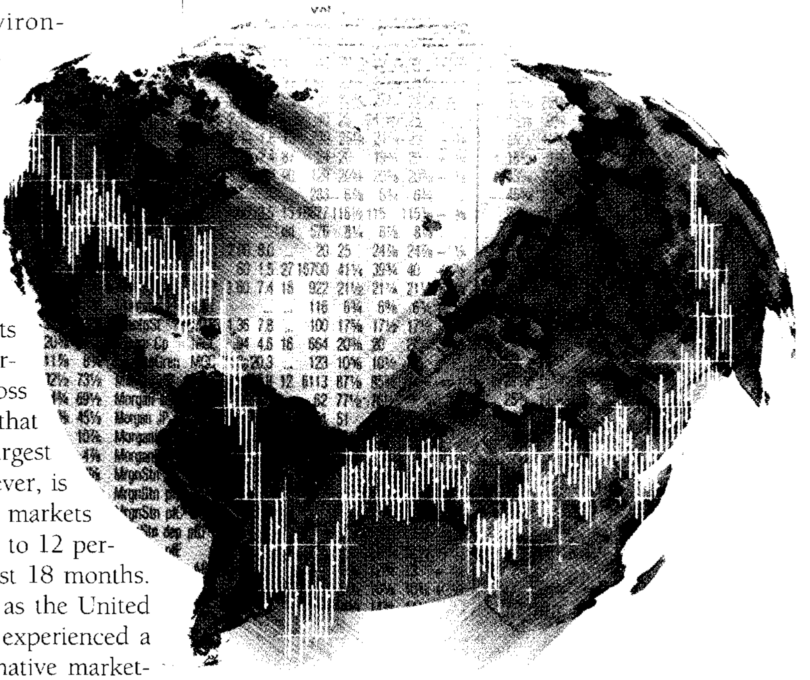
Emerging Issues IN GLOBAL RISK MANAGEMENT

BY TERESA L. PAHL

Today's risk management professionals are well-versed in traditional areas of program structure, market capacity and services within our business culture. However, with the expansion of the global marketplace, there is a growing need to understand other operating environments in which these programs exist. Therefore, it is necessary to realize how local environments are changing in the various countries of operation and how shifts in management philosophy in overseas operations can affect the risk management function.

The growth of the global insurance industry has been significant. Seventeen percent of the world's population accounts for 88 percent of non-life premiums, a market that is estimated at $800 billion in gross written premiums. These figures confirm that developed economies continue to be the largest markets. What is important to note, however, is that the premiums generated by emerging markets have grown from an estimated 3.4 percent to 12 percent of the worldwide total in only the last 18 months. Conversely, the developed markets, such as the United States, Japan, Germany and France, have experienced a level of market stagnation while the alternative marketplace has seen significant growth. Market projections for the next 10 years, along with current levels of direct foreign investment in the developing world, indicate that these percentages will increase drastically. ➢



CATE BEHRINGER

Teresa L. Pahl, CPCU, ARM, is executive vice president of Aon Risk Services Global in the Chicago office.

The growth rates of direct foreign investment, which reflects where businesses are investing, are startling: Over the last 18 months, growth in the Pacific region has reached 38.7 percent; in Eastern Europe, despite Russia's difficulties, 18.7 percent; in South America, 18.9 percent; and in the Middle East, 14.6 percent. This compares with 4.1 percent for the United States and 1.4 percent for Western Europe. This rapid growth has increased the complexity of dealing in new markets and is of critical concern to risk managers.

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Local Environmental Issues

There is disagreement over the cumulative result of increased media exposure to Western trends and values on populations of emerging countries, often called the "CNN effect." However, there is no dispute that Western legal systems, as well as perceptions regarding liability, are having an effect in developing countries in environmental and product liability legislation. Parts of Asia have duplicated existing U.S. legislation, particularly in environmental concerns. Employers' liability, directors' and officers' liability and the consumer movements in many of these countries confirm that the United States has exported many of its values and attitudes in addition to its goods and services.

Much of this is actually good news. Increased interest in life, safety and property loss conservation is prudent business. There are indications, however, that the deterioration of many of the social programs, notably in the northern European countries such as Germany and Sweden, is leading to private market remedies. This trend will clearly increase costs in those countries, especially if the operations involved are labor-intensive and unionized.

Dealing with these changes has proved to be challenging. For example, European Union directives in the environmental area have been rewritten four times in as many years. In China and Vietnam, the absence of case law regarding contractual dispute resolution has led to complicated interpretations of such matters based on a combination of Socialist doctrine and U.S. practices. The best defense in these scenarios is current and accurate knowledge and enlisting the aid of consultants who have the political and social contacts to navigate the local terrain successfully. To ensure that a prospective service provider has the necessary expertise, risk managers need to explore its experience in the local market and its local clients. Merely having a roster of U.S. multinational clients may not indicate that a provider has the necessary expertise to deal with increasingly complex local issues.

Trade Treaties

The operating environment in many countries is further complicated by trade issues, notably the current negotiations surrounding the General Agreement on Trade in Services (GATS). Unlike the more publicized General Agreement on Tariffs and Trade (GATT), these discussions have to do with opening the financial sectors of markets. Currently, GATS negotiations for both underwriters and brokers are not what had been hoped for, particularly in the areas of right of establishment and national treatment. Both of these areas, if not sufficiently liberalized, will result in increased costs to multinational companies that have active global risk management programs. For example, there are indications that the offerings out of India are prohibitive in the area of insurance market and brokerage licensing, with the distinct possibility of increased taxation on insurance premium and loss reimbursements under master controlled programs. The World Trade Organization (WTO), successor to GATT, hopes to have a final treaty by June 1997. Until then, however, lack of clarity remains a problem. There have been instances of discriminatory taxation, suspension of operating licenses of suppliers and general confusion regarding tax rates in many of the rapidly growing emerging economies.

A number of initiatives are under way within various industry trade organizations to participate directly in the WTO/GATS discussions and to better educate both the regulatory authorities and the U.S. Department of Commerce trade negotiators on the importance of market liberalization. Of particular importance is the increased cost structure that accompanies a lack of proper market liberalization, which would have an affect on direct foreign investment. The National Association of Insurance Brokers (NAIB) had been particularly active in the Geneva negotiations, the development of educational programs for foreign regulatory bodies, trade delegations and introduction of last year's comprehensive model brokerage law. In addition, the NAIB is working with the Risk and Insurance Management Society, Inc. (RIMS) whose members represent the majority of the Fortune 1000 firms in the United States, to assist in the educational process and lobby for necessary market access both in Washington and in countries where there is significant investment.

Industry Consolidation

It would be extremely difficult not to have read, heard or even experienced the insurance industry consolidation that has been occurring for the last few years. Market consolidation has improved operating margins because international service networks had become very expensive to maintain. However, it has also resulted in decreased net capacity in the primary markets. This has not proved to be a problem for buyers because new capacity for the global segment has emerged in both the Bermuda and continental European markets. Consolidation has resulted in fewer but possibly higher quality choices for the buyer. Many risk managers had also prepared for a consolidated market several years ago, when they stabilized their insurance programs by introducing consortium structures (layering their programs by utilizing several different markets) in response to several large consolidations in the underwriting markets. Although this approach was used primarily to assemble capacity, it also insulated the program from consolidations or significant changes upon renewal of a market's reinsurance treaty. An interesting side effect of this is the not-so-active market, much to the disappointment of the underwriting community.

Consolidation will continue in light of the margin pressures that are being placed on the industry as a whole. This pressure is being felt acutely on the international side of organizations as expenses associated with running overseas networks continue to accelerate. Another area of concern is the more intensive and sophisticated service demands of the typical global customer. The operating environments in nearly all countries have become more complex and require greater expertise to navigate, therefore making it more difficult to meet these increased demands.

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Consolidation is one way to overcome these obstacles and still meet the service requirements of the client segment cost-effectively.

Labor costs, long a competitive advantage for many firms, have skyrocketed with the opening of markets due to the shortage of experienced personnel equipped to deal in this complex operating environment. Combined with increased demands for service in the home country and locally, one can understand why there are so few players in the global insurance arena. "It is amazing that a U.S. domestic client would think that handling their program in 30 different countries with 30 teams of people on the ground in those countries would actually cost less than their domestic program in today's environment," commented one senior risk management executive.

Aggressive Decentralization

A popular trend that we have experienced first-hand over the last few years is the return to a highly decentralized management approach. Decentralization has always existed, but has been executed in a different fashion over the last business cycle. This is reflected primarily in the ways clients manage their risk management programs, as well as in the level of engagement we now experience by foreign subsidiaries in their programs.

Decentralization is also driven by economics and market requirements: It is prohibitively expensive to have centralized management and resources that will respond quickly. Expatriate programs, which used to be all the rage in organizations, have become too costly and difficult to involve senior management. Finally, high growth areas such as Asia and South America require a great deal more local sensitivity than countries with established investment activities.

This has implications in both the development and the implementation phases of global risk management programs. The astute risk manager will first solicit the opinions of the overseas management staff on service requirements and on the selection of an underwriting market. Understanding which functions are already centralized, or are about to be brought in on a consolidated basis, is important if only to gauge anticipated resistance levels. A good strategy is to offer options because it acts as a way to gain support and also phases in a total program over a period of time. A large number of companies cannot list the top issues (such as allocations or the inability to capitalize loss control) that their overseas people face, but they can articulate their own concerns, such as their need for information and to respond easily. With today's technology, securing this information should not be difficult.

The changes in the global marketplace have increased the frequency of executive travel, often to remote areas of the world. This requires that the risk manager work with the human resources department to determine exactly how exposures should be handled. Understanding the mechanics of the foreign voluntary compensation policy becomes vital. There are extremely comprehensive new products and services available to cover these exposures. Current kidnap and ransom programs can be expanded creatively to accommodate the needs of the firm. And coverage on such things as dread disease does not seem so exotic or expensive when a significant number of a firm's senior staff are spending three weeks at a time in obscure regions of India. Twenty-four-hour service hotlines for everything from emergency medical assistance to legal counsel is now considered prudent business. These issues, long overlooked, need to become part of the design phase of a true global asset management program.

Regionalization, particularly of financial functions, can become the risk manager's ally in the design and implementation of programs. Typically, financial executives have some experience in risk management and insurance. Access to these professionals is important because they can provide management support and assure compliance of any program that is developed. Executives also look to resources, such as the risk manager, to provide training as well as budgetary input into things such as loss control capitalization and local insurance budgets.

Political and Credit Risks

No discussion of global risk would be complete without considering the increased awareness of financial risk, particularly in developing markets. Political risk is another area of prime concern. When assessing the viability of purchasing political risk coverage, remember that the market changed fundamentally when the political process was separated from many of these countries' economic processes or ideologies. For instance, renewal of Most Favored Nation trading status for China has been granted regardless of overt human rights violations. There is worldwide recognition of the fact that a country's economic stability and growth must be encouraged and sustained for political systems to remain intact. Therefore, any companies that are involved in activities that are close to the national interest of a country such as telecommunications or energy generation would be wise to give coverage serious consideration.

Credit risks have also grown incredibly. Emerging markets, particularly those that have come out of socialist structures that have no basis of contractual law, require some level of coverage.

Conducting business globally has changed a great deal in just the last few years. Political, economic and insurance industry changes have complicated our lives and created some exciting challenges. The ability to respond to these changes will separate those who can survive from those that will simply have to step aside. Surviving in the global arena boils down to constructing the best risk management approach using proven techniques and common sense as well as gaining insight to understand the changing operating environments. RM