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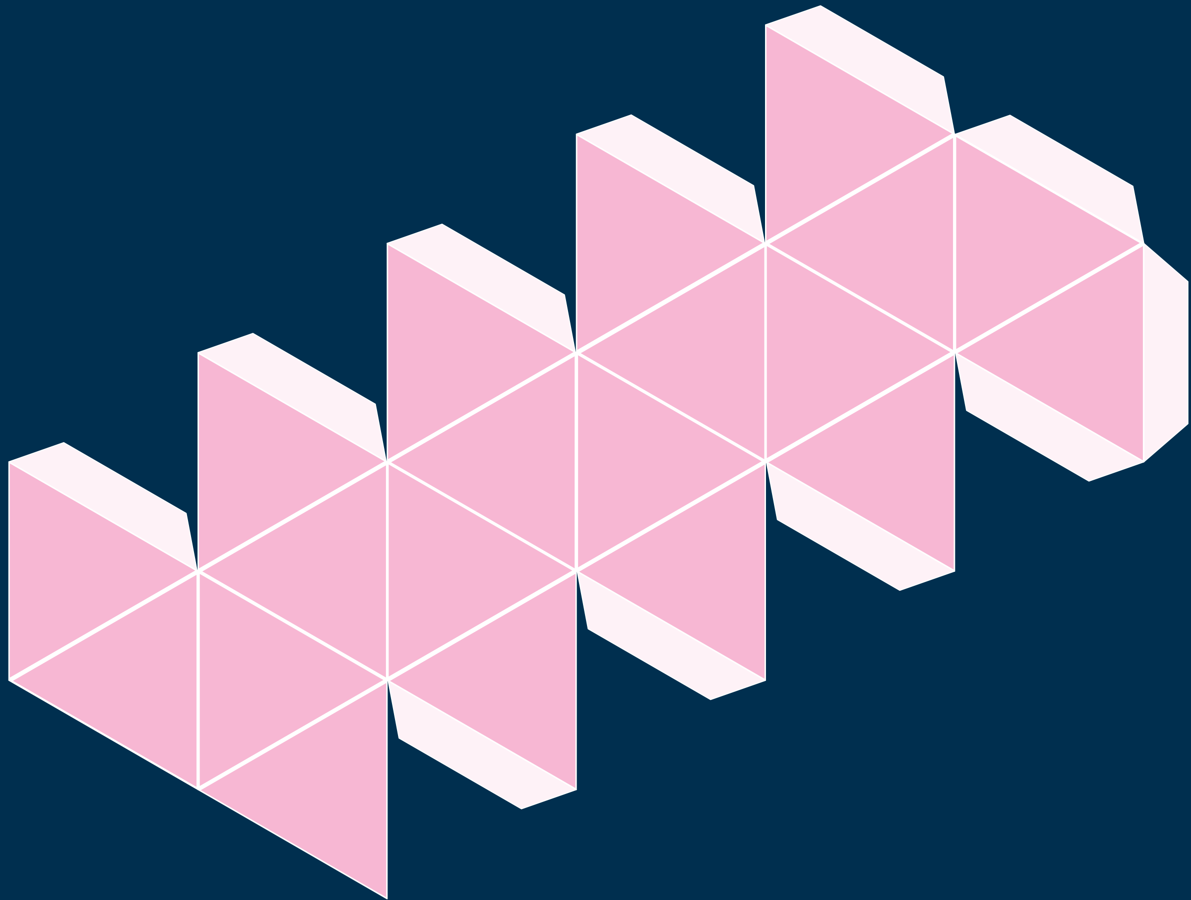

Insurance remodelled

2018/19 MARKET CONDITIONS & TRENDS

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Welcome

Following on from our Australasian launch of Legalign Global in Sydney in March this year, I am delighted to welcome you to the launch of our Insurance Market Conditions & Trends report in this region. The report has been produced by our Legalign Global partner, DAC Beachcroft, for a number of years to assist the insurance industry in the UK. This year, for the first time, the report has been expanded to include contributions from all Legalign Global partner firms to produce a truly global perspective.

The insurance world is of course changing rapidly. As the nature of risk continues to transform in this digital age, insurance must change with it. Our global alliance of pre-eminent regional insurance law firms was formed with a view to providing our insurance industry participant clients with both a global legal solution where required, as well as thought leadership to assist our clients build stronger insurance businesses.

With this latter goal in mind, I commend these thought leadership pieces. The future of general insurance, the impact of a global supply chain, the options available to insure natural catastrophes increasingly prevalent via climate change and the challenges involved in insuring cyber risks are issues very relevant to this region and our global insurance law leaders seek to provide insights to assist your thinking.

I hope you enjoy reading our report.

David Kearney
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LEGALIGN™ GLOBAL

Legalign Global comprises four well-recognised, insurance-focused law firms that are leading brands in their respective regions. It is uniquely positioned to offer clients unrivalled levels of legal excellence and uncompromising service. Each of the Legalign Global member firms has built a significant reputation for delivering high-quality legal services to the insurance industry.

BLD Bach Langheid Dallmayr, a German firm with close associations throughout Europe.
DAC Beachcroft, an international firm with coverage across the UK, Ireland, Spain, Latin America and Asia Pacific.
Wilson Elser, a firm with 34 offices in the US focused on North America and another in London.
Wotton + Kearney, a firm operating in the Asia Pacific region with a focus on Australasia.

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Reimagining general insurance

A strategic view of the extent and scope of the changes that will transform the market, developed in conversation with Helen Faulkner and Wendy Hopkins.

The very nature of insurance, its role and its relationship with society is undergoing a profound and irreversible transformation. This is not just about managing change and disruption. It is about reimagining what insurance is. The industry has to take a step back and challenge a wide range of assumptions that have underpinned it for generations. This is not easy when the bewildering pace of change sweeping through and around insurance seems relentless, rarely leaving time to reflect on the impact it is having on a sector vital to all modern economies.

Technology and the changing nature of risk

The biggest drivers of this change are technology and globalisation, but alongside them is the changing nature of risk. This ranges from the escalation in terrorist attacks on people (as opposed to property), the threat of major cyber-attacks and the impact of climate change on natural catastrophes at one extreme, to the fragmentation and individualisation of insurance at the other. Changing lifestyles mean the established model of annual insurance contracts is no longer relevant to many people and businesses.

Into this mix must be added the way people communicate with each other and, in particular, the way they wish to communicate with the corporate world that provides the products and services on which modern lifestyles depend. Communication is mobile, fast-moving and social and is fraught with awkward contradictions, especially around privacy. People appear willing to share personal details and yet are increasingly aware of their privacy rights around where their data goes and how it is used.

Reimagining insurance

The combination of these powerful forces is doing more than just reshaping the insurance industry. It is demanding that we reimagine what insurance is for, what society expects from it and how it can deliver the promises that lie at its heart. It also means reimagining the skills insurers and brokers need in order to flourish in the future and what they will expect of service providers, including law firms.

Many of those skills will be transformed – or eliminated – by artificial intelligence (AI). Roles involving the scrutiny and processing of data can now be carried out more efficiently using AI. This includes roles in underwriting and finance, where once high-level human skills, knowledge and experience were vital.

AI will staff the call centres of the future, interact with customers, answer their queries, sell them policies and process their claims. A small number of human customer service staff will be there for customers with complex needs, but they will be far, far fewer. To embrace this aspect of the digital revolution will require investment, but often over-looked is the fact that it will also require writing off some of the major investments of the last two decades in call centres, including the once highly controversial offshoring projects of the major insurers.

It also brings challenges around business continuity and succession planning. What happens when the technology fails, perhaps because of a major cyber-attack? At present, in most businesses, there are plenty of people available who have the knowledge, experience and traditional tools to keep the business running and restore it to its full operational capacity. These are not IT staff, but people who until recently did the jobs that the machines are now performing and so know what to do instinctively when asked to step in. In a decade's time that knowledge and expertise will not be so readily available and companies need to think about how they will replace them.

"There are new partnerships, new solutions and innovations emerging, which will require more dynamic and flexible partnerships between insurers, businesses, regulators and governments to ensure they can flourish."

Similar considerations apply with succession planning – developing the smaller number of highly skilled and knowledgeable people who will control what the machines do, add the vital human element and become the next generation of senior managers shaping the strategy of the industry. In many professional, technical and customer-facing roles these people start at a junior level doing routine, even mundane, work and progress up a career ladder, gaining invaluable experience and insight along the way. What happens when that work is carried out using AI? Where does the next generation of human managers and experts come from and on what should they 'cut their teeth'? This is a challenge across the insurance industry and the professions.

Transforming risk

The revolution in transport technology is one of the most obvious areas transforming risk, with active development towards driverless cars, crewless ships and pilotless planes. As this revolution gathers pace, risk arising from human error will be overtaken by risk of product safety defects, software failures and cyber interventions. This transfer of liability will be felt most acutely on our roads, where over 90% of accidents are currently caused by human error. To quote Alex Glassbrook, barrister and expert in the law relating to autonomous vehicles, the impact on society of 'robots on wheels' will be akin to the advent of 'horseless carriages' in the late 19th century.

As automation becomes the norm, eventually leading to fully autonomous vehicles, the consumer may not see much change in how insurance works. But behind the scenes it will be transformed as the fronting insurer seeks to recover from product software and infrastructure manufacturers and their insurers when things go wrong. This, in turn, is prompting manufacturers to seek new ways of mitigating, sharing or transferring risk. We are already seeing a trend towards retention of risk (through captive entities) in a bid to compete for

"It is all about imagination. Those with the imagination and courage to apply it will thrive in the digital age and meet the challenge of protecting society against the consequences of risks that are transforming apace."

market share by offering consumers the simplicity of a single price package for car, maintenance and insurance. Another commercial imperative is the war for control over personal data, where one of the key outputs from vehicle automation is the generation of data about how, when and where vehicles are driven.

Attitudes to car ownership are changing too and automation will accelerate that trend, especially as we move towards an era in which 'driving' will become a sport relegated to racing tracks. Even now, Generation X and Millennials do not have the same desire as previous generations to own or be responsible for cars. This is linked to a potent mix of other factors such as greater urbanisation, scarcity of property and parking space, enhanced environmental awareness and more flexible lifestyles. The insurance industry needs to respond to that with affordable, short-term insurance that insures people's mobility (for example, through car pools and daily leasing arrangements) and which is available through the full range of mobile technologies.

That is one of the many implications of what is often termed the sharing economy. The pay-per-click insurance model that is emerging in response threatens established distribution channels dependent on longer-term customer relationships and the commission they generate.

The connectivity now prevalent in developed economies is transforming risk beyond how people buy insurance. The Internet of Things – devices which interact with humans and with each other – is at the heart of this for insurers as it opens up new opportunities for risk mitigation. The monitoring of pipes for potential water leaks is already helping to reduce claims. In the US thousands of agricultural workers are now wearing biometric devices that monitor when they are becoming fatigued or in danger of injury so managers can intervene before injuries and accidents occur.

Connectivity also brings greater interdependency, especially in complex and extended supply chains. All businesses need a greater awareness of whom (or what) they depend on and who depends on them; this helps them to understand fully the risks to which they are exposed and where their liabilities might lie if that connectivity fails or is attacked.

The risk of cyber-attacks constantly grows with criminals developing new lines of attack faster than adequate responses to the existing threats can be devised. With cyber terrorism now a serious threat and cyber warfare between states a reality, the need to rethink the scope of cyber risks and how the insurance industry responds to them has become urgent.

Terrorism and malicious acts have not just inevitably found an outlet in the digital world but are changing their nature in the physical world too. Previous manifestations of terrorism, especially in the UK, have largely been focused on property. By the 1990s, that caused sufficient strain on the insurance industry that Pool Re had to be set up with the Government standing behind it as reinsurer of last resort. Present day terrorism has changed its focus from causing property damage to causing human casualties and business disruption. This fundamentally changes the insurance risk. The Government has recognised this in its recent commitment to amend the 1993 Reinsurance (Acts of Terrorism) Act to enable Pool Re to extend its cover to include non-damage business interruption losses resulting from acts of terrorism.

As man-made risks grow rapidly, so do natural catastrophes, although at their heart may lie another man-made factor – climate change. As reported by Munich Re, 2017 was the worst year on record for insured losses through natural catastrophes, but also one that highlighted the growing gap between insured and total economic losses. This has prompted a search for fresh solutions.

A brave new world

The answer to the changing face of risk does not lie exclusively in the hands of the insurance industry. New forms of capital from the InsurTech sector are being attracted into a market striving to find solutions to providing cover for mega-risks, and innovators are constantly reinventing the relationship insurers have with their customers. There are new partnerships, new solutions and innovations emerging, which will require more dynamic and flexible partnerships between insurers, businesses, regulators and governments to ensure they can flourish. Commerce is, after all, driven by consumer forces.

In the reimagined insurance industry the boundaries between private and public will become intertwined, much as they have already with pooling arrangements for some risks and with the emergence of parametric insurance for some previously uninsured catastrophe risks. It will also require regulators to move at a pace that supports and does not inhibit the industry in responding to the changes in how society wants to buy insurance and interact with the industry.

Forging this new relationship with society, governments and regulators will in itself require imagination as the relationships between states and the private sector are often defined by history and legacies that are hard to challenge. It is all about imagination. Those with the imagination and courage to apply it will thrive in the digital age and meet the challenge of protecting society against the consequences of risks that are transforming apace.

Helen Faulkner, Head of Insurance, DAC Beachcroft, England

Wendy Hopkins, Partner, DAC Beachcroft, England

Full contact details can be found at the back of the report.

The global supply chain: a thoroughly modern maze

As supply chains become more global, the insurance industry must be prepared to identify new risks and deal with the challenges that they bring.

There is a global technology revolution underway that is turning even everyday objects into complex products supported by highly connected and equally complex global supply chains. As Wendy Hopkins, Partner at DAC Beachcroft, puts it: "This digital interdependency is creating new, unforeseen and often unmanaged supply chain risks and exposing gaps in information and understanding that need to be addressed by both insureds and insurers. It also brings a new focus on resilience and business continuity."

Businesses have always looked to source as competitively as possible and in the modern connected world the result is an international matrix of suppliers and service providers – of mind-boggling complexity – that can be all but impossible to trace, let alone monitor adequately.

The upshot is that mapping the potential risks along the chain around the world – fire, natural catastrophe, industrial action, regulation, trade wars, the spread of isolationism and cyber to name a few – is fraught with difficulty. And the potential information saviour – sophisticated digital connectivity – is itself vulnerable to cyber-attack, system failure and energy supply disruption.

It can be no surprise that, according to the 2017 Business Continuity Institute's (BCI) *Supply Chain Resilience Report* (supported by Zurich), 69% of respondents do not have full visibility of their supply chains; and that unplanned IT or telecommunications outages (48%) are the main cause of disruption, with cyber-attacks and data breaches second. The rest, in order, are: loss of talent/skills, outsourcer failure (33%), transport network disruption (26%), adverse weather, fire, new laws and regulations, insolvency in the supply chain, and finally energy scarcity. Looking forward, cyber-attacks and data breaches (60%), unplanned IT or telecommunications outage (59%) and loss of talent/skills (34%) remain the main concerns for businesses.

Nick Wildgoose, Global Supply Chain Product Leader at Zurich Commercial Insurance UK, comments that when they started the survey, nine years ago, he nearly fell off his chair when there was a 70% incidence of significant supply chain disruption. "Sadly that figure has remained high, with 2011 marking the peak at 85%," says Wildgoose.

Corporates and their supply chains
"Corporates are, however, increasingly having to get a grip on their supply chains," continues Wildgoose, "as legal and regulatory pressures mount – including the Modern Slavery Act 2015 and incoming corporate social responsibility regulation. And while many do have the information, it is often not communicated across the company due to the existence of functional silos."

This point is echoed by Jessica Collier, Partner at Wilson Elser, USA, a Legalign Global partner, who highlights the US Food & Drug Administration's Food Safety Modernisation Act – with upcoming compliance dates over the next few years – which contains a host of supply chain transparency demands. Collier adds that the present lack of clarity and understanding along the supply chain is clearly linked to "a significant increase in product contamination and product recalls over the last two years, both in the number of claims and the size of the losses".

Robin Shute, Partner at Wotton + Kearney, Australia, another Legalign Global partner, adds that product safety law around ingredients is surprisingly subject to little detailed regulation in Australia – excluding nuts – and by and large is left to the supplier/importer to comply with general provisions. "I had a case several years ago involving iodine, which is dangerous to those with iodine deficiency. It surprised me that there were no regulations about labelling products that contained a greater than anticipated level of iodine. Parties must assess issues by reference to the statutory provisions which give general relief. In consumer situations the most important legislation is the Australian Consumer Law which gives protection against defective products."

A rise in claims is also attributable to the complexity of many modern products says Carsten Hösker, Partner at BLD Bach Langheid Dallmayr, Germany, a Legalign Global partner. "The complexity, in particular, of modern motor vehicles is a key reason why we have seen a noticeable increase in claims volumes and costs." He says the risks of complicated software and parts from a vast array of different suppliers – accompanied by a squeeze in testing timeframes as part of a focus on reducing costs – together with the increase in the spreading of news about faults via social media are all exacerbating the problem.

This pressure on reducing costs is also picked up by Hopkins: "One of the emerging challenges is that the pressure to keep product prices down often results in the stripping out of cost from the supply chain. This ranges from sourcing cheaper components to simplifying distribution models and reducing vital processes such as quality assurance, which can have far-reaching consequences along the supply chain."

Insurance products
There are insurance products designed to protect companies against supply chain disruption outside standard property and business interruption cover. Policies now exist that provide broad, multi-tier cover, not just for physical damage events but a range of non-physical risks such as industrial disputes, transportation and logistics disruption, supplier insolvency, political risk and cyber – but take-up is low. Referring to the BCI survey results, over half (51%) do not insure for supply chain losses.

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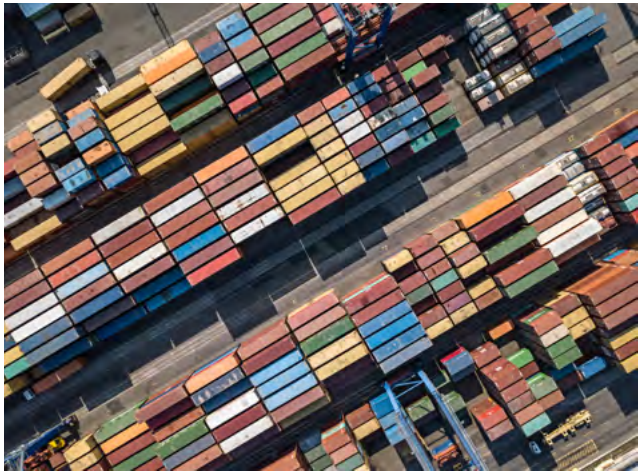
Members of risk manager association Airmic say that take-up is low outside pharmaceutical, motor and food manufacturing. They claim supply chain insurance is too costly, collecting the relevant risk information is over-complex and there is a lack of clarity over when and under what circumstances policies will pay out.

It is the issue of the relevant risk information that sits at the very centre of the global supply chain and insurance challenge. If companies do not know – or are not asked – who their second, third or fourth tier suppliers are, how can insurance underwriters correctly assess, measure and price the risks? If underwriting is challenging, then handling claims and identifying liability in this hyper-connected world is also fraught with difficulty.

Underwriting issues

Martin Alexander, Partner at BLD Bach Langheid Dallmayr, adds that another issue he is seeing is a rather lax approach to underwriting. "In product liability and recall, policy terms have become broader and wider in response to the soft market, with a trend for brokers to push for more generic clauses," says Alexander. "Most insurers are simply not asking many questions about companies' supply chains and they are not learning from and passing on experiences gained by their claims teams. We have seen many examples of underwriters only being asked about clauses once a claim is made – and it is quite typical for that underwriter to have left the company, so they cannot say what they meant or the answer they provide is not legally usable."

Shute adds that he has always been surprised underwriters are not more prescriptive about asking for details of contractual recourse with a view to recovery down the contractual chain in the event of a problem. "One of the perennial problems, of course, is China, due to non-reciprocation of enforcement of judgments, and one of the solutions I've seen is insisting Chinese suppliers take out insurance with a reputable company that has the ability to pay in the event of a claim. Even that is of dubious protective value."



"Technology in the form of big data, AI and blockchain provides a major opportunity to drive forward innovation and to help trace, identify, monitor and mitigate risks around the globe, but equally important are transparency and communication."

The gap between underwriting and claims is also highlighted by Collier who sees a clear disconnect between the two. "Insurers' focus is on winning the business and they are failing to be rigorous during the application process, in terms of gathering relevant information about the client's supply chain," she says. "Questions are left blank, and no or little information is recorded on who in the supply chain has insurance, where they are located and what potential risks they face."

Wildgoose responds with a focus on the companies themselves, with concerns that even some of the larger corporates have not always undertaken basic research into their critical supply chains – something insurers can and are helping with. "We, and other insurers, are helping corporates understand their critical supply chain risk better – including with regard to non-property damage risk," insists Wildgoose. Leading companies in respect of supply chain risk management are also increasingly investing in technology and big data to help them.

Innovative approach

Collier agrees that insurers are now really trying to grapple with the issue and demonstrating an appetite to embrace innovation, be proactive and help spread the risk – for example exploring how blockchain technology and data-driven analytics could be used to track and map their customers' supply chains themselves. However, she believes insurers are struggling to embrace digital transition – even for their own loss information and databases – and are facing a steep learning curve.

Wildgoose agrees that blockchain does have some potential but says presently big data and artificial intelligence (AI) are more advanced. Zurich, for example, which already offers the self-service risk engineering service Risk Advisor app and geo-political analysis tool Risk Room, is developing prototypes to help corporates manage their critical suppliers' risk profiles using, for example, social media and machine learning. There has, he says, been a flurry of investment in technology start-ups using AI and big data to provide tools to help companies drive transparency across their supply chain risks. These also offer significant opportunities to insurers to work alongside their customers.

Wildgoose concludes that both insurers and the larger firms have learnt much from case-by-case underwriting, with some of the latter developing their own comprehensive supply chain risk assessment processes. The next step is to extend that learning to develop viable solutions for mid-market companies.

Insurance is increasingly critical "as the glue that sticks international transactions together," adds Shute, who believes coverage gaps are now few and far between. "Product policies and particularly product recall policies are inching ever closer to product guarantee – through, for example, loss of use as part of the definition of property damage." The issue, however, confirms Shute, is that if products are below the specified standard and do not cause damage then it is unlikely that insurance will offer protection.

Supply chain risk remains a key issue for business; and as complexity and interconnectivity of both the supply chains and the products themselves increase, together with prescriptive legislative and regulatory oversight, it is imperative that insurers and insureds work together to develop innovative solutions. These will have to demonstrate new layers of resilience to ensure business continuity. Technology in the form of big data, AI and blockchain provides a major opportunity to drive forward innovation and to help trace, identify, monitor and mitigate risks around the globe, but equally important are transparency and communication.

Martin Alexander, Partner, BLD Bach Langheid Dallmayr, Germany

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Wendy Hopkins, Partner, DAC Beachcroft, England

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Full contact details can be found at the back of the report.

Cyber, conflict and cover: time for a re-think?

Cyber warfare is being openly discussed, with both offensive and defensive cyber capabilities featuring in national cyber security strategies. This poses questions about where the boundary lies between what is insured as a commercial cyber risk and what is a war or terrorism risk.

The debate about the boundaries of cyber policies cuts right across the insurance industry's strenuous efforts to raise awareness of the need for cover and the availability of a growing range of solutions. Just as many more businesses look to the insurance market to protect them, the market is starting to raise warning flags over issues around aggregation and systemic risk.

Many businesses are ill-prepared for the potential impact of major cyber-attacks, with smaller firms often believing they are too small to be a target. This leaves them vulnerable because they frequently do not put the policies, staff training and technical measures in place to protect themselves and do not buy the insurance protection that would provide them with the right indemnification and support when an attack comes.

This is a common problem around the world, says Dr Maya Bundt, Head of Cyber & Digital Solutions at Swiss Re. "Many smaller companies are still not aware of the true nature of cyber risk that has crept into their business model as the flip side of digitisation. An often-heard argument from the industry is that their small size precludes businesses from being targets. Unfortunately, this is not true. Smaller companies can be hit by a wide-spread or large scale cyber event just the same as larger companies. In fact, they might even be less prepared and more vulnerable."

Awareness of the need to take cyber security seriously and insure against the consequences of attacks and data breaches was given a major boost by the arrival of the General Data Protection Regulation (GDPR) in Europe at the end of May. This not only helped push cyber risks up the boardroom agendas of European business but has had a significant impact elsewhere.

In Australia, mandatory reporting was introduced in February this year and is already having an impact. "Even though mandatory reporting was introduced in February, GDPR is prompting Australian companies, especially those with customers in Europe, to look at adopting an even stricter regime. This could prompt an earlier than expected review of current legislation," says Kieran Doyle, Special Counsel at Wotton + Kearney, Australia, a Legalign Global partner.

"Other jurisdictions are having to adopt GDPR procedures if they have significant business relationships in the UK and Europe. In New Zealand, export-driven businesses are likely to be ahead of the game and need to be right on top of what GDPR requires of them," says Mark Anderson, Partner at Wotton + Kearney, New Zealand.

Exposures have grown much wider than protecting against the typical data breaches, phishing, malware and ransomware attacks that are almost an everyday occurrence for businesses. Major incidents such as last year's worldwide cyber-attack by the WannaCry ransomware cryptoworm dispelled a lot of complacency about the potential for attacks to propagate and have a serious impact on a wide range of businesses in the highly connected world of modern commerce.

This creates a potential "shrapnel effect," says cyber expert Hans Allnutt, Partner at DAC Beachcroft, in which businesses far away from the centre of an attack suffer. "It is easy to rationalise a cyber-attack that is focused on your business system or data, but when you see things happening in your system that do not seem to be focused on your business, this might be the shrapnel effect. You are not the original target of the attack, but you get affected by it."

Covering this risk means taking a much broader view of the range of business interruption (BI) cover businesses require, a trend that is already running strongly in the US, says Gregory Bautista, Partner at Wilson Elser, USA, a Legalign Global partner.

"Many companies are increasingly concerned with potential BI losses triggered by cyber events such as the global WannaCry and NotPetya attacks last summer. These incidents have made cyber BI coverage more relevant from a buyer's perspective. As property and other traditional insurers seek to reduce their potential exposure for cyber-related losses, cyber insurers in turn have begun expanding their policies to include BI and contingent (third-party) business interruption (CBI) coverage resulting from cyber events or attacks. These BI losses can dwarf any potential privacy losses arising from a loss or theft of personal data."

"Smaller companies can be hit by a wide-spread or large scale cyber event just the same as larger companies. In fact, they might even be less prepared and more vulnerable."

UK insurers need help to determine and price cover but may step away from conflict cover

Joe Ahern, policy lead for cyber insurance at the Association of British Insurers (ABI), told a recent event hosted by the Centre for the Study of Financial Innovation (CSFI) that insurers needed more help from the Information Commissioner's Office (ICO). In particular, he said the ICO must share more information about data breaches with insurers.

The ABI has called on Government and the ICO to allow insurers access, in a secure and anonymised way, to data from the mandatory breach reporting requirement under the GDPR. This, says the ABI, would provide a valuable source of data for insurers to assist them in assessing and pricing the risk of potential customers and enable insurers to offer broader and more tailored cover to firms of different sizes and sectors. The ABI says it has support from Government for this proposal and will continue to make its case to the ICO.

The issues around the extent of the commercial market to continue to offer cover without exclusions for war and terrorism was also raised at the CSFI event. The ABI says that if the market is to continue to evolve sustainably, insurers may look to exclude damages emanating from attacks on critical national infrastructure, war and terrorism. This would be intended to mitigate against aggregation risk arising from cyber-attacks and is in line with insurers' responsibility to the Prudential Regulatory Authority to manage exposures prudently.

Global reinsurers share this concern according to Dr Bundt: "Insurance and reinsurance companies need to measure and manage their exposure to cyber accumulation carefully. Also, for very large events that are too big to be borne by the insurance industry alone, it might make sense to find additional risk-sharing arrangements in public-private partnerships or with capital markets."

His colleague Anjali Das, Partner at Wilson Elser, says the market is responding to this by extending the cover that is available. "Increasingly, CBI coverage is being offered in some cyber policies, which protects companies which depend on third parties for their operations from cyber-attacks on those third-party providers. CBI coverage anticipates third-party supply chain disruptions that may have a significant adverse impact on an insured's operations. Recently, we have in fact seen an uptick in cyber claims reported by an insured originating from an attack on one of their vendor's computer systems or networks."

While the extension of cover to protect against the 'shrapnel effect' will accelerate, preparing and protecting against attacks will get harder as the techniques used by criminals constantly evolve. If that is not already a big enough challenge, identifying the source of attack is getting harder too, says Allnutt. "The methods of attack are quite wide-ranging and the people who are motivated to carry them out are increasingly diverse too. They could be states, criminals, terrorists, activists – or just a renegade with some basic technology skill."

For the insured who has bought cyber cover they just want the insurer to move quickly to help them mitigate their losses and get back to normality as quickly as possible, secure in the knowledge they will indemnify them against the losses suffered: "The policyholder doesn't want a lot of questions about whether a terrorist or a malicious individual was behind the attack," says Allnutt. "They will just want their cyber losses insured."

The challenge for policyholders now is that insurers are looking for greater clarity and will need to ask precisely those questions. The answers might determine whether – or to what extent – the policyholder is covered, adds Dr Bundt.

> *"…when you see things happening in your system that do not seem to be focused on your business, this might be the shrapnel effect."*

"Until a few years ago cyber business was written with both war and terrorism exclusions. Mostly due to the difficulties in defining and proving cyber terrorism and the fact that insureds have a strong need for protection and contract certainty, terrorism exclusions have largely vanished for cyber business," she says. "In fact, different jurisdictions have been reacting in different ways to deal with terrorism risk. For example, Pool Re in the UK has explicitly included property damage resulting from cyber terror attacks into its scope."

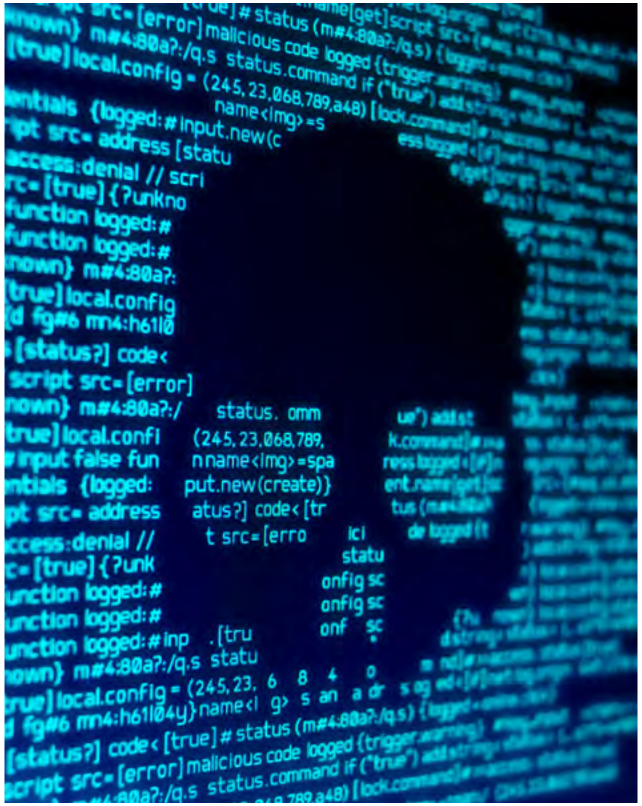
There are no easy answers to questions around the definition of terrorism, says Bastian Finkel, Partner at BLD Bach Langheid Dallmayr, Germany, a Legalign Global partner. "It all depends on the question of what exactly I want to insure. If I want to exclude war or – more relevant – terrorism risks, I must be clear about the definition of terrorism. Will this only be defined by the subjective goals of the terrorist or, alternatively, also by objective criteria regardless of the terrorists' motivation? In our experience, the cyber world knows different forms of terrorist-like acts, although they might not fulfil criteria of classical terrorist acts. Maybe such a distinction must be ignored in the cyber-insurance world. That, of course, would lead to a broader coverage."

Australia could extend terrorism cover

In Australia, many cyber offerings from local insurers provide cover for cyber terrorism rather than exclude it. This is probably due to the cyber insurance market still developing, albeit at a fairly rapid pace. Additionally, while there is cover under the Australian Reinsurance Pool Corp (ARPC) for declared terrorist attacks for property risks, the same cannot be said for a cyber terrorist attack so it is important that there is cover in cyber policies for cyber terror, says Kieran Doyle. The ARPC is pushing to review this later in 2018.

Allnutt says the question now being debated among cyber underwriters is how to define the scope of their cover and to whom they offer it so as to limit the potential for aggregation. "There is a fear of aggregate systemic exposures among insurers," he says. "This is leading some of them to question the current definitions and scope of cover. We know that the physical risks from war and terrorism are too large for individual insurers to cover and that market solutions such as Pool Re have to be put in place. It is time to look at definitions of conflict in the age of cyber too as, indeed, Pool Re has done by extending its cover beyond physical damage."

This is far from being a UK problem alone but the solutions are going to be hard to define, says Dr Bundt: "In times of cyber conflict, the picture has become even more challenging, the main reason being that it is very challenging to attribute cyber-attacks to a certain actor. That makes it also extremely difficult to decide if a cyber event is, in fact, an act of terror or not. One example here is the apparent terror attack on the French TV network tv5, which later turned out was not performed by ISIS, but by a well-known group of Russian hackers.



"For the insurance industry this means that trusted mechanisms like airtight exclusion language does not work anymore," she concludes. "We need to find ways to safeguard both potential victims of such an attack and the insurance industry as a whole."

The challenge of reconciling those two laudable objectives is going to draw the insurance industry into another debate about its role in modern society.

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Natural catastrophes: can the market withstand the storms?

Climate change and natural catastrophes are necessitating new approaches to insurance and reinsurance, posing real challenges to traditional models.

Across the globe, natural catastrophes are increasing in frequency and scale, as illustrated in the accompanying timeline. The impact on the insurance market has been dramatic with Lloyd's of London's results last year showing exposures of £2 billion as it bore the brunt of the worst year on record for insured losses from catastrophes.

These escalating losses are putting a huge strain on the insurance market and traditional coverage. This has pushed the debate about availability and affordability to the fore in many markets and prompted an expansion of parametric insurance in some of the most at-risk regions. Another response has been the rapid growth in cat bonds, posing a further challenge to traditional models of insurance and reinsurance.

The growing gap between insured and total economic losses is also putting pressure on the insurance and reinsurance market to find fresh solutions. This creates an opportunity for insurers prepared to embrace non-traditional forms of cover, according to Ernst Rauch, Head of Climate and Public Sector Business Development at Munich Re.

"In many developing countries, losses from natural catastrophes often remain almost totally uninsured," says Rauch. "Even in highly developed countries like the US, whose share of insured losses is significantly greater, more widespread insurance coverage would still be very beneficial to the economy.

"When hurricanes Harvey, Irma and Maria struck, some Caribbean islands were hit twice in a row. Yet only a few days after the events, the Caribbean Catastrophe Risk Insurance Facility, a public-private regional insurance pool, was able to pay out around US$50 million in emergency funds."

Climate change
The market is facing huge challenges as climate change contributes to an increase in catastrophic weather events, says Munich Re board member Torsten Jeworrek: "A key point is that some of the catastrophic events, such as the series of three extremely damaging hurricanes, or the very severe flooding in South Asia after extraordinarily heavy monsoon rains, are giving us a foretaste of what is to come. Because even though individual events cannot be directly traced to climate change, our experts expect such extreme weather to occur more often in future."

Even in Europe, where major natural catastrophes are rare, the increased frequency and severity of coastal and alluvial flooding has put weather-related risks and climate change firmly on the agenda, says Carsten Hösker, Partner at BLD Bach Langheid Dallmayr, Germany, a Legalign Global partner: "We see the impact of climate change in the increase in big storms over the last few years, especially in areas near large rivers."

Martin Alexander, also a Partner at BLD Bach Langheid Dallmayr, says business and domestic property owners near rivers do not necessarily buy all the cover they need and in parts of eastern Germany cover has actually been withdrawn because of the frequency of claims: "The question has now come up as to whether insurers should be obliged to provide cover. This will be taken seriously because Germany is a country of compulsory insurance. The problem is then about affordability."

Keeping insurance affordable
In the UK, the increased frequency of severe flooding led to the creation of Flood Re. "This market initiative has ensured that homeowners in high-risk areas can retain access to flood cover. It was launched in April 2016 and now collects £180 million a year from household insurers in order to provide cover for properties for which there would not otherwise be flood insurance. The success of Flood Re is likely to pave the way for similar pooling arrangements across Europe," advises Simon Jones, Partner at DAC Beachcroft.

At the end of March 2018, Flood Re announced it would not be increasing the premiums it charges insurers when they cede policies to the scheme, with an acknowledgement that affordability has to be addressed.

"The latest data, from our half-year results, showed a continued improvement in the availability of home insurance for both those with prior flood claims as well as those in at-risk areas. On affordability, the average premium for those in flood risk areas rose by less than the mass-market average," said Andy Bord, the new Chief Executive at Flood Re, when he announced the freeze.

Catastrophe timeline

1991	Tropical cyclone Bangladesh – 139,000 deaths
1992	IRA bomb Baltic Exchange, London – cost £800 million
1993	IRA bomb Bishopsgate, London – cost £350 million
1994	Northridge earthquake, USA – cost $44 billion
1995	Kobe earthquake, Japan – cost $100 billion
1996	Canary Wharf and Manchester shopping centre bombings
2001	World Trade Center attacks – 2,996 deaths
2003	Heatwave, central Europe – 70,000 deaths
2004	Indian Ocean Tsunami – 220,000 deaths Madrid train bomb – 193 deaths
2005	Pakistan earthquake – 88,000 deaths Hurricane Katrina (and Rita, Wilma) – total cost $150 billion London tube and bus bombs – 56 killed
2008	Hurricane Ike, US/Caribbean – cost $38 billion Cyclone Nargis – 140,000 deaths China (Sichuan) earthquake – 88,000 deaths, cost $150 billion
2010	Pakistan floods Haiti Earthquake – 159,000 deaths Earthquake and tsunami, Chile – cost $30 billion
2011	Earthquake and tsunami, Japan – cost $210 billion Thai flooding – cost $43 billion Christchurch earthquakes
2012	Hurricane Sandy, USA – cost $68.5 billion Major drought, USA – cost $20 billion
2013	Boston Marathon attacks Flooding in Germany – $12.9 billion Typhoon Haiyan, Philippines – major impact on 16.1 million people
2014	Typhoon Hagupit, Philippines Worst floods in 50+ years in Northern India
2015	Nepal Earthquake – cost $10 billion South Indian Floods Indian Heatwave with temperatures of 118 degrees Fahrenheit Terrorists attacks in Paris – 137 deaths
2016	Earthquake, Japan – cost $3.5 billion Terrorist attacks in Berlin Brussels bombing – 35 deaths
2017	Earthquake, Mexico Hurricanes Harvey, Irma, Maria, USA/Caribbean Bushfires in Australia, California and Portugal Terrorist attacks in Barcelona, London, Manchester, Paris, Stockholm, Brussels Central Station attack

Much larger pooling arrangements are common in other parts of the world where the potential scale of losses from natural catastrophes makes the provision of insurance on a normal commercial basis impossible.

In California, for instance, there are pools for earthquake cover and for wildfires. However, their existence still does not stop regulators and legislators from putting additional pressure on insurers to provide generous cover and to pay out quickly when disaster strikes, says Paul S White, Partner at Wilson Elser, USA, a Legalign Global partner.

"When there are catastrophic events affecting significant numbers of people, regulators and legislators want to put pressure on insurers to help their citizens," says White. "This often means there is a rush to judgement as to how insurance policies will apply."

This has led to a quasi-parametric approach to settling catastrophe claims. Insurers are paying out for total losses in wildfires without the need for a detailed inventory of the items destroyed. This pushes the boundaries of traditional indemnity insurance contracts.

"The growing gap between insured and total economic losses is also putting pressure on the insurance and reinsurance market to find fresh solutions."

It has kept domestic policyholders content, says White, but it is not the full answer to the challenge of responding to thousands of claims in a disaster situation: "It is not clear who will take the lead on moving towards a parametric approach. It would have to allow insurers to take this approach into account in the underwriting process. There is also a need to better understand the scope of the likely cost of claims."

He adds that insurers must be able to decline some risks, something the California insurance commissioner makes it very hard to do: "At some point the insurance industry needs to be able to push back on the certainty that there will be a total loss. Compelling insurers to cover everything will not be attractive to them."

Parametric insurance would have a significant impact on the way natural catastrophe claims are handled, says Tony Rai, Head of London Market Claims at Hiscox. "As the triggers for claims pay-outs are already agreed, there will be much less need to send teams of adjusters out to disaster areas in the immediate aftermath to carry out a traditional claims assessment. How does this change the disaster response models of major insurers and adjusters? In the event parametric covers were widely used in catastrophe-exposed areas, then it would change the way in which such claims are adjusted. If the triggers in parametric covers were the same across multiple policies, then once they were affirmed as met, claims payments should flow very quickly. Loss adjustment expenses would reduce dramatically from the current average of 8% to 12%."

Parametric insurance should make the claims process simpler but there are also potential complications, continues Rai. "In theory, parametric covers will make the adjustment process simpler but only where the policy terms are very clear and the assessment of the requirements can be proved to have been complied with at the outset. For example, whether a specific area has been impacted by a category 1, 2 or 3 hurricane is simple, but determining whether there have been sustained wind speeds in a specific area can be far more difficult if there is no wind-speed measuring equipment at that location or it is inoperable due to the hurricane."

What is parametric insurance?

Parametric insurance is a rapid-response financial instrument that makes an immediate payment based on a specified trigger or intensity of an event (for example, wind speed or earthquake magnitude) or the amount of loss calculated in a pre-agreed model. Unlike traditional insurance settlements that require an on-the-ground assessment of individual losses, parametric insurance relies on an assessment of losses using a predefined methodology.

What is a cat bond?

A catastrophe bond is a high-yield debt instrument. They are used by property and casualty insurers and reinsurers to transfer defined risks to investors. This lowers reinsurance costs and frees up capital for underwriting. The structure of a cat bond provides for a payment to the insurance company if the defined event occurs, such as a certain magnitude earthquake or a total insurance loss greater than a particular amount. Although cat bonds reduce risk to insurance companies, this is borne by the buyers of the securities who might see their interest payments reduced or even the principal wiped out. It is mitigated by the short maturity, which is typically three to five years.

Australia and New Zealand show signs of strain

Australia and New Zealand have had a series of natural catastrophes in recent years and the strain is beginning to show. There has also been a significant infrastructure boom in Australia on the back of Government-led stimulus which has increased exposures. When catastrophes have hit, these infrastructure projects have generated some significant property damage losses.

"The generosity in the wordings and the pricing has to be addressed quickly," says Adam Chylek, lead Partner in the major loss practice at Wotton + Kearney, Australia, a Legalign Global partner.

He says many major defect losses, especially in infrastructure projects, could have been predicted but were not properly priced. The magnitude of other significant losses caused by Australia's haphazard weather – particularly contingent business interruption losses in the crucial mining sector and associated industries – were simply not foreseen. That combination of factors seems to be causing insurers and reinsurers to review their pricing, policy structures and coverage parameters.

Aggregation is also a hot topic as regional losses can cause quite varied outcomes based on the event and aggregation language chosen. Many Australian insureds have international operations and event aggregation in different markets has led to a range of coverage results, for example Australian industries operating in California and affected by the wildfires. Insurers have been prompted to get more sophisticated about aggregation, says Chylek, with event clauses and common cause clauses being tightened up.

2017 losses

The hurricane trio of Harvey, Irma and Maria cost the insurance industry a record amount in 2017. The final insurance bill for those and other natural catastrophes, including a severe earthquake in Mexico, is estimated at US$135 billion by Munich Re – the worst ever. These pay-outs only covered around 40% of the total economic losses which are estimated to be over US$330 billion. Across the world, over 11,000 people died in natural disasters in 2017.

Flood and other exposure cover is an ongoing subject of debate in Australia with insurers regularly locking horns with the Federal Government to try to hammer out coverage solutions in problematic areas regularly affected by weather events.

The serious earthquakes that have hit New Zealand in the last few years have prompted a review of the levy imposed by the Government's Earthquake Commission and an end to the cross-subsidy from less hazardous regions, says Antony Holden, Managing Partner at Wotton + Kearney, New Zealand.

He continues: "Parametric insurance is on the agenda but faces a few hurdles. It has had an airing in the New Zealand market but hasn't got much traction yet. It could be offered as a standalone or as a trigger for a cat bond. One major hurdle is that the Earthquake Commission is only allowed to obtain reinsurance via traditional models. If that is relaxed we could have cat bonds with parametric triggers."

Elsewhere in the Pacific, the World Bank has been trialling a parametric solution for 14 island countries in the Pacific Ocean working with five major reinsurers – Swiss Re, Munich Re, Sompo, Mitsui and Tokio Marine – and backed by over US$40 million from the US, UK, Japan and Germany to capitalise the scheme.

The involvement of the World Bank in promoting parametric insurance is a clear indication that governments see it as a solution to the growing gap between insured and economic losses. The pressure on the insurance industry to embrace it will grow, as will the expectation that national insurance markets will participate in expanded pooling arrangements to meet the challenges of climate change and natural catastrophes.

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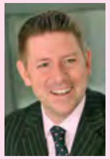
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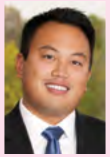

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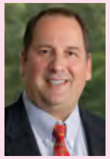

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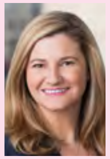

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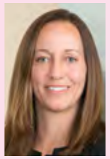

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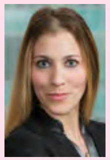

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