

SPEECH TO AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS

MELBOURNE, 18 JULY

**“THE CHANGING RISK ENVIRONMENT
FOR GLOBAL BUSINESS”**

Good morning, I am delighted to see you all.

Thinking about the subject of risk on the way over here today, I was reminded of the story of the wife, reading a letter at breakfast. She looked up suspiciously at her husband, explaining that she had received a letter from her mother, which said she wasn't taking up their invitation to come and stay, as they did not appear to want her. “What does she mean by that?” asked the wife. “I told you to write and say that she was to come at her own convenience. You did write, didn't you?” The husband confirmed that he had indeed written: “But I couldn't spell *convenience*, so I wrote *risk*.”

Everyone considers risk in a different way. At a personal level, all of us are familiar with personal health and safety risks. On a business level, we also have to deal with many familiar risks: a deal may fail, a relationship can go sour, a market can collapse and a fire can consume production

facilities. Typically, executives have dealt with one sort of risk, while health and safety officers and risk managers handled the other kind.

Today, however, risks can increasingly set off a chain reaction, causing losses that are unexpected, and that don't fall into any management pigeon-hole. At the risk of making myself sound old, it's not so long ago that cash registers and typewriters were powered by fingers. Contact databases were made of ledgers and index cards. For fresh air we would open a window. But now, as our society and business environment becomes ever more advanced, those chain reactions are becoming greater and greater. Operations can cease for days or weeks, and reputations can be ruined by a simple event that in days past might have passed with much less concern.

So in December 2001, when bushfires were raging to the north, west, and south of Sydney, many businesses were affected even though they were located in areas untouched directly by the fires. The reason? The electricity was not flowing properly. The blazes were causing spikes in the power supply throughout the city, and some companies shut down their computers and reduced their air conditioning¹. And it could have been a lot worse. Should the Transgrid supply system be more severely tested

¹ Sydney Morning Herald, Firestorms Paralyse Sydney, 5 December 2001

next time, business in Sydney could come to a complete halt, possibly for weeks, with billions of dollars in losses. Fifty years ago, these knock-on effects would not have existed.

My point is that, quite simply, risk is changing.

Today, I want to talk about three particular ways in which I believe risk is changing, which are beginning to have an impact on all of us and are shaping our future. Together, they present us with what I believe is an unprecedented challenge, because if we don't keep abreast of the changes, they have the potential to overtake and engulf us.

Terrorism

The first major trend I want to talk about today is the changing risk of terrorism. September 11th altered - for ever - the way in which we think about this risk.

First, the nature of attack has changed. Suddenly, we need to reckon with the idea of suicide bombers, amongst us in our communities, who can attack at any time. We also need to factor in the threat of biological, chemical and nuclear weapons being used.

Not here, you might say, in Melbourne. But if 2001 introduced the new horror of terrorism, it was the atrocities in Bali and elsewhere the following year which prove it is a global risk, not confined to any one city or one nation. At Australian Industry Group's April security conference here in Melbourne, the unanimous view was that any Australian businesses is a potential target if it has strategic importance, is key to the country's infrastructure, provides a key service or product, or has a high profile in the community².

Third, the impact of terrorism has changed. September 11 was a terrible reminder that the terrorist's battlefield are our streets, our shopping malls and our homes. And the devastation caused by the destruction of the World Trade Centre illustrated that the terrorist act itself can have untold, unforeseen consequences for businesses far and wide.

That explains why companies now see business interruption as the number one threat. Lloyd's believes this accounts for 20 to 25% – or US \$10 billion – of the overall September 11 loss³. Protecting industry from the insurance costs of such disruption has become a major task for us. In fact, Lloyd's has decades of experience in this area and is the leading international

² April 2003 newsletter, Australian Industry Group

source of terrorism insurance and reinsurance products. Lloyd's has long supplied cover for customers in countries where terrorism exclusions were commonplace before September 11th.

So, you will not be surprised to hear that Lloyd's is a supporter and an active participant in the new Australian terrorism pool, established to protect against the terrorism risk. In my view, this partnership between government and the insurance industry will prove to be an effective way of combatting losses from terrorist acts. And, as you may know, the system is very similar to the one we have in the United Kingdom.

I should add too, though, that in the UK, a private insurance market for terrorism risks has always operated alongside the government-backed scheme. For various reasons, some companies feel they require more or different terrorism insurance than that provided through Pool Re; and as always, we have been keen to develop solutions. So my message to businesses is, think about and weigh up the risk, in view of the changing environment. If you decide that you do need access to commercial insurance expertise, the good news is that there are specialist players who will work with you to provide it.

³ Lloyd's CFO survey 2002, as cited in "Altered States", Lloyd's, 2002

The rising toll of natural catastrophes

No less a daunting challenge to 21st century society is the changing risk profile of natural catastrophes.

Here are some facts. First, 12 of the worst 13 storm losses happened in the last ten years⁴. Second, insured losses in the 1990s were more than 20 times greater than in the 1960s, even when inflation is factored in⁵. By 2050, it will be even worse, with the UN predicting that losses will then be a staggering 900 per cent higher than they are today⁶.

In other words, both the frequency and severity of natural catastrophes is increasing. That means that we have to change our assumptions.

Australia, as you know, is subject to the full range of natural catastrophe exposures, including earthquake, cyclone, hail, flood and bushfire. Here, total economic losses from natural catastrophes total more than \$1 billion annually⁷.

⁴ Source: Insurance Services Office, Munich Re, Swiss Re, all 2002

⁵ Source: Munich Re Topics 2002

⁶ All statistics in this sentence *Global Climate change threatens the insurance industry*, The Environmental News Network, August 2002.

⁷ Bruce Thomas, "Caution Pays: The impact of natural events on insurance"; Victorian coastal conference, Melbourne 2002

Why the dramatic change? First, weather patterns are changing. In the period between January 2001 and February 2002, nine separate storms caused insured storm losses in Australia of over \$202 million⁸. The number of moderate storms is growing. And at the more extreme end of the spectrum, the Sydney hailstorm was Australia's largest ever loss, at \$1.7 billion. It happened in April, at a time when the season for such storms was supposed to have ended. The lion's share of the claims cost was for damage to private cars and residential property, with a staggering 800,000 claims filed.⁹

To an Englishman such as myself, accustomed to rather cooler grey winter weather, global warming might all sound very attractive. But the insurance industry is thinking through what this change in the weather means in reality. Have we enough research to make proper judgements? Do we have the right modelling techniques in place? Have we thought through the hidden consequences of hotter summers and wetter winters on demand and supply of goods, of business performance, on mortality?

⁸ "Natural Disaster Costs Continue to Climb" media release, Insurance Disaster Response Organisation, 14 March 2003

⁹ All statistics in this paragraph except footnote 8 are Insurance Disaster Response Organisation website, viewed July 2003

Which brings me to a second reason behind the growing impact of catastrophes. People are populating exposed areas in ever increasing numbers, such as South East Queensland and the North coast of New South Wales¹⁰. It is happening all over the world: more people are moving to coastal areas, increasing the potential for damage from natural catastrophes, at the same time that the catastrophes themselves are becoming more frequent and, in some cases, more intense.

A third part of the explanation for these mounting losses is that our business environment has become more complicated. Here's an interesting fact: the most expensive claims resulting from the Hailstorm were for not for property or motor losses, but for business interruption. They averaged 368,000 Australian dollars, compared to about \$9,600 for household claims and \$6,600 for motor claims¹¹. Once again, the combination of changing risks – more frequent storms and new business practices – has changed the nature of the risks we face.

Floods halt deliveries, storms take out power supplies, and earthquakes knock sophisticated machinery out of alignment, even if it is miles away from the tremor.

¹⁰ Bruce Thomas, “Caution Pays: The impact of natural events on insurance” ; Victorian coastal conference, Melbourne 2002

¹¹ General & Cologne Re Topics #8, April 2002

Earthquake provides another case in point. We don't really know if the world is getting more or less shaky. Here in Melbourne I understand your earthquake risk is lower than elsewhere in the country.

But the earthquake risk is changing too, even if its frequency and severity is not changing in the same way as for weather-related disasters.

Technology is vulnerable to earthquakes, as the 1999 Chi Chi earthquake in Taiwan showed. Even though the island's seismic profile was well known, the quake took insurers by surprise. The growth of the semiconductor manufacturing industry had been enormous. The main centre for the industry was a long way from the epicentre of the quake – just as Melbourne is likely to be distant from a major Australian quake – but it still knocked the sensitive manufacturing equipment out of alignment, supplies of water and power were cut off, and business shut down for up to two weeks.¹²

Again then, my message is that businesses today need to look at these risks in a different way, and plan accordingly. Here in Australia, the 1989 Newcastle quake caused over \$1 billion in damage¹³. What would be the

¹² Reuttener, Erik: Chi Chi three years on, Global Reinsurance, December 2002

¹³ Bruce Thomas, "Caution Pays: The impact of natural events on insurance"; Victorian coastal conference, Melbourne 2002

impact on Melbourne if it was repeated today, perhaps just a bit bigger and a bit closer? A disaster on that scale could have a massive practical impact on your business – and indeed on the entire economy. In today's highly advanced environment, you need to factor in the risk and cost of interruption to your business.

The Cost of Litigation

The third area of risk I want to discuss is the rise in litigation around the world, and its impact on business.

Not long ago in the United Kingdom, we always saw the costs of litigation as an American problem. But it is not so any more. And here in Australia, as in the United States, it seems that going to court to sue other people or companies has become a national pastime, something that ranks alongside catching a game of soccer or rugby.

Insurance markets have no choice but to pass on the cost to the consumer sooner or later. So the final nail in the coffin is the effect of higher premiums on companies, small businesses and individuals.

The cost to the economy has been huge, and at last the governments in the US and here in Victoria are trying to tackle part of the problem through tort reform. The Insurance Council of Australia is absolutely right when it says that reforms are the only way to achieve improved accessibility and affordability for liability insurance¹⁴.

We have ended up with a situation where the current Australian professional indemnity capacity is estimated to be only \$110 million. Most companies have left the market due to the poor claims record¹⁵.

Already, claims against doctors have risen so high that they cannot buy insurance at prices they can afford. The surgical and obstetrics units of Australia's hospitals are shutting down as a result¹⁶. Surely that cannot be the intent of any justice system.

But unrestrained litigation has a wider and more dangerous impact on business too. When you read that companies have been sued for not warning customers that the coffee they are selling is hot, you begin to wonder what you cannot be sued for. Incidentally, the "McDonald's hot coffee" case was repeated more recently in the UK. The UK courts ruled –

¹⁴ ICA News release, 20 May 2003

¹⁵ Insurance Council of Australia. Professional Indemnity Briefing Note, ICA website, viewed July 2003

¹⁶ The West Australian, "Doctors' cover row hits", 1 July

more sensibly in my view – that buyers of coffee actually expect the stuff to be hot, and would probably be upset if it wasn't.

The compensation culture problem can start with seemingly insignificant things. I was slightly amused but also slightly worried earlier this week when visiting New Zealand to read about some farmers who want compensation from the council because a jet boat an engineer was using had frightened some grazing calves, and 19 sadly drowned. One of the farmers said in the Herald that the council should compensate him for the loss of the cows, even though, and I quote, he said: "There's no doubt... it was an accident. They didn't do it deliberately."¹⁷

We need to strike a balance, to achieve a position where individuals do have a means of redress, and where risk-takers have a safety net should things go wrong, but are not dragged into court at the merest excuse. I would urge all of you to do what you can to ensure that the march of litigation culture does not gain pace. We cannot allow ourselves to create a culture in which you have everything to fear, unless you have a good solicitor.

¹⁷ New Zealand Herald, 24 May, 2003

Of course, specialist insurers like Lloyd's have a role to play. We can help provide cover. But just as importantly, we can help companies to help themselves. What do I mean by that? We can help you to ask the right questions and we can help you to be better prepared. For example, to analyse carefully the type of claims you might face, and the impact that they might have on the balance sheet. To trace the trends of claims, so that you can discover the source of the most common ones, and make provision for them. And in today's business environment where we rely on the services of consultants and outsourcing arrangements, to pay attention to the small print of contracts to see who is liable for what. And to ensure that any subcontractors they use are properly covered themselves. All these points are key to reducing your liability exposure, and managing your business.

The role of insurance

Insurance is perhaps most commonly associated with paying up when things go wrong. Be it re-plastering a ceiling after the bathroom above has flooded, or helping to re-build a city or a company after a catastrophe, insurers pick up the pieces and try to put them back together again.

But what I want to leave you with today is another role, often forgotten but just as crucial: enabling people to take risks in a more positive way.

Samuel Johnson, back in the eighteenth century, described the risk worth taking as the “risk of the certainty of little for the chance of much”. This is what has motivated the entrepreneurs, the risk takers who have invented, explored, created and expanded the boundaries of human knowledge and increased our wealth over the centuries.

And that's how Lloyd's started. The Lloyd's market first sprang up in a coffee shop during the 17th century, and business was done on these premises. The insurance cover provided, quickly became the safety blanket for inventors, investors, and traders around the world, and indeed for pioneers, including those who came here to build a new nation.

Lloyd's has always had links with Australia, covering the ships and the cargo, and many of the businesses, making the risk of taking on a new, unspoilt land a risk worth taking. The ties continue to grow today. Our Australian business increased by two thirds between 2000 and 2002, to more than 610 million Australian dollars¹⁸.

¹⁸ Source: Lloyd's regulatory return to APRA for calendar years 2000- 2002

So, wherever you find people creating new places, testing new devices or building new businesses, you need insurers. That tradition continues still.

Today, 93 per cent of the Dow Jones companies have policies at Lloyd's – as do 96 per cent of the FTSE 100, the world's top ten banks, the world's top 10 pharmaceutical companies and the world's top five petroleum companies¹⁹.

Why do people in opposite corners of the world – whether it be Australia or the United States – come to Lloyd's? For the simple reason that they trust us. Our reputation is built on our history of honouring our word and fulfilling the first role of insurance – to rebuild and repair when things go wrong.

Nowhere has this been shown more strongly than in the aftermath of the terrible events which took place on September 11th, 2001. Although September 11th was the greatest single loss in our three hundred year plus history, we have now paid out 3.26 billion US dollars²⁰ in the wake of this barbaric crime, and are still paying out. Some commentators said that

¹⁹ All statistics in this paragraph from FTSE 100, Dow Jones IA, Fortune Global 500 & Lloyd's statistics, Nov 2002

²⁰ Lloyd's global results 2002

we would not be able to meet our obligations. But we are doing so. We keep our word.

Meanwhile, our capital base has not dwindled. Quite the opposite. Our capacity is currently at a record level, the largest in our 300-year history at more than 40 billion Australian dollars²¹ – the largest in our 300-year history.

So I believe that Lloyd's, with more than three centuries of risk experience, and a strong financial base, is well-equipped to face up to the ever-changing risk environment of the 21st century. Lloyd's is a rock of certainty in today's uncertain world.

Conclusion

Litigation, natural catastrophes, terrorism – three broad areas where insurance has a part to play – rebuilding, repairing and protecting those who risk all on new ventures.

Some of these risks are new, others centuries old. But progress requires change, and to change you must be prepared to embrace risk.

²¹ Source: Lloyd's Membership Services Unit, February 2003. A\$=£2.86 at 1/1/03

The author William Bridges wrote that: “Change comes more from managing the journey than from announcing the destination.” As the world – and especially the business world – continues to change, it is difficult to know precisely where we may end up.

In another 50 years time, email and the other features of today's technology may look just as antiquated as the index cards and typewriters do today. But seeing the risks that arise from change, and managing them with a strong partnership between insurers, businesses and individuals is the key towards ensuring that change is welcome, and not to be feared.

Thank you.