Chief Executive

Transferring Risk Helps Relieve Leaders' Biggest Fears

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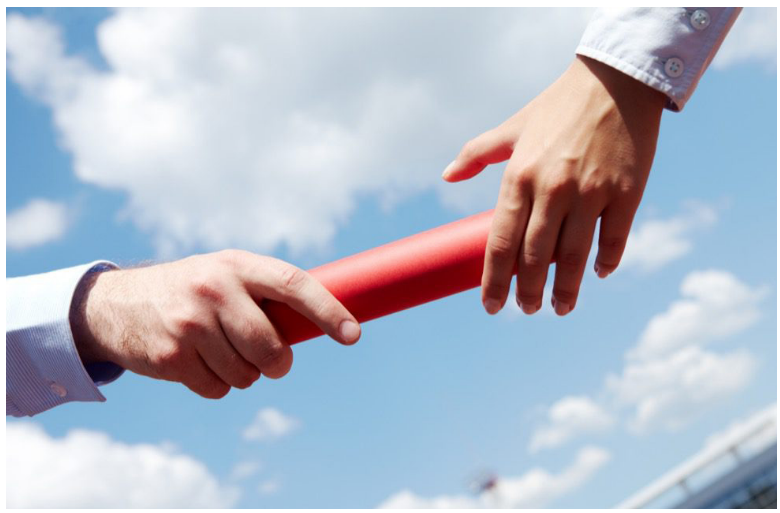

ACCORDING TO AON'S 2022 EXECUTIVE Risk Survey, which aggregates and examines responses to its annual international survey of C-suite leaders and senior executives in the U.S., the EU and the UK including 800 respondents at companies with at least 500 employees, 79% of global business leaders expect a recession in 2023. The business leaders highlight several key risks driving their pessimistic expectation including, the following: (A) supply chain disruptions, (B) geopolitical violence, and (C) extreme weather events that some leaders attribute to climate change.

Only one-third of the surveyed leaders reported being "very prepared" for a possible recession. But rather than focus on the potential for doom and gloom, we offer one avenue companies can explore to be better prepared to face those risks: sell them to someone else. Some companies perceive buying insurance purely as an expense, a drain on profits. However, sophisticated companies and their leadership enthusiastically identify the risks with the greatest potential to cause them financial damage and transfer those risks to insurers through a robust insurance portfolio tailored to best protect their business continuity.

The following are just a small handful of risks that the surveyed global leaders identified as being most troublesome, and potential insurance solutions that may be worth considering to transfer those risks.

1. Insurance for Supply Chain Disruptions

Global leaders cite possible supply chain disruption as one of the most significant negative impacts on their businesses. Given this risk's ubiquitous affect, companies should be considering how to best transfer it in an effort to eliminate, or at least soften, the potential downside.

Almost all companies already have commercial property insurance. One coverage frequently included in property insurance policies is contingent business interruption ("CBI") insurance. CBI insurance comes in many forms with varying policy language that must be analyzed carefully to know what it does and, importantly, does not, cover. To illustrate CBI, assume "Company A" is the policyholder. Broadly speaking, CBI is Company A's losses when physical loss or damage to a third-party's property interrupts Company A's business. CBI insurance can provide an important line of defense against a company's financial losses caused by disruptions to suppliers' or downstream customers' locations.

One avenue companies can explore to be better prepared to face a host of business risks: sell them to someone else.

To recover from CBI insurance, a company does not need to show physical damage to its property. Rather, CBI insurance covers the company's financial losses because a business or individual upon which the company depends incurred physical loss or damage. Many CBI coverage provisions describe the business or individual as the insured company's "customers" or "suppliers." The rationale behind CBI insurance is that the third-party property generally is "contributing" or "dependent" property to the insured company's business.

Some companies purchase a type of CBI coverage in which certain specified third-party properties that are essential to the insured's business operations are expressly described on a schedule annexed to the insurance policy in a "dependent property" coverage endorsement. For example, a hotel located in close proximity to a large theme park may list the theme park as a dependent property in its insurance policy. If, in this example, a non-excluded peril such as a fire damages the theme park and, as a result, the hotel's business is interrupted, it will have a dependent property CBI claim in the dollar amount of its business interruption loss even though the hotel did not sustain any physical loss or damage from the fire.

CBI insurance may be limited in some respects because it provides coverage if the businesses or individuals on which the insured company depends are disrupted by property damage. To fill this potential gap that exists if there is a supply chain disruption without any property damage, some companies purchase separate supply chain insurance that, in addition to broadly covering disruptions caused by property damage to suppliers' or customers' locations, covers losses caused by a wide range of events, including labor-rated issues such as strikes and shortages, political upheaval including war, transportation closures, and public health emergencies. In today's tight insurance market, supply chain insurance may be too expensive for some companies, but the added protection may be worth the cost for other businesses.

In any event, discussions about this risk and potential options to transfer it outside the company are valuable.

2. Insurance for Losses Arising From Geopolitical Violence

Global leaders note global violence – the Russia / Ukraine conflict, for example – as being a risk that poses the potential for significant negative impact on business. Several types of insurance may add coverage for business losses arising from upheaval in foreign countries, such as supply chain insurance discussed above. Additionally, companies should consider whether political risk insurance may be an effective risk transfer tool for its business.

Political risk insurance is a highly specialized form of insurance that protects a company's assets, investments, or contractual rights in foreign countries from losses caused by political events happening abroad. Depending on the type of political risk policy, covered political events may include civil unrest, vandalism, riots, wars, terrorism, expropriation, confiscation of assets, or the enactment of new laws. Companies doing business in or with significant assets moving through foreign countries should consider political risk insurance to guard against financial losses from such events.

While there are multiple variations, the following kinds of political risk insurance may be available to companies looking to transfer the risk: expropriation insurance, currency inconvertibility insurance, contract frustration insurance, political violence insurance, forced abandonment insurance, and terrorism insurance. These policies are available in varying forms, and policies are available that include more than one type of political risk coverage. For example, a single political risk insurance policy may include all three of the following coverages: expropriation insurance that protects a company from a foreign government's unlawful taking of the company's investment or assets in that foreign country; currency inconvertibility insurance that protects a company doing business in a foreign country from losses caused by the inability to convert the foreign currency being used to conduct business there back into U.S. dollars; and forced abandonment insurance that protects a company that, as a result of conditions created by political violence, must abandon an entity that owns or operates the company's assets in a foreign country.

Businesses also must decide to whom it would transfer political risks because the insurance is available from official insurers and commercial insurers. Official insurers include Overseas Private Investment Corporation, "OPIC" (associated with the United States Department of State), Multilateral Investment Guarantee Agency, "MIGA" (associated with the World Bank), and Exports Credits Guarantee Department, "ECGD" (a United Kingdom government agency). Commercial insurers offering political risk insurance include, among others, certain London Market insurers, AIG, Zurich, and Chubb. There are pros and cons associated with official insurers – which also impose eligibility requirements that may impair availability for some companies – and commercial insurers, which must be analyzed carefully before jumping into this complex risk transfer market. In addition to the stand-alone political risk policies, businesses are able to add political risk coverage to their marine cargo and shipping policies to protect against losses for goods in transit or being stored at locations worldwide. The broad coverage provided by cargo and storage policies, and the flexibility to add and tailor desired coverages to the specific business needs makes the insurance vital to companies with exposure to losses from goods shipped or stored internationally.

Lastly, geopolitical violence may have ripples across the globe including, for instance, an increase in cyber attacks resulting from the perceived instability or in retaliation for aiding one side of the original conflict. For example, a global pharmaceutical company filed a coverage lawsuit against its cyber insurance company, which denied coverage for NotPetya's impacts to the pharmaceutical company's networks, citing an insurance policy exclusion for "acts of war." NotPetya was a series of powerful cyberattacks using the Petya malware in 2017 that hit websites of Ukrainian organizations, including banks, ministries, newspapers, and electricity firms and spread worldwide. While not confirmed, Russia is the primary suspect. Indeed, the pharmaceutical company's insurer asserted that because the cyberattack originated from the Russian government as part of its hostility toward Ukraine, the pharmaceutical company's losses should be subject to the "act of war" exclusion. In the lawsuit, the pharmaceutical company claims more than $100 million in lost revenue, approximately $175 in remediation costs to bring systems back online, and more than $750 million to remediate disruption and encrypted files and improve security and acquire new equipment. In the trial court's 2022 decision, which the insurer appealed, the pharmaceutical company prevailed because the act of war exclusion applied only to traditional forms of warfare. In response, however, beginning this year some cyber insurers will add exclusions addressing state-backed cyberattacks.

Cyber insurance policies vary greatly from policy to policy and while some professionals who specialize in the area seek to address every potential cyber risk through the policy language, doing so may be counterproductive. As a practical matter, it may be wise not to lose sight of the fundamental goals when assessing insurance policies (risk transfer contracts), which include broad insurer agreements and narrow exclusions. At times, too much detail describing the specifics of a covered risk creates unintended gaps in coverage when new risks arises during the policy period or when, despite best efforts, not every nuance is addressed.

3. Insurance For Extreme Weather Events

Global leaders name severe weather / climate change as a potential significant negative risk to business that may lead to a recession in 2023. Indeed, it seems all but impossible to avoid tragic news about devastation caused by earthquakes, wildfires, hurricanes, tornadoes, and other natural disasters. Given this ever-present risk, companies may consider how to best transfer as much of its financial impact as possible.

Insurance for losses caused by natural disasters and severe weather events can be provided by several different types of insurance policies. Most companies transfer some risk of these losses through commercial property insurance policies. Many property insurance policies cover losses to real property and business interruption from all causes of loss not expressly excluded. Such policies are referred to as "all risk" insurance. Because of the breadth of coverage afforded by an "all risk" insurance policy, the burden of proof shifts to the insurer to show that the loss is excluded, once the insured company shows it suffered a fortuitous loss. By comparison, a second type of property insurance—a "named perils" policy—covers only those perils expressly stated.

Natural disaster and weather-related risk may also be transferred by other types of insurance, such as those providing coverage for environmental losses, maritime losses, transit losses, and warehouse losses, and a host of specialized coverages including, for example, event cancellation. Companies should consider if its business' revenues rely on certain events happening or are largely generated in a certain specialized industry that may not be covered by some of the more traditional types of first-party insurance and weigh whether it should consider specialized coverage to transfer the business' key risks. For example, in addition to property insurance, real estate investment trusts may find comfort in pollution liability insurance that provides business interruption coverage without any property damage requirement.

Companies that coordinate internally to align their risks that have the greatest potential to significantly affect their bottom lines with the risk transfer options available to address those risks will be best positioned to face the uncertainties ahead. Insurance is only one piece of a comprehensive risk management plan, but it is an important piece that companies and their leaders should not overlook when transferring the risks that may have the greatest negative impact on financial performance. Of course, all insurance policies include terms, conditions, and exclusions that vary by product and, often, by insurer—this article discusses them in broad strokes. CE


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