



Black swans can put your company into the red

Paul J Davies says executives should think the unthinkable because they live in a world of oil spills, terrorism, computer worms and tsunamis

Black swans, once such a rarity, appear now to be gliding across all areas of the corporate pond.

Two years ago, the financial crisis was the black swan event – a phrase used by Nassim Nicholas Taleb, a trader turned author, to explain the disproportionate role of high-impact, hard to predict, and rare events.

These would be so extreme and unlikely that for the vast majority it was hardly worth thinking about, let alone attempting in any way to prepare for.

Since then, individual companies or countries have been struck by – or just escaped – a series of “unthinkable” events that ought to make executives everywhere reassess the realm of the plausible.

BP’s oil spill was extreme, but in all likelihood avoidable, as was the Hungarian toxic sludge disaster. The Stuxnet worm highlighted the chaotic and fast-moving nature of cyber-threats even when – as widely suspected – they are targeted at a very specific victim.

The recent return of terrorist activity with the bombs found in Dubai and the UK en route to Chicago is a reminder that, while this risk is sadly not unthinkable, it is impossible to predict and has now apparently become more difficult to detect.

In Indonesia, the combined tsunami and volcano eruption – with thankfully relatively low loss of life – has had catastrophe-focused insurance actuaries shaking their heads over calculators trying to work out the probability of two “non-correlated” black swans swimming into view together.

There are even warnings that the world is overdue a pounding by massive solar flares with the potential to destroy communications and power infrastructure.

But perhaps the least expected event of all is that no hurricane has made destructive and costly landfall in the US in spite of predictions that this year would be one of the most dangerous.

When you look for them, there are so many so-called black swans that a sensitive soul – or a cynic – would be forgiven for asking who killed all the white ones.

For BP, the question might be whether the black swan was really the spill itself, or the raging political reaction that led to a \$20bn compensation bill. Either way, other large companies would do well to reassess what kind of events are really possible and whether they have the resources to cope.

Many large companies self-insure through special vehicles called captives. These vehicles are already facing possible financial pressure from incoming EU capital rules for insur-

ers. But in any case they are almost never set up to cover such extreme events as BP faced.

John Davies of the global broker Marsh, will not comment on BP’s situation, but says other companies are drawing lessons from the situation. “Where people previously thought ‘It could never happen to us’, they are now more prepared to consider black swan events and whether it is worth buying extreme risk insurance for that,” he says.

Martin Fessey, vice-president, international operations at FM Global, says that in the end, the answer to combating such operational risks is not really insurance, but mitigation. “Companies should be looking to identify the unthinkable event,” he says. “Ask questions such as: ‘What’s the most crucial piece of infrastructure that we could not operate without in a natural catastrophe?’ for instance.”

Nicola Harvey, group risk director at Christie’s and current chairman of Airmic, the risk managers’ association, says that companies would also do well to look over these issues from the point of view of reputation and culture. “Risk management is not just about process, it’s about culture,” she says. “It needs to be embedded and driven from the top.”

But it is not just black swans that are catching risk managers’ eyes. Another big issue for international companies – particularly any that have connections with the UK – is bribery laws that come into force in Britain next year. The US and EU already have such laws in place, but the UK act goes further in its descriptions of new corporate offences of bribery and in its extraterritoriality,



Black gold, black future: the oil spill in the Gulf of Mexico damaged BP’s reputation and profits

Reuters

according to experts.

Ms Harvey says the act is coming down the track rather too quickly and many companies will have to work very hard to ensure they are prepared. One of the immediately tricky areas is corporate hospitality, which is extremely popular in the UK and elsewhere.

“You have to make sure that what you do in corporate hospitality is well defined and for specific business purposes,” she says. “Things that work fine, or are appropriate, in one country or type of business might not in a different situation.”

Richard Abbey, managing director at Kroll, the risk consultants, says awareness of the issue among companies is surprisingly low, given the amount of publicity the act has had in the UK.

He says: “Nearly two-thirds of companies we spoke to with operations in the UK either didn’t think the laws applied to them or weren’t even aware,” he says. “Just under half didn’t have the right controls in place to combat potential breaches.”

The new offence of failing to stop a bribe from taking place means companies can no longer blame rogue agents acting on their behalf and hang such individuals out to dry.

“Companies will have to undertake proper due diligence of all third-party agents they might use and they may have to review their portfolio of third parties that they have used in the past,” he says.

Such investigative work could mean more business for companies such as Kroll, of course.

Mr Abbey is more sanguine on corporate hospitality, saying most routine and “inexpensive” hospitality was unlikely to breach the law, but he points out that companies have to be

sure it is suitable for the clients and regions involved.

A day at the races for clients from London would be fine, he says, but in some markets the equivalent spend could be well above average monthly

salaries.

“Companies will need to ensure they monitor and record what hospitality is being offered and accepted by its employees,” he says.

But despite the disasters and traps,

Ms Harvey says all is not doom and gloom. “In this tougher political and economic environment, there is an opportunity to persuade boards who have not taken risk management seriously to start to do so,” she says.



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Rules changes will lead to greater burdens

Solvency II

Paul J Davies looks at the likely impact on the sector of capital regulations

The European insurance industry is fast approaching the deadline for what was supposed to be the final test of the new capital rules, known as Solvency II, that are due to come into force at the start of 2013.

But as the intensive data gathering, modelling and reporting process comes to an end, some are concerned that the extreme demands of regulators over everything that must be reported could throw up risks.

The new rules, which are designed to create a better match between the capital that insurers hold and the risks that they take, will do much more than merely set different capital requirements for insurers.

The bigger impact will be the requirement to demonstrate that all risk management processes are fully embedded in their decision making and operations. For many companies, this will entail not only overhauling their risk management, but also ensuring each element is fully documented and reportable to their regulator.

George Culmer, chief financial officer of RSA, the UK insurer, says that one concern with all the extra reporting requirements is that insurers will be unable



Lloyd’s: the FSA is interested in interpretation of rules

to see the wood for the trees.

“The granularity of detail the companies are being asked for has gone off the scale,” he says. “It has gone beyond what is needed to demonstrate that risk management is embedded in decision making.”

RSA is among a small number of companies that are at the forefront of working with the Financial Services Authority in the UK to

go through a pre-approval process of their internal models and risk management practices – designed to help ensure that both the industry and the regulator are ready.

The importance of this has been highlighted in recent weeks by the situation in Switzerland, which is reaching the end of a five year transition to a new

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Risk Management

Rule changes increase burden

Continued from Page 1

capital regime, similar to Solvency II, known as the Swiss Solvency Test. Companies there have complained that they are expected to comply fully with the new rules by the end of this year, but that their regulator is yet to pre-approve any company's internal models.

Another aspect of this approval process is working out what the new European regime will mean in practice.

It is a principles-based regime and the FSA is said by industry executives to be just as interested in how individual companies interpret the rules, which will feed back into what the regulator expects of all companies generally.

Some smaller groups that have grown rapidly in recent years, such as Amlin, the Lloyd's of London insurer, anyway planned to overhaul their operating models and practices to adjust to their greater size and reach. They now have the chance to ensure everything is fit for purpose.

Others have to make more pragmatic decisions about where to invest and where to adapt what they already have.

Investment will still be significant, however.

As John Davies, an expert at Marsh, the broker, puts it: "I don't think this is a Y2K-type issue – this is going to bring big changes to the market, it is not a damp squib."

But even where systems costs can be held down, the people costs are rocketing. Recruitment companies say salaries for sen-

'This is going to bring big changes to the market, it is not a damp squib'

ior actuaries who can oversee projects and communicate effectively with other senior executives have leapt from £100,000 to as high as £200,000.

Mr Culmer adds that there is also a big opportunity cost, because companies are tying up some of their best and brightest during the transition in adaptation rather than in their normal, operations-driven jobs.

Insurers, in general, say they support the purposes of the new regime as originally laid out.

Tim Breedon, chief executive of Legal & General and the current chairman of the Association of the British Insurers, said recently that the core concept of updating the rules used to be that: "If you understand your risks properly as a company, if you manage and control those risks, then you will receive the benefits of a lower capital base."

However, the financial crisis has made regulators more cautious and the industry is now protesting that too much prudence will only reflect badly for retail and corporate customers alike.

"Customers must have confidence in financial institutions, yes, but this does not equate to an overcalibrated regime based on capital levels that target zero failure, with the result that the industry is forced to change the products it provides to such a degree that they no longer meet the needs of customers at a price they can afford," Mr Breedon said.

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When the unthinkable begins to look likely

Captives

Paul J Davies explains why big companies may opt to end the practice of using their own insurance companies to provide cover

BP's more than \$20bn bill for its huge oil spill in the Gulf of Mexico this summer was a painful hit even for such a cash-rich energy company.

But while the UK group could cover such costs by simply skipping a couple of dividend payments, other companies faced with such a disaster would be looking much more nervously at their insurance cover.

For BP, this cover was low – and deliberately so. The oil group bought no external insurance, but ran everything through its own, or captive, insurance company. In BP's case this was a \$6bn Guernsey-based vehicle named Jupiter, which covers all the group's property and liability risks except some shipping and directors' and officers' liability.

Most of the FTSE 100 companies run a captive insurer, which is usually set

up specifically to write insurance for its parent company, although in practice it is often done through writing reinsurance for a normal insurer that acts as a front. According to AM Best, the rating agency, there are hundreds set up across Europe in tax-efficient jurisdictions such as Dublin, Gibraltar, Guernsey, the Isle of Man, Luxembourg and Malta.

However, these and hundreds of others in places such as Bermuda and the Caymans are now likely to face a thorough review. This partly reflects the realisation that they may not come anywhere near to covering the "unthinkable" – extreme events that can cause the biggest losses.

The other reason for a review is the potential effect of tougher European Union capital rules for insurers. These will affect not just how much capital they have to hold, but how they demonstrate their use of risk management and the amount of financial information they have to report.

Add to these things the general softening, or decline, of premium rates in many insurance markets over the past couple of years and most large non-financial companies that run captives have reason to re-examine the costs, benefits, tax advantages and overall value of their mini-insurers.

"What was once considered to be a lightly regulated industry has become exposed to significantly higher standards, and the Solvency II [capital rules] may tighten captive regulation further – not just in Europe but in domiciles outside the European Union," says Yvette Essen of AM Best.

"The cost of complying with increased regulation, combined with the general desire to achieve greater capital efficiency in the wake of con-

'Some large insurers are saying to big companies that they like the captive business and they will not penalise corporate clients for the higher costs'

strained capital markets, has resulted in parent companies increasingly evaluating the effectiveness of using captives."

According to Jonathan Groves of Marsh, the global insurance broker, the Solvency II rules look set significantly to increase the amount of capital a captive must hold. Under the last big

test of the rules – Quantitative Impact Study 4 – conducted in 2008, the minimum capital requirement for such vehicles rose 3.3 times, he says.

The industry is currently finalising submissions of QIS 5 and so far it looks as though that minimum rise will be 3.7 to 4 times, Mr Groves adds.

"This clearly puts extra capital drain on companies with captives in the European region – and that's just the minimum average increase in capital due to Pillar 1 [the first quantitative element of the rules]," he says.

"If you look at the Pillars 2 and 3 [the other more qualitative elements] and the increased reporting and review processes they bring, it's fair to say this will put a big strain on companies' ownership of captives."

All of this is hugely important within the European Union, no matter what the tax advantages, but also in Bermuda, historically a leading home for captives, which is on a fast track to gain equivalence with the new European rules as soon as possible.

Some suggest that companies may look to re-establish their captives in jurisdictions that do not adopt the new capital rules.

However, Paul Hopkin, technical director of Airmic, the industry association for risk managers, says that,

because many captives operate through a fronting insurer, in the case of European companies it will make little difference where their captive is based. If a captive is not compliant with Solvency II, the front insurer cannot get full capital relief from passing risk to it, so the extra costs remain.

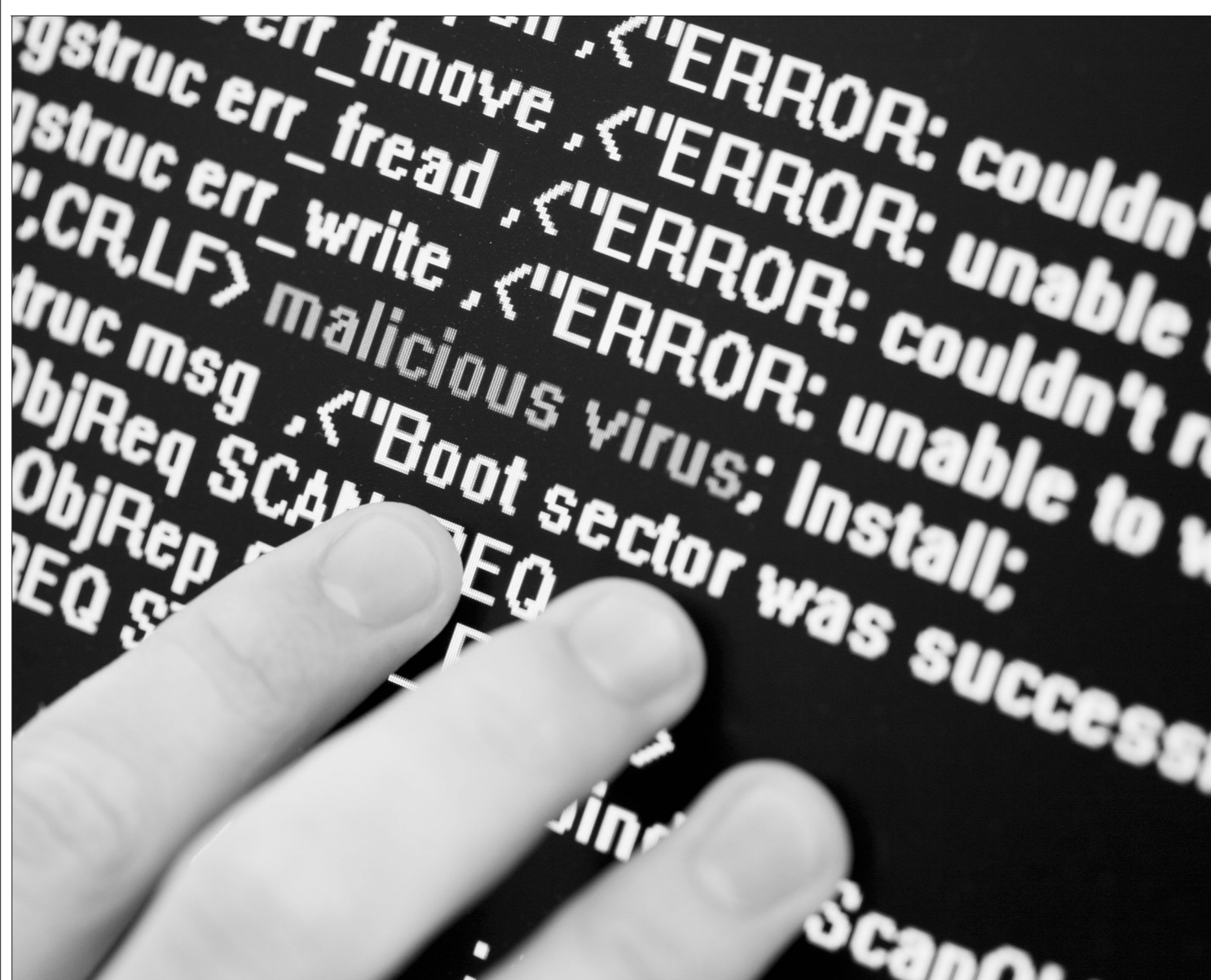
"But some of the large insurers are saying to big companies that they like the captive business and that they will not penalise corporate clients for the higher costs," Mr Hopkin says.

But he adds that Solvency II is likely to add to the costs of owning and running a captive and will bring companies back to the question of why they have one, whether it is an efficient use of capital and whether the tax advantages are valuable enough.

"Many organisations will come to the conclusion that their captive still brings benefits and value," he says.

It helps that there are options to offload historic liabilities from captives and free capital.

WM Morrison, the UK supermarket chain, for instance, has just completed a deal with a specialist insurer named Grafton, set up specifically to take on the billions of pounds of old liabilities from corporate captives that tie up capital directly and through collateral that must be placed with a front insurer.



Key stroke: targeted threats to specific systems or companies have become a common part of cyber crime

Dreamstime

The rats that gain access by the click of a mouse

Cyber crime

Mary Watkins explains the growing significance and increased ingenuity of online attacks

When Iran took the unusual step of announcing that its Bushehr nuclear power plant had been infected by a piece of malicious software, it came as little surprise to the security world.

Concern had been growing for months over the potential impact of Stuxnet, a new highly sophisticated computer worm that had been targeting the programs at the heart of core industrial operating systems around the world. What particularly worried the security community was that Stuxnet was the first example of a computer program designed to cause serious damage to the physical world.

Stuxnet initially exploited holes in Microsoft's Windows operating system. It then looked for software made by the German industrial conglomerate Siemens that is used to control vital industrial components such as the pressure on a gas pipeline or the temperature in a power plant.

Matt Moynahan, chief executive of security firm Veracode, says that Stuxnet shows how security threats have now moved "beyond data breaches to impacting the safety of entire nations".

In Stuxnet's case, the attack was targeted at one specific type of control system. However, Mr Moynahan says: "Stuxnet is no different from someone target-

ing an industrial control system or a healthcare device or a smartgrid."

Security experts at Symantec, who had been monitoring Stuxnet since Siemens spotted it in July, say the malicious program had the potential to be used for stealing corporate data or to sabotage critical parts of industrial operating systems.

And because the worm can lie hidden in the system, experts say Stuxnet is likely to have infected thousands of operating systems at factories, refineries and pipelines around the world. Stuxnet represents a fresh development but targeted threats either to specific systems or specific companies have become an increasingly common part of cyber crime, as hackers look to steal not just money from bank accounts but also data and intellectual property.

According to a recently published fraud survey by Kroll, companies are for the first time reporting more thefts of information and electronic data than physical property.

Mike Jones, a security specialist at Symantec, says that hackers have switched tack in recent years moving from "broad and loud" hits on an entire system, to "small and quiet" targeted attacks run by criminal gangs.

In September, police made a string of arrests in the US and UK in relation to a global attack on bank accounts using a widely available piece of malicious software known as Zeus that has been around for at least five years and is able to reconfigure to take on new functions or capabilities once it has found its way into a computer.

Zeus is often spread to individual computers using rogue e-mails or spoof links sent via social networking sites.

Some say the cost of cyber

attacks globally could be more than \$1,000bn a year. But experts say the true cost to companies and government is hard to estimate, given that the crimes being committed often go unpunished.

More often, hacking also goes unreported or undetected. The malicious programs on offer to hackers in internet forums can be used to acquire bank account passwords, data, intellectual property, corporate secrets or money.

Many programs have become so sophisticated that they can be easily configured to each individual attack, meaning no two computers may have the exact same version of malicious software. And hackers have also

'Stuxnet is no different from someone targeting an industrial control system or a healthcare device or a smartgrid'

found ways to disguise their entry.

Stonesoft of Finland recently found evidence that hackers were using "advanced evasion techniques", the equivalent of having master key to a door, to breach security barriers and then steal data without being spotted.

Paul Simmonds, co-founder of the security industry think-tank Jericho Forum, says companies need to reassess fundamentally how they approach security. He says many groups often look at security from the basis that anything inside their firewalls is protected while ignoring the fact that internal networks can easily be breached.

Giving users' the least amount of privileges possible, for example, prevents any rogue updates of software. Updating to the latest version of a system can sharply reduce infection.

Mr Simmonds says that companies often ignore "basic hygiene" principles, from security checking the members of their technology team to making sure any safeguards they have in place are tailored to the company.

"It's not a one-size-fits-all [issue] and the problem with the security industry is that they are trying to sell you a one-size-fits-all product," says Mr Simmonds.

He says the Stuxnet virus highlights a more common flaw in corporate thinking. "In the days before firewalls, you had process control systems that were really dumb but totally isolated," says Mr Simmonds.

He says that once those were updated and connected to a computer, they became exposed. "It is based on the false premise that somehow your internal network is secure."

Companies often focus on the network and forget that the end user is often the real problem, says Dave Jevans, chief executive of IronKey and Chairman of the Anti-Phishing Working Group.

He says malicious software often finds its way into a system via a laptop, a USB stick, a mobile phone, a social network site or even a piece of rogue antivirus software.

Cyber attacks on Google reported this year represent "just the tip of the iceberg", says Mr Jevans. Once hackers find their way in to the network: "They are like rats – hard to get rid of and before you know it they have infested your system."

Distance can add danger as well as value

Supply chain

Andrea Felsted spells out the hazards inherent in cheaper offshore locations and sourcing components from further afield

From soaring prices for cotton and wheat to currency wars, the risks in the supply chain have never been greater.

In the relentless drive to cut costs, companies have increasingly moved production to cheaper locations offshore during the past decade, or sourced components or raw materials from farther afield.

While this has made the cost of supplies cheaper, it has increased the number of things that can go wrong along the way.

Mark Hudson, retail and consumer leader at PwC, says: "There is a long-term trend to higher risk in the supply chain."

The perils in the supply chain have been starkly illustrated by the increase in commodity costs that is affecting food manufacturers and retailers.

The cost of wheat has risen by 65 per cent since mid-June, forcing suppliers to pass on costs to retailers. However, big supermarkets are resisting price rises, as they attempt to woo increasingly conservative consumers – often facing cuts in government spending and increasing unemployment – with price cuts and promotions.

Tesco, the world's third-biggest grocer by sales, recently jettisoned some lines of Hovis bread after balking at price rises implemented by manufacturer Premier Foods, the London-listed foods group.

Robert Wiseman Dairies, supplier of nearly a third of the UK's fresh milk, warned in September that competition among supermarkets and added capacity by rivals would dent profits.

Elsewhere, the price of cotton has gained 60 per cent since June, partly because of floods in Pakistan, which devastated crops in the world's fourth-largest cotton grower.

Bad weather has also reduced China's cotton crop, while there is concern about export restrictions in India. Cotton recently reached a high of close to \$1.25 a pound.

The effect will be felt around the world. For instance, according to Verdict, the retail research group, British consumers face the biggest increases in the price of clothing for more than two decades.

Lord Wolfson, chief executive of Next, the UK retailer, recently warned that the more than a decade of deflation in the cost of clothing had ended.

"Clothing prices will have to go up," he said. "I would not say it's the end of cheap clothes. It's the end of the cycle where clothing prices have come down every year for 15 years. The age of ever-decreasing clothing prices is over."

These expected higher prices are unlikely to be confined to British shoppers.

Consumers in continental Europe and the US will also be affected by the increase in cotton prices. Levi Strauss & Co, the Jeans maker, has already

announced price rises as a result of rising cotton costs.

Other factors that could disrupt the supply chain are variations in the value of currencies, which may mean companies that source products from farther afield will be at risk from "currency wars".

For example, efforts by the US to force China to allow the renminbi to appreciate could be bad news for European companies buying Chinese goods. A more muscular renminbi makes goods purchased from China more expensive.

As if this were not enough to contend with, inflation in China's labour market has returned after an absence of about three years. Strikes this year over pay underlined the demand for higher wages, which can be one of the biggest costs of manufacturing.

Retailers in particular, in an effort to manage the inflation in the supply chain, are moving to cheaper Asian locations.

But sourcing from less developed markets exposes companies to another set of risks. These range from managing quality to ensuring the supply chain is free from child labour.

Rod Ratsma, head of the Business Continuity Practice at Marsh, an insurance broker, says it is essential for companies to examine their supply chains in order to know exactly where and how goods or components are being manufactured.

He says that while it may not be possible to prevent risks completely, companies should try to

investigate their supply chain as much as possible.

"The only thing you can reasonably do is the best job you can to understand your supply chain and all its components, but quite a lot of organisations choose not to. As long as the [product] turns up, they are happy with that," he says.

"Best practice now for ethical and environmental [reasons], or simply the fact you are a big retailer and you have a core product and you want it in your shops, you need to understand where you stuff comes from and how it gets there," he adds.

Primark, the European retail group, whose supply chain has come under scrutiny, is taking a number of steps to improve its ethical sourcing. These include audits of its overseas suppliers, which look at areas such as health and safety, that workers are of a legal age and that they are being paid an adequate wage.

It is also working with non-governmental organisations in the countries where its garments are made, and increasing its own staff there. Amid the heightened risk, some companies are reversing the trend of moving the supply chain further from their domestic market, back to sourcing more goods closer to home.

"The big question on my mind is how many years will it take before the economics of sourcing closer to home start to look better," says Mark Hudson of PwC.

It's the end of the cycle where clothing prices have come down every year for 15 years' – Lord Wolfson

investigate their supply chain as much as possible.

How sex and scandal can ruin a reputation

He scores: the most talented British footballer of his generation has been a magnet for brands wanting to associate themselves with his sporting success

Sponsorship

Jennifer Hughes analyses the attractions of linking a corporate brand to a sports star

When Wayne Rooney was accused of having hired prostitutes while his wife was pregnant, his sponsors can only have gulped.

The most talented British footballer of his generation has been a magnet for brands wanting to associate themselves with his sporting success and what appeared to be a stable family life with his childhood sweetheart.

The scandal was, however, merely the latest in a series of sordid sex stories involving sports stars from Tiger Woods

to Mr Rooney's England teammates Ashley Cole and John Terry, that have all underlined the need for sponsors to evaluate carefully the risks they are taking.

"Individuals are fallible – and elite athletes are very fallible. Sponsors must be aware of the risks but equally, the long-term benefits of sponsorship, whether individuals or teams, far outweighs any negatives," says Richard Moore, chief executive of Capitalize, the PR and sponsorship agency. "If you're not prepared for a little heat, then perhaps sponsorship isn't the marketing vehicle for you."

Tiger Woods famously lost a strong of lucrative endorsements in the wake of the news about his infidelities, including deals with Gillette, Accenture, Gatorade and Tag Heuer.

In Mr Rooney's case, his sponsors seems to be hanging in there. While Coke Zero has dropped the star from an advertising campaign, it signalled

that it still plans to work with him in future.

"That's probably the right thing to do for Coke," says Mr Moore who cites Adidas's long-running relationship with David Beckham, which has survived several tabloid scandals, as an example of a good sponsorship. "My gut feel is that some organisations that rush out the door are seen as shallow and were in it for the wrong reasons. Those that stay loyal can develop significant incremental benefit."

Frank Van Den Wall Bake, the Dutch sports marketing expert, says it is about knowing there are risks and considering how you might handle them

"If you want to differentiate yourself in your communications strategy, you have to take risks," he says. "You can't foresee everything, you can't take action in advance for whatever happens, but you can take measures to protect yourself."

He cites the Rabobank sponsorship of a cycling team. The

sponsorship is one of the longest-running in a sport with a history of performance-enhancing drugs and an eye-watering (for sponsors) record of catching the biggest stars. Now, the riders' contracts have a clause that allows them to be dropped if there is suspicion about doping:

'If you're not prepared for a little heat, then perhaps sponsorship isn't the marketing vehicle for you'

a move designed to distance the company from headlines.

Cycling teams are known by the name of the sponsor, providing a name-check boost few other sports can match – but with the equal downside risk should a big star be caught. This has led a number of sponsors, including Deutsche Tele-

kom and Liberty Seguros, to walk away.

However, Mr Van Den Wall Bake says the risk can usually be contained if the scandal focuses on a particular rider.

"All kinds of research has shown if there is any sort of problem in a team event, the consumer doesn't necessarily blame the sponsor for a team that is misbehaving," adds Mr Van Den Wall Bake.

The risk for cycling sponsors however is wider than that. It since all risk being tainted by general association with a sport perceived to be drugged. Currently Lance Armstrong, the sport's biggest star, is under federal investigation in the US over allegations he doped during his record seven Tour de France wins – a claim he vehemently denies.

The allegations were sparked this year by a confession to using performance-enhancing drugs by Floyd Landis, a former Armstrong teammate who won

the Tour himself in 2006 after Mr Armstrong retired, only to become the first winner in the event's 100-plus year history to be stripped of the title for doping.

Rabobank's involvement in sponsorship of the sport far precedes recent scandals, but Garmin, the US navigation device specialist, is an example of a company that has braved the dangers, only entering the sport as backer of one of the top-ranked teams in 2008. It believes the doping conversation actually gives it a bigger voice.

The team it backs, previously known as Slipstream, had already built a reputation for innovative and open anti-doping policies, from extra independent testing to offering reporters the chance to embed with the team. This, Garmin says, helped give its sponsorship an extra twist.

"I don't see a downside because we have the opportunity to be one of the voices calling for change," says Jon Cas-

sat, vice-president of communications. "We want to talk about allowing athletes to ride to the best of their natural ability and using technology to help them. In a way, the doping conversation going on allows us to tell that message louder and clearer."

The real key to managing looming risks, says Mr Casset, is maintaining open communications with the team.

"I really don't think there's a topic I can't discuss openly with JV [Jonathan Vaughters, team manager] and I don't sense any hesitation on their part either – and that's vital," he adds.

Mr Van Den Wall Bake agrees close association is crucial for managing risks. "You'd expect to pay a lot of attention to any multimillion investment. Sponsorship is no different. It's no longer just exposure, it's a transfer of values you're looking for – and that means getting very involved in what you're paying for."

A long life and a happy one – but not for trustees

Pensions

Jane Croft looks at the steps many schemes are taking to deal with increasing longevity

During a hearing in the UK's High Court this year, a barrister evoked a striking example to illustrate the risks of pension scheme members living longer than expected.

He reminded the court of Alberta Martin, a US widow who died in 2004 and had been in receipt of a war pension from her long-dead husband, who had fought in the American Civil War of 1861-1865.

Such a case may be extreme but it demonstrates the risks trustees have to consider when tackling longevity – that schemes will have to pay out to retirees and dependants for much longer than assumed.

Longevity increases in the UK have been about 2 per cent a year for 30 years, mainly as a result of health-care and better medicines.

Experts view longevity as one of the biggest unmanaged risks facing funds and it has become a hot topic, as trustees look at how to reduce risk and volatility in defined benefit schemes.

Swiss Re, the reinsurance group, said recently that underestimating life expectancy by just one year could increase liabilities by up to 5 per cent. For a defined benefit scheme with £1bn of liabilities, a one-year error would mean a shortfall in reserves of about £50m.

Trustees now have more options to mitigate longevity risks. These include full buy-out, which passes the entire scheme to a specialist insurer, or longevity swaps, which insure the scheme against the cost of members living longer than expected.

Investment banks are offering these types of solutions, traditionally provided by insurers.

The first longevity swaps, where investors take on the risk of paying for longer-living pensioners in return for an agreed stream of payments from the seller, started in the UK last year with a deal between Babcock International and Credit Suisse, followed by another between RSA and Rothery Life, the insurance company owned by Goldman Sachs.

Investment banks with expertise in derivatives and hedging are well placed to manage risks.

A number of FTSE 100 companies have already completed risk transfer deals for their schemes.

Deutsche Bank took over the longevity risks of nearly £3bn of liabilities from BMW's UK scheme, a transaction that promises to be the largest in corporate longevity insurance.

This year BA, the airline, became the eighth FTSE 100 company to complete a material risk transfer for its scheme via a £1.3bn buy-in with Rothery Life.

Most recently Alliance-Boots insured itself against further costs associated with a portion of its final salary scheme, which it closed to further accruals in June.

The Alliance UniChem

section of its scheme – acquired when Boots merged with the company in July 2006 – has had all its benefits insured against further losses through a contract with Pension Insurance Corp.

Becoming more popular are so-called "DIY buy-ins" where a scheme combines a longevity swap with an investment strategy that matches what it pays its pensioners every year.

'Schemes can make use of the apparent anomaly in the bond markets to fund a longevity swap'

James Mullins, senior liability management specialist at actuaries Hymans Robertson, says he expects a quarter of FTSE 100 companies to have completed a risk transfer by 2013.

"This reflects a number of reasons," he says. "One is that market conditions have improved over the past year, meaning risk transfer deals are more affordable for many UK schemes."

He says the market is "ideal" for schemes to replicate the buy-in deal RSA completed with Goldman Sachs in July 2009 and says it would not be surprising to see another UK scheme completing a DIY buy-in deal in the final quarter.

"Schemes can make use of the current apparent anomaly in the government bond markets to fund a longevity swap, with potentially no adverse impact on the scheme's financial position," he says.

Jay Shah, partner at the Pension Corporation, which provides solutions to the trustees of defined benefit funds, says full buy-outs usually happen when companies undergo corporate activity such as restructuring or selling a division.

"Over the next 10-15 years I think we will see more full buy-outs," he says. "Many companies are using longevity swaps as an interim measure before going for the buy-in or buy-out options," he says.

The industry has also been helping cash-strapped trustees transfer risk.

For example, the Pensions Corporation used a deferred premium when helping Arnold Laver, a UK timber merchant, deal with the deficit in its scheme using a buy-out.

This deferred premium is a large portion of the total premium and is deferred over five years even though the full level of member benefits is insured at the outset.

This type of deal could be attractive to trustees who want to remove risk, but do not feel they can start doing that because of the deficit in their funding.

But as more schemes transfer away risk by signing up to such transactions, pressure starts to mount on schemes that have avoided taking action.

"There is a snowball effect," says Mr Mullins of Hymans Robertson.

"The more pension schemes tackle risk, the more pressure there is on others to follow suit."



An age-old problem: pensioners at keep-fit class

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Risk Management



Red tide: hundreds of thousands of cubic metres of the mud flooded from a waste reservoir into three villages, polluting farmland and rivers

Getty

Hungarian spill puts financial provisions under the spotlight

Environment

Paul J Davies looks at liabilities after the toxic sludge discharge

The Hungarian villages swamped by a toxic red sludge from an alumina plant last month may now have had their drinking water declared safe by the World Health Organisation, but the damage to animal and plant life around them will take much longer to assess and repair.

Hundreds of thousands of cubic metres of the red mud, a byproduct of alumina extraction that contains heavy metals and other toxic elements, flooded from a waste reservoir into three villages, polluting farmland and local rivers including a tributary of the Danube.

Nine people died and 150 were injured – for which the company responsible, MAL, has offered almost €6m compensation – but the spill also killed unknown quantities of fish and other wildlife.

Under recently introduced European rules, these and the local flora have to be restored to their former levels, no matter what the cost. If restoration is not possible, the company responsible must pay compensatory damages.

Experts say companies are

only just becoming more aware of the liabilities they face if they cause environmental damage.

However, Simon Johnson, head of environmental liability in Europe at Aon, the broker, says clients are increasingly making enquiries about the cover they might need. “What we’re seeing is European and global companies in Europe beginning to understand that they have a real gap in their traditional liability programmes,” he says.

Insurers have been promoting various kinds of cover for these potential liabilities for some years, but the nascent environmental market has struggled to grow significantly because of inconsistencies across Europe. The 2004 environmental liability directive (ELD) has been implemented sporadically across the EU, with some countries, such as the UK, taking years to introduce legislation.

Hungary, ironically, was among the most proactive in enacting the directive and is one of a handful of the 27 EU nations that planned to make financial provisions against environmental damage compulsory for large industrial groups. Industry lobbied hard in Europe to block compulsory financial provision in the directive, making it optional for individual countries.

Such provision does not have to be an insurance policy, it could instead be a trust fund, bond

issue or strong parental guarantee. However, insurance has proved to be usually the cheapest and simplest form of provision available.

Simon Harwood-Matthews, an environmental expert at XL Insurance, the industrial insurers, says the Hungary spill could prompt European policymakers to re-examine the question of financial provisions.

“I think this will make Brussels look at this issue more urgently and will add weight to the argument for compulsion to

‘Failure to enforce the environmental liability directive could make it meaningless, not just in Hungary but throughout the EU’

financial provision,” he says.

In the US, where financial provision has become far more commonplace, especially in states that have suffered serious environmental disasters, the market for such financial provisions already generates up to \$2.5bn in annual premiums. In Europe, the equivalent market is worth less than €100m, experts say.

Lawyers are warning that if the directive is overlooked in the case of the Hungary spill, it

could weaken the rules across the EU.

“Failure to enforce properly now could make the ELD meaningless, not just in Hungary but throughout the EU,” says James Thornton, head of ClientEarth, a European environmental law pressure group.

But one of the key features of the ELD is that it gives powers to interested parties and individuals, including green pressure groups, to demand that regulators look at the full extent of environmental damage caused and hold polluters to account.

The provisions on remedy and restoration in the ELD, however, make the liabilities related to a spill extremely hard to quantify. Mr Harwood-Matthews says it is difficult to assess the value of potential environmental liabilities.

However, insurers can estimate the probability of a company causing a high impact event, based on its operating standards and history, its business and its physical environment – for example whether it is located near water supplies.

Tony Lennon, European manager of Chubb Environmental Solutions, says understanding risks and liabilities can help companies internalise those costs to help prevent them declaring bankruptcy after an event – which helps neither the environment or the company and its workers.

In practice, however, he says

that the insured company usually decides how much cover it wants to buy and then the insurer works out what the premiums and the excess will be depending on the risks the company presents.

“In most cases, people who buy environmental insurance don’t make a proper assessment of their risks, they just think about what they can afford,” Mr Lennon says.

Even though compulsory financial provisioning would be expected to boost the market for insurers to write such business, opinion in the industry is split as to whether that would be a good thing.

The CEA, the main European insurance trade body, said last month it welcomed continued reticence from Brussels on such compulsion.

It said the insurance industry faces challenges in developing products because of a lack of available data on ELD claims and on the cost of preventive and remedial measures because of late implementation of the ELD into national law in many countries.

“It is likely to take a number of years before detailed and reliable data emerge, especially where compensatory remediation is involved, as the time required to restore the damaged resource to its previous condition could take several years,” said Michaela Koller, CEA director-general.

Sun storms pose threat to satellites

Solar flares

Increased activity could hit power grids and communications, says Sharlene Goff

In an age defined by terrorist alerts, natural disasters and economic uncertainty, it may seem incongruous that businesses would concern themselves over the bizarre sounding threat of solar flares.

But scientists are taking seriously as a threat the idea that powerful bursts of radiation from the sun might interfere with satellite operators and power suppliers.

Solar flares are caused by large explosions in the Sun’s atmosphere. These release huge amounts of magnetic energy and, if strong enough, the radiation they emit can travel to Earth, potentially wreaking havoc with its vital infrastructure.

The danger is that the energy from the flare could interfere with the Earth’s communications systems and power supplies, disrupting satellite transmissions and, in extreme cases, shutting down power grids around the world.

While these kinds of solar storms are not a new threat – one in 1859 caused telegraph systems in Europe and North America to fail and several big flares have been identified in recent years – they occur in cycles, depending on when the Sun is most active.

Solar cycles last 11 years and at the peak of each cycle more sunspots – areas of intense magnetic activity – appear on the Sun’s surface. It is the eruption of these spots that can trigger solar flares.

Scientists at Nasa are predicting a period of intense solar activity between 2011 and 2013, prompting some warnings of a kind of “solar tsunami” in this period.

Richard Fisher, head of Nasa’s heliophysics division, recently said: “The Sun is waking up from a deep slumber, and in the next few years we expect to see much higher levels of solar activity.”

Risk managers warn that the effects of a big solar flare during this period could be more damaging than in the past, given society’s heavy dependence on communications technology and electronics.

In an extreme case Britain, the US and other nations could face widespread and prolonged power cuts, plunging millions of homes, offices and hospitals into darkness and wreaking havoc with systems from financial services platforms to air travel controls and crucial communications signals.

“But should people stop investing in telecoms as a result? No,” he says.

While power grids are designed to withstand relatively small outages, a particularly powerful solar flare could cause serious disruption by closing down a big part of the world’s power supply.

If this happened, the knock-on effects could be huge. The US National Academy of Sciences has warned that a big solar storm could cause 20 times more economic damage than hurricane Katrina.

“Shutting down the grids would shut down business and commerce,” says Hamish Roberts, chief executive of the power division at Aon, an insurance broker. “It could cause a catastrophic loss of earnings or revenue, as the grids can’t easily just be switched back on – it can take days.”

While the risk of such severe consequences is slim, experts say companies are beginning to take the threat of solar flares more seriously.

“The message we are sending to our telecoms clients is that solar flares are an issue they need to address alongside many others,” says Fredrik Motzfeldt, a communications, media and technology specialist at Marsh, another broker.

He adds: “The potential impact on terrestrial communications networks is one of the risks that have been identified, but it is not top of the agenda.”

Risk managers point out that solar flares happen too infrequently to pose much of a concern to companies and, even if the threats become more serious during the next few years, businesses have limited options for what they can do to protect themselves.

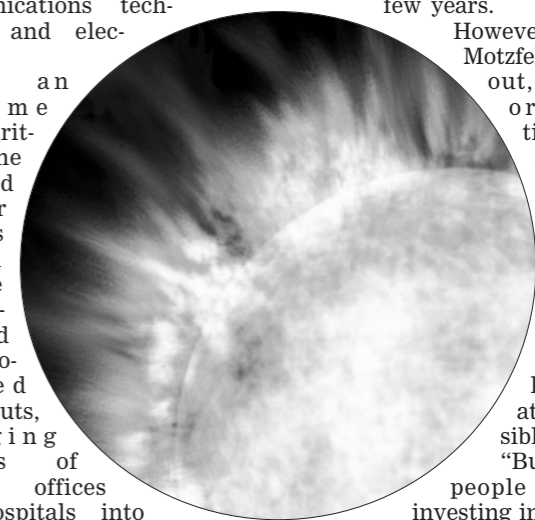
Mr Roberts says it is difficult to insure power grids, as they are already susceptible to damage from other causes such as storms.

Rather than relying on insurance – which is also unlikely to cover this kind of incident, as providers tend to exclude natural disasters from their policies as soon as they become a real threat – Mr Roberts expects companies to take other measures against solar flares.

Already companies are insulating power grids and satellites from the effects of solar flares and this is likely to improve in coming years.

Experts say new satellites are well equipped to withstand solar storms, even the strength of those predicted over the next few years.

However, as Mr Motzfeldt points out, if an organisation such as Nasa is warning about solar flares, companies should at least look at the possible effects. “But should people stop investing in telecoms as a result? No,” he says.



Bursts of radiation from the sun might interfere with satellites

Dreamstime

When a restructuring comes knocking at the door

Directors

Anousha Sakoui looks at challenges faced by boards in managing liabilities when at risk of insolvency

The sale of Liverpool Football Club last month to the owners of the Boston Red Sox baseball team was one of the most high-profile and contentious sales of a UK company in recent times.

In the weeks before a deal was finalised on October 14, the board of the club, led by chairman Martin Broughton, and its lenders, were locked in courtroom battles with shareholders in both London and Texas. Fears of administration and points deduction – at a club already suffering a run of bad results that has put manager Roy Hodgson under pressure – by the Premier League swirled around.

Ultimately, the sale was sealed and the shareholders were left threatening a \$1.6bn claim for damages.

The process highlights the

Liverpool manager Roy Hodgson is under pressure after a run of bad results



challenges boards face in managing liabilities when at risk of insolvency – something that became a reality in the wake of the financial crisis.

Roger Barker, head of corporate governance at the Institute of Directors, says: “There have been more insolvencies in the downturn and that has been reflected in rising numbers of director disqualifications.”

“This is a concern for our members, particularly directors of smaller companies. We advise any company getting into difficulties to seek professional advice. They need to be careful that in the steps they take, they are seen to have acted properly in the eyes of creditors.”

The losses many investors faced prompted fights among stakeholders in restructurings.

“What happens in a lot of restructurings is that you

are cutting someone off,” says Richard Fleming, UK Head of Restructuring at KPMG. “It gets difficult for directors when creditors get under water. But directors also face a bit of double jeopardy if they call for administration too early, as this can be damaging for creditors.”

In the main, the fights in restructurings are between different classes of creditor over who should own the business and who should bear the brunt of the losses. This was the case in restructurings of Dubai International Capital’s German alumina business Almatris, IMO Carwash or Greek telecommunications business Wind Hellas.

Mr Barker says that seeking advice alone can help mitigate criticisms of directors’ actions that may emerge after insolvency. “If [directors] favour one creditor over another by paying off certain creditors but not others, or take on new liabilities when this could harm the interests of existing creditors, it could lead to potential legal liabilities in the wake of a corporate bankruptcy,” he says.

One key concern for boards is at the same time avoiding trading while insolvent.

“There is a ‘bright line moment’ after which a company loses reasonable prospect of avoiding insolvent liquidation,” explains Adam Gallagher, partner at Freshfields Bruckhaus Deringer. “That is the test by which boards of distressed companies live and die, as wrongful trading can incur personal liability for the directors.”

Wrongful trading is defined as when a board knows, or ought to have known, that the company no longer had reasonable prospect of avoiding liquidation. “Directors can become personally liable for the extent to which they increase the losses to creditors by worsening the company’s position after any reasonable hope of a rescue has faded,” says Mr Gallagher.

“However, if you file for administration too early, you are rarely doing the right thing for creditors given the stigma still associated with any sort of UK insolvency filing.”

Directors have to balance not filing for insolvency too early with not exposing themselves to personal risk. “However, if life gets just too difficult and personal liability becomes a real risk with no clear way forward, the point may come

where the directors say ‘we are directors... not liquidators’ and at that point filing may become inevitable,” says Mr Gallagher.

He advises boards to look forward and identify timing imperatives. “Know how much time there is to covenant testing dates or account-signing deadlines. And know it might be shorter if other events happen. Ensure everyone knows the timetable,” he says. “Frequent board meetings are necessary. And think seriously before taking on new liabilities.”

Francis Bridgeman, partner at law firm Macfarlanes, says the multiplicity of lenders and their diverse interests cause problems for directors when managing their liabilities.

“Directors are often stuck in the middle,” Mr Bridgeman says. “They can’t escape their fiduciary obligations by agreement.”

“The fact that one or more groups of financial creditors may have specific contractual rights that they could enforce will of course colour directors’ decisions, but it does not alter the underlying duties, something that becomes particularly relevant where there is still

clear equity value in a business.”

He advises that directors be methodical in making decisions and record their reasoning for decisions at the time. “Directors are in effect the custodians of the business and its value – whichever stakeholder may be entitled to share in that value. They need to do the best by the company and its owners (even if those owners are in practice its lenders).”

Directors are also expected to do contingency planning for a possible administration if insolvency is a risk. “We advise directors that entering an unplanned insolvency could pose as great a potential liability to them as continuing to trade for a short period while as much preparation as possible is made – and that period could be hours, days or weeks, depending on the particular situation,” says Mr Bridgeman.

“Even where lenders may have the right to initiate such a process, it is usual for them to ask the company to commence a formal insolvency – hence the need for directors to include this in their planning and not simply abrogate this responsibility to their lenders.”