works as a freelance journalist for the Telegraph as well as other specialist publications.

View a copy of our full report 'Directors in the dock' at www.lloyds.com/360



COMPENSATION CULTURE OR COMMON SENSE CULTURE?

Research undertaken by Lloyd's and the Economic Intelligence Unit reveals a widespread belief among global business leaders that a US-style compensation culture is developing in other regions. In the UK, the liability environment is undoubtedly becoming more complex, but here two experts from different fields argue that this does not necessarily mean that a US-style compensation culture is inevitable.



Common sense culture prevails in the UK argues Gary Slapper, Professor of Law at The Open University and legal columnist for the Times.

In Britain, compensation culture is a myth. Most people and organisations go through their entire lives without suing, being sued or being related to someone who is involved in litigation.

Figures show that during the last ten years, the sort of civil litigation that people mean when they speak about "compensation culture" has gone down. According to official figures, in 1998, the number of county court claims issued nationally was 2,245,324 but last year it was 2,157,000.

People might have become more emotionally litigious and more prone to shout "I'll see you in court" over the garden fence, but that has not lead to more court cases. The law does not make it significantly easier to sue anyone now for

negligence or a defective good or service than it did ten years ago.

Sometimes newspapers highlight silly cases but the claimants in those cases invariably lose. Ludicrous claims don't get past the first five minutes of an interview with a solicitor. Even when a lawyer is exceedingly keen, injustice will almost never occur because judges tend not to make daft decisions. There is a key difference between "man sues over nuts in peanut butter" and "man wins damages over nuts in peanut butter".

It would be wrong to say the UK has got more litigious simply on the basis that more people now read about and discuss legal cases. You wouldn't say the UK has become more sporting because it watches more sport on TV.

If people and companies behave well and all their processes are reasonable, they can't be liable for any loss or damage. Just because an accident happens doesn't mean anyone is to blame. Reasonableness immunises against all claims of negligence. That is common sense culture.

Perception need not become reality with good risk management says Bronek Masojada, Chief Executive Officer, Hiscox.

There is definitely a perception of a compensation culture in the UK and perhaps a fear of one. This perception is broadly fuelled by three phenomena – a general increase of protective legislation (for example, legislation affecting the rights of employees), a rise in awareness of individual rights ('blame culture') and access to "no win, no fee" legal agreements.

It is correct to say that people are much more aware of their rights, and access to lawyers willing to take on cases under conditional fee agreements is much easier. Historically, there have also been less scrupulous "ambulance chasing" claims management companies who have sought out and pursued claims, however unmeritorious, on behalf of claimants, although the introduction of legislation governing this activity in 2007 has weeded out the worst culprits.

More claims may be pursued in light of the trends I've mentioned, however to describe it as a 'compensation culture' akin to the US is wrong. We are a way off that yet in England

and Wales – largely due to the independence of the judiciary but also as a result of stronger regulatory pressures, control of lawyers' costs and fewer jury trials.

However, the reality is that businesses today are operating in complex environments. There is the potential for claims against businesses on so many levels. Directors need to be aware of what their potential liabilities are and, most importantly, make sure they have in place robust procedures and systems to limit the risk of a claim being pursued in the first place. While the courts have taken a sensible and practical line in relation to public liability cases, the raft of legislation designed to protect employees does mean that businesses face significant liability if they do not have in place systems and risk assessments to protect themselves from claims arising from wrongful employment practices.

Compliance is time-consuming and often not the main focus of any specific business. There is evidence that compliance with UK company law is one of the more pressing concerns for small business entrepreneurs, with two thirds of new small businesses citing it as a

risk. Hiscox research also shows that over half of British small business entrepreneurs believe that government red tape is a major barrier to setting up their own business. However, there is a need to balance the interests of businesses against the need to protect potentially vulnerable employees from risks inherent in their jobs.

Claims will never be eliminated, nor will the events that give rise to them. Taking all the preventative steps possible by investing in good risk management is crucial, backed by quality insurance from an insurer who is proactive in helping clients to manage their exposures.



ENERGY SECURITY: NATO Secretary General speaks out on the need for greater partnership



Until now, energy security has felt like a high-level geopolitical issue best left to governments and strategists, remote from the boardroom. However, Lloyd's research with global CEOs identifies that the supply chain is becoming an increasingly important consideration – often driven by concerns about energy security. For example, around 30% of business leaders are concerned about their company's exposure to collateral damage to an indirect attack, or the impact of political violence on energy supply lines. North American and larger companies show even greater concern.

Energy security is a huge and complex topic. An event organised in London this autumn by the Economist and Lloyd's, supported by NATO, has been designed to help business leaders and insurers to better understand the impacts for business. In this article, NATO Secretary General Jaap de Hoop Scheffer spells out NATO's priorities.

In the security business, some crises and challenges pass by fairly quickly; but there are others that are likely to be on our agenda for a long time, and which, therefore, call for a long-term and concerted response.

This is the case with energy security. Although many energy consumers will be relieved that oil prices and other commodities are tumbling on international markets, the factors that have pushed energy security to the top of the agenda are likely to remain with us.

The economies of China and India will continue to grow, and their legitimate quest

for reliable sources of supply will no doubt continue. The field of consumers is growing fast; so is demand. For both suppliers and consumers, ensuring reliable supplies is a must.

Also, as energy is produced and transported in ever more remote and hostile environments – whether on land or at sea – the challenges in protecting critical infrastructure become ever more formidable. Recent crises in the Niger Delta or in Georgia, not to speak of the threat to commercial shipping from pirates off the coast of Somalia, are a constant reminder of our vulnerability.

NATO cannot provide all the answers – but energy security is too important a challenge to neglect. What can we, as an international community, do to better protect our energy supplies?

In the first place, we can help to police the oceans. Just a few days ago NATO defence ministers decided to detach parts of a NATO Maritime Task Force to the Gulf of Aden to protect shipping against piracy, alongside the very welcome EU initiative. Our presence in this region, where more than 10% of the world's shipping passes every day, can only help to reassure the suppliers and transporters of energy and goods that their supplies will reach their destinations safely. Indeed, NATO has been doing a good deal of work in the

field of critical infrastructure protection, particularly in the maritime area where our multi-national naval task forces are in increasing demand.

Second, we can promote partnerships. Just this week we are holding a major conference in Doha on energy security with our partners from the Middle East and the Mediterranean. Those partners include Qatar, which is the world's largest producer of liquefied natural gas, but also major energy producers in Central Asia such as Kazakhstan or Turkmenistan, not to speak of important African producers such as Nigeria. Energy security is today very much on the agenda when we meet

with these countries in our Euro-Atlantic Partnership Council, our Mediterranean Dialogue or our Istanbul Cooperation Initiative, which involves countries in the Middle East. Through such initiatives we can encourage transparency and dialogue, while

at the same time exchanging best practices and developing training to protect critical infrastructure such as refineries, pipelines and LNG terminals – all of which, of course, remain first and foremost national responsibilities.

Finally, NATO can and should also produce solidarity. I am not suggesting that NATO should be the place where decisions should be taken on where pipelines should be constructed, nor take the lead in addressing energy cut-offs. The European Union and the International Energy Agency are obviously key when it comes to developing common approaches to energy policy. But I do believe that in a crisis situation NATO should be ready to provide necessary practical assistance, such as in response to energy blackmail or terrorist threat.

The crucial question for any international organisation dealing with energy security is: does it add real value to our collective efforts to guarantee the security of supply? In the case of NATO, I would argue that the answer is we definitely can and are doing so.

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COASTAL COMMUNITIES AND CLIMATE CHANGE

Maintaining future insurability

Melting ice caps and rising sea levels are putting coastal communities at risk of flooding. Recent research by Lloyd's and RMS found that, while mitigation is the only way to halt the effects of climate change, adaption is vital to protect coastal properties and to ensure the affordability of insurance.

// Whether it be hurricanes in the US or flooding in the UK, the insurance industry plays a vital role in helping communities to recover and rebuild. //

On our cinema screens we see a huge storm surge heading towards New York City, crashing down on Manhattan and bringing with it destruction and chaos. Meanwhile, on TV the Thames barrier is overtopped, leaving London exposed to raging flood waters.

These may be fictional scenes, but will climate change make catastrophic flooding a reality in the future?

The risks faced by coastal communities have been brought home in the last few years by hurricanes Rita, Katrina and Wilma in 2005, and Ike and Gustav this year. Sweeping across the Caribbean and southern US states, these storms washed homes away and left businesses closed and shut off from their supply chains.

But coastal flooding catastrophes are not limited by region or season. Over a timescale of just decades, rising sea levels are expected to pose a serious threat to global coastal communities in low-lying areas. In fact the Stern Report (2006) states that rising sea levels will result in "tens to hundreds of millions more people flooded each year".

Cities at risk

By the 2070s, Calcutta, India will top the list of cities whose population is most vulnerable to coastal flooding. Other cities on the list include Shanghai, Miami, New York and Tokyo. European coastal cities are absent from this list only because they tend to have more sophisticated defences. For example, the Thames barrier, which protects Greater London, was built to withstand the type of storm that would only happen once in 1,000 years. Yet despite the levels of flood protection in the UK, last year brought some of the worst flooding that the country has ever experienced. The floods in 2007 led to 55,000 flooded properties and 13 deaths.

Whether it be hurricanes in the US or flooding in the UK, the insurance industry plays a vital role in helping communities to recover and rebuild. The Pitt Report, commissioned by the Government in wake of the 2007 floods, notes that there were 180,000 insurance claims – the equivalent of four years' worth of flood claims under normal circumstances – totalling around £3bn.

Adaptation is critical

Lloyd's and independent catastrophe modellers Risk Management Solutions (RMS) have published a new report on the availability and affordability of insurance for properties in coastal regions – particularly as a result of sea level rise. The research reveals that, if no action is taken, losses for high-risk properties could double by 2030. The good news is that with an effective adaptation strategy, future losses for typical properties could be reduced to below present-day levels.

The importance of adaptation is a message that is echoed in the Pitt Report. The report says that adaptation is "crucial to deal with the unavoidable impacts of climate change". The implementation of adaptation measures can either be on a large or a small scale. First the Government and local councils need to take action to prevent flooding. Measures that can be taken include building flood walls

along the coast and initiatives such as the Thames barrier and the River Severn barrier in Hereford.

The individual home-owner also has a role to play. Properties can be adapted in many ways, depending on the specifics of the building. For example, Caribbean houses are often raised on stilts to lift them away from flood water. Other options include reinforced cladding and dry flood proofing. Even a simple measure like moving valuable items such as computers and kitchen appliances to the first floor can avert excessive flood damage. If a property has been damaged by flooding, many of these adaptation measures can be incorporated cost effectively while repairs are being undertaken.

Preparing for the future

As sea temperatures continue to rise and the weather becomes ever more unpredictable, the flooding we are seeing from coasts across the globe is only a taste of what lies ahead. The world cannot insure its way out of climate change. But the insurance industry can, and increasingly does, play an important role in helping society to explore how to adapt effectively for the future, thereby allowing insurers to continue taking on weather risks as climate change starts to grip the world.

View a copy of our full report 'Coastal communities and climate change' by Lloyd's and RMS at www.lloyds.com/360



ARCTIC ANSWERS?

Insurers look to the Arctic for answers



Pen Hadlow, Arctic Explorer

Few people probably believed that they would ever see an ice-free Arctic in their lifetime. Now some scientists are predicting that it could become a reality within as little as five years, and insurers are calling for closer investigation.

The Arctic has been covered with perennial ice (ice that does not melt during the summer) from anywhere between 700,000 and four million years – and for around the last 50 years or so, we have been able to measure conditions there by satellite. Recently, the amount of perennial ice seems to be decreasing rapidly. In fact, according to the Intergovernmental Panel on Climate Change, "summer sea-ice has shrunk by 20% (880,000 km²) over the past 30 years in the Atlantic part of the Arctic Ocean" – an area approximately the size of Pakistan.

When exactly the Arctic will become "ice-free" is a much debated question, with suggested timescales ranging from in five years' time to the end of this century. In Lloyd's report *Rapid Climate Change*, Dr Stephen Harrison, of the Oxford University Centre for the Environment, said that the sophistication of current numerical ice sheet models does not allow us to accurately understand ice sheet behaviour. We are, therefore, reliant on past behaviour and observations for our future predictions.

What we do know is that the melting of Arctic ice could result in sea level rises of around six metres. The ice also serves to reflect the sun's rays, keeping the water underneath cool. Warmer sea water could generate a further rise in overall sea

temperatures, potentially leading to even more extreme weather events, including more severe windstorms over longer storm seasons.

While the absence of reliable scientific data on climate change creates uncertainty for the whole of society, it is a particular problem for the insurance industry, because it makes the pricing of certain risks very difficult. Accurate insurance pricing often requires a wealth of information. For instance, when insuring an aircraft the underwriter will have all the information about that plane, such as the number of crew it requires, the number of flights it makes in a year and the amount of fuel it uses. When assessing weather related risks such as hurricanes and flooding, however, it becomes more difficult to assess the effects of climate change as we move into uncharted territory.

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Increasingly, insurers are concluding that they cannot accept the status quo. A lot of research has been done recently into the

impact of rising sea levels and temperatures on flood risk, and this has been fed directly into the relevant insurance policies. Insurers within the Lloyd's market are also taking the initiative in innovative ways. Specialist insurer and reinsurer Catlin recently announced its sponsorship of an Arctic expedition to attempt to fill some of the knowledge gap that exists around melting ice in the Arctic – and its knock-on effect on the pace of global warming. Chairman Stephen Catlin explains:

"Catlin is a company that manages risk based on hard facts, so we believe that this information is vital. The Catlin Arctic Survey will help inform all those who must plan for the potential effects of global warming."

The expedition, which sets off in February 2009, will start at Point Barrow in Alaska and travel 2000km to the North Geographic Pole over the course of four to five months, following the route first set in 1968 by a British Trans-Atlantic Expedition, led by British explorer Sir Wally Herbert. Temperatures at their coldest may reach as low as -40 degrees Celsius – conditions that are harsh for even the most experienced explorer. The expedition has four main aims: to measure the thickness of the ice floating on the ocean, to establish the thickness of the snow on top of the ice, to calculate the density of both the ice and the snow and to record the particular features of the ice along the route. Ice and snow samples will be collected for analysis.

The expedition will be led by polar explorer Pen Hadow who, among his many other achievements, was the first person to trek solo and without outside support from Canada to the Geographical North Pole. Pen's Arctic career began in 1989, when he partnered an explorer who was photographing polar bears on the edge of the Arctic Ocean. Since then, he has become passionate about the conservation of the Arctic region, and informing the world of the issues surrounding the melting ice cap. Hadow says he is particularly passionate about the potential that this project has to increase wider public understanding of what's happening in the Arctic:

"Personally, I am excited that my hard-won skills travelling on sea ice over the last 20 years can finally be deployed to the benefit of the global community. To be the leader of the Catlin Arctic Survey, and the genuine exploration it seeks to undertake, is a rare privilege."

Joining Hadow on the expedition will be leading female explorer Ann Daniels, a veteran of seven Arctic treks. On one of her

ARCTIC ANSWERS?

continued...

Arctic trips, Daniels was stalked for five days by a hungry, nine foot polar bear. Undeterred, Daniels will be managing operations on this Arctic adventure.

Making up the trio is Martin Hartley, who will document the expedition through photography. Hartley has ten Arctic and Antarctic missions under his belt. Hartley is excited that his images will reach a global audience through live and delayed-live videos, pioneering technology that will bring the Arctic into people's homes for the first time.

The patron for the expedition is HRH The Prince of Wales, whose support will take a

number of practical forms. The environmental significance of the project is tantamount to the Prince, who says, "The work of Arctic Survey is crucial to ensure we have the information to know the scale of the damage we are doing to our planet and then, hopefully, inspiring us all with the determination to make the necessary transformations to the way we live."

Everyone involved with the project hopes that the research will result in more detailed data on the thickness of the ice cap, feeding into our understanding of how fast the Arctic ice is melting. This information will be crucial for scientists and policymakers, to help them

make decisions based on the actual impact that global warming will have on our environment. The insurance industry will also benefit from the accurate data that the survey will produce. The impact on our understanding of a variety of climate-related issues will allow insurers to be much more precise in their understanding of a range of risks. Whether the results suggest that perennial ice will be gone in five years, or that we have another 40 years until our ice caps melt, it is Catlin's expectation that we will at least be more informed and better prepared to adapt for the future as a result of this ground-breaking project.

LLOYD'S

LIABILITY

TO WHAT
DEGREE ARE
YOU PREPARED?

360

DRIVING THE
DEBATE ON
EMERGING RISK

There are different degrees of liability. And different degrees of terrorist risk. Understanding them takes a degree of experience.

At Lloyd's, we've been anticipating emerging risk for over 300 years.

The 360 risk project combines our experience with expert opinion and world leading research to create an evolving resource and a forum for discussion. By challenging opinions and driving the debate, we're helping to anticipate and manage emerging risk.

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