

Caught unawares:

Failure to keep pace with escalating commercial risks
leaves insurers dangerously exposed



Overview

- **Escalating commercial risk:** A far-reaching new study by Mactavish, a specialist research organisation, which focuses on risk and developments in the commercial insurance market, has found that the commercial risk landscape has changed dramatically as a result of the recent economic turmoil
- **Asleep on the watch:** PricewaterhouseCoopers¹ believe that many commercial insurers have failed to keep pace with the ‘unprecedented’ changes in commercial risk profiles in their risk assessment, risk selection and risk pricing and are facing a surge in claims as a result. The reaction of many is to sit back and passively wait for the losses to materialise
- **Stemming the tide:** PricewaterhouseCoopers believes that insurers need to act quickly to identify areas of their portfolio where underwriting is most seriously misaligned, adjust reserves and explain the implications to their stakeholder community. Failure to get to grips with the threat can only exacerbate the losses and further undermine market confidence
- **Wake up call:** The findings of the study highlight significant flaws in the way commercial risks are assessed and insurance is placed. PricewaterhouseCoopers believes that insurers and insurance intermediaries need to fundamentally re-think how risk is assessed, how companies are insured and how to keep pace with an increasingly complex, uncertain and fast-changing risk landscape

The alarming findings of a new study by Mactavish suggest that insurers’ failure to keep pace with the ‘unprecedented’ changes in commercial risk profiles emanating from the recession will leave them facing a costly surge in claims. PricewaterhouseCoopers believes that this breakdown in underwriting exposes the flaws in a commercial risk market that puts placing business quickly and easily before the rigour of risk assessment. As such, it could provide an opportunity to move away from the current approach towards the development of more comprehensive risk partnerships, which aim to create a full understanding of the company’s evolving risk profile and how risk can be most effectively managed or transferred.

About the study

Part one of Mactavish’s 2010 sector risk analysis programme, a report into the impact of the recession on commercial risk profiles and how they are insured, was released today. Carried out by Mactavish, a research and analysis organisation which specialises in developments in commercial risk and associated underwriting solutions, the report is based on in-depth consultations with operational and financial management from around 250 companies, along with some 40 senior commercial insurance underwriters. The study looks in particular at the retail, construction, financial services and independent manufacturing sectors.

Many observers might have thought that commercial insurers had emerged from the financial crisis relatively unscathed. In fact, the sector could be sitting on top of substantial additional liabilities as companies’ response to the recession transforms their risk profiles. What is perhaps most concerning is that insurers seem largely unaware of the extent of the changes to commercial risk profiles and the scale of the resulting threat to their businesses.

In the first cross-sector paper of its risk analysis research programme, Mactavish looks at how almost every aspect of business has become riskier and more uncertain in the wake of the economic turmoil. Examples of the impact range from cuts in buffer stock or spare capacity; cuts in health and safety personnel as companies seek to curb costs; to the potential for supply chain risks created by the growing shift towards low cost offshore sourcing arrangements. Many companies have also been forced to operate in unfamiliar markets or accept more onerous contract terms, which have heightened the risks of counterparty default and failure to deliver. The sheer speed and scale of the changes creates its own inherent risks. While the immediate disruption may recede, many of these developments and associated impacts on risk profiles are here to stay.

‘These flaws are compounded by over reliance on historical data. In times of stability and slow claims development, this backward-looking approach can just about suffice. However, when risk profiles and the external risk environment are changing so rapidly and to such an extent, projections based on past experience are meaningless.’

Achim Bauer, PwC



Serious flaws in the evaluation and transfer of risk

The Mactavish study warns that commercial insurers have largely failed to keep track of the recent changes in commercial risk profiles and are not prepared for the resulting claims. We believe that this failure highlights serious flaws in the evaluation and transfer of risk within the commercial insurance market.

In PricewaterhouseCoopers' view, the root cause of these flaws is an approach to placing business that provides no effective mechanism or incentive for proper company-specific risk assessment. Management often fail to provide enough information about their risks and how they are developing. The inadequacy of risk disclosure is highlighted by the fact that nearly two-thirds of respondents in the Mactavish study do not review the information used to place insurance for completeness and accuracy. While good brokers will look closely at their clients' needs, the most profitable business is that which is placed swiftly and straightforwardly. Inevitably, the desire to close the deal quickly can run counter to in-depth risk scrutiny. In turn, insurers' ability to satisfy their supply channel and generate business is best served by offering cover with the minimum of fuss and searching questions. For companies, the insurance provided is therefore unlikely to meet their real requirements, leaving them with needless or uncertain gaps in cover in some areas and over-insurance in others. For insurers, there is a real risk of misaligned pricing and unforeseen claims.

These flaws are compounded by over reliance on historical data. In times of stability and slow claims development, this backward-looking approach can just about suffice. However, when risk profiles and the external risk environment are changing so rapidly and to such an extent, projections based on past experience are meaningless.

Insurers need to act now to reduce the immediate business impact

Some insurers may simply wait for the adverse claims developments to come to fruition and, as in the past, trust to a hardening of rates to recoup their losses. However, this reactive response will provide little immediate comfort to investors as reserves, profits and share values come under severe pressure.

Insurers therefore need to scrutinise their portfolios and judge where underwriting is most misaligned and use this evaluation to provide the basis for revised underwriting, reserving and reinsurance buying strategies. To reassure stakeholders (customers, intermediaries and investors), insurers should develop a proactive market communications strategy explaining the potential for financial losses and how the company is looking to mitigate them.

'While damaging in the short-term, the impending losses could encourage a much needed re-think of how risk is assessed, companies are insured and how all sides can keep pace with an increasingly complex, uncertain and fast-changing risk landscape.'

Achim Bauer, PwC

Managing risk as a partnership

Whilst mitigating the immediate threats to business is critical PricewaterhouseCoopers also believes that insurers and insurance intermediaries need to seriously reconsider how the risk assessment process operates, whether companies are appropriately insured and how to adapt to the rapidly evolving risk landscape.

The industry needs to create genuine strategic risk partnerships between underwriters, intermediaries and company management, in which they are able to fully investigate how the business' risk profile has changed, the external factors that could influence its development and where insurance provides the most efficient and cost-effective form of risk mitigation. To make this work, insurers will need a significantly improved understanding of how the company operates, its business goals and the dynamics of its risk profile. If successful, the insurance industry can play a much more meaningful and proactive role in enabling firms to understand their risks, manage them more effectively and ultimately realise their strategic objectives.

Insight and support

PricewaterhouseCoopers is looking closely at how insurers can respond to the issues raised in this article. If you would like to discuss how your company can manage the immediate implications of the changes and put itself on a stronger strategic footing in the long-term, please contact one of the authors listed below.



Achim Bauer

Partner

(44) 20 7212 1405

achim.r.bauer@uk.pwc.com



Brian Chadwick

Assistant Director

(44) 20 7213 4159

brian.c.chadwick@uk.pwc.com

pwc.co.uk/strategy

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers LLP, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2010 PricewaterhouseCoopers LLP. All rights reserved. "PricewaterhouseCoopers" refers to PricewaterhouseCoopers LLP (a limited liability partnership in the United Kingdom) or, as the context requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate and independent legal entity.
M&A Design: 0900067