Mactavish FREETHS

CHANGE, UNCERTAINTY & OPPORTUNITY

Motor Trade, Retail, Leisure and Hospitality – Risk Roundtable Discussion With Senior Business Leaders

The risk environment faced by firms across the UK has never been more fraught and unpredictable. Earlier this Summer we brought together a group of senior business leaders from across the motor trade, retail, hospitality and leisure sectors to discuss their perceptions of the risk landscape they face and to explain why we thought there was a growing grey area between those risks that could be transferred and those that could not.

Our aim was to foster a candid and open discussion that would help us share learnings and viewpoints from across these industries.

In this document we outline some of the themes that came up in our discussion and explain why we think they are of critical importance to all business leaders with responsibility for strategy and risk.

THE CHANGING NATURE OF RISK

Some of the risk challenges we discussed have blindsided us, most obviously the ongoing pandemic, but if anything, we were surprised to find that the focus of our conversation was as much on issues like supply chain concentration, labour shortages, trade barriers and cyber risks as it was on epidemiological factors.

Whilst there's nothing new about risk management appearing on the Board agenda, it's now more common for "strategic risks" to be elevated to high priority and be seen as materially relevant to corporate decision-making.

Along with changes in the actual risks companies are concerned about, there is a feeling that scrutiny of risk management and mitigation is also increasing. This is especially true for public companies where investors and non-executive directors are placing more emphasis on understanding the controls and mechanisms that have been put in place. This was backed up by a general mistrust of insurance from many of the businesses we talked to – a prevailing attitude that if there is a large claim then insurers will likely dispute it either in whole or in part, so insurance should be a last resort, with "front-end" risk management being the primary defence. We would suggest that in the future, this trend may be allied to broader societal changes and increased focus on sustainability, creating a profound shift in mindset by those responsible for corporate stewardship.

One of the key indicators to watch in this regard will be investor and corporate communications. A Mactavish report produced last year demonstrated that only 13 companies in the FTSE 100 had cited infectious diseases or epidemic events in the Principal Risks and Uncertainties sections of their annual reports in 2019, despite the relative frequency with which regional and global epidemic events occur.

The report also used data from World Economic Forum surveys to suggest that attitudes to risk were fundamentally backward-looking and not based on firm empirical foundations. It is striking that risks related to infectious diseases were considered much more important in the immediate aftermath of SARS and Swineflu, but much less so in the last five years. In fact, water shortages were deemed both more pressing and more serious than the risk of an epidemic. In short, perceptions of risk are too often based on last year's issues and this year's headlines.

If investors, boards and senior leadership teams continue to place more emphasis on strategic risk management we might expect to see a marked improvement in the way in which they describe those activities to the outside world. Indeed, those companies that do improve their risk reporting may find that they enhance their long-term competitiveness and also improve their investor proposition.

As James Hartley of Freeths explained, the positive business perspective on risk is that strategic risks are part and parcel of driving a business forward and making investment decisions. In the words of senior decision-makers we have spoken to:

"The responsible management of regulatory and compliance risk gives us genuine competitive advantage, which our senior management are acutely aware of."

"Taking on appropriate risk in a controlled way enables the business to generate growth and returns."

RISING INSURANCE COSTS

With growing focus on risk, it is inevitable that much of our conversation would focus on risk transfer and specifically, insurance. In a discussion guided by Mactavish's Chief Technical Officer, Rob Smart, we explained current trends in the insurance market and what they mean for policyholders.

Insurance costs have spiked over the last two years in a way not seen since the turn of the millennium. There are multiple drivers behind this trend including the long-term impact of low interest rates on insurers' investment revenues, claims arising from the impact of Covid-19 and a growing awareness that underwriters have opened themselves up to considerable exposures arising from litigation risk against directors and officers, and the ever evolving arena of cyber risk. As a result, the cost of some lines of cover has increased by several hundred per cent and prices look likely to stay high for some time.

This market context places significant pressure on brokers who are suddenly faced with a surge in their workload and, since most brokers were not in senior or decision making roles in the last hard market, there is a real lack of the skills required to handle the new challenges. In contrast, broking has been relatively easy for the last two decades as capacity has been plentiful and insurers have had to compete for business.

UNCERTAINTY AROUND RISK TRANSFER

Rob Smart explained that while rising costs might be the most obvious symptom of a hard market, there were other factors that buyers needed to be aware of. Chief amongst these is a deterioration in the quality and extent of cover that insurers are willing to provide.

In a hard market, underwriters look to limit their exposure by tightening their terms, reducing limits and excluding certain aspects of cover. A high profile example of this is infectious disease risk. Quite naturally, insurers have looked to limit their exposure to Covid-19 related losses by removing clauses from their policies, however, many have gone much further and have, in fact, removed any cover for diseases and illnesses that companies routinely depend on. For policyholders in the retail, hospitality and leisure sectors this has clear and significant implications.

These restrictions are not confined to the headline pandemic related risks, with Cyber a further key example highlighted in our discussions. There is lots of uncertainty over how risks can be reliably transferred (e.g. business interruption caused by a non-damage Cyber event, or supplier interruption with a similar cause), how best to communicate complex issues from IT specialists to insurers, and indeed whether Cyber underwriters sufficiently understand their policies and their clients' exposures to provide an appropriate product.

Some of the factors that make insurance unreliable are not specific to the current market. Mactavish has long held the view that the increasing use of standardised, one-size-fits-all policies that are not adapted for the specific needs of the client represent a significant problem. These errors often arise as a result of the use of 'panels' or 'facilities' in which brokers place business with a small pool of insurers (from whom they derive additional revenue) on prearranged terms. In one recent example Mactavish has seen a firm involved in the catering industry was sold a policy that explicitly excluded catering activities, rendering the policy worthless. The application of inappropriate policies affects all classes of insurance, but is particularly common in Directors' and Officers', Cyber, Professional Indemnity and other complex, high risk lines.

Finally, we explained that claims disputes are likely to rise in the years ahead as insurers look to preserve their reserves by delaying, reducing or repudiating claims made on historic policies. Mactavish's own research – conducted in soft market conditions – showed that 45% of large or complex claims are disputed, they take an average of three years to settle, and typically, the policyholder receives only 60% of the value of the initial claim. These are shocking statistics and we would expect them to grow worse in the current market conditions.

Often, the grounds on which an insurer will dispute a claim can be highly spurious. Some recent examples include:

- A company's headquarters started to fall apart months after construction – the insurer responded to the claim by saying the damage was a result of "wear and tear"
- A product claim against manufacturing was rejected as the product was sold via a retailer – completely undermining the basis of product liability cover for a split manufacturer-retailer model
- A large industrial explosion with multiple causes was simply ascribed to "operator error"

Even when claims are not rejected on the grounds of technical factors, insurers will often look to errors of process to avoid settlement. Policy wordings often contain complex stipulations about how a claim is notified that often bear no relationship to the reality of a company's operations. In practice, a relatively small error in how a claim is notified and presented can be used by an insurer to avoid payment, even when they have no bearing on the actual loss.

DISCLOSURE PRESENTS A GROWING RISK

Aside from disputes arising from decisions made after a loss has occurred, Mactavish's Rob Smart explained that insurers may well return to an older tactic, disputing claims based on 'non-disclosure'.

Put simply, this entails an insurer claiming that they were not sufficiently informed of some aspect of a risk or organisation's operations and that, were they fully aware of the facts, they would not have covered the risk – or not on the terms they offered at the time. This area of law was fundamentally revised by the Insurance Act 2015 (the Act) – although few disputes have reached the courts to set precedent in the years since.

Mactavish was heavily involved in the Act, which set out to clarify exactly how disclosure should work and to create a fairer system for remedying disputes. The Act protects policyholders by defining the Duty of Fair Presentation, but it also requires that they meet certain standards. In very simple terms, policyholders must pass on relevant information that falls into three categories: the knowledge of senior management, knowledge of those involved in insurance (including the broker, where relevant) and knowledge that could be gleaned by conducting a 'reasonable search' of the organisation. Any policyholder that cannot demonstrate that it processed and communicated the information it held under these three headings is at risk of a dispute. Since the situation on the ground is changing so rapidly as we navigate the conditions imposed by the pandemic, it will be particularly difficult to keep your insurers abreast of everything they may later claim they should have known. The result may be invalidated cover.

Importantly, since relatively few disputes of this type have actually reached the courts, there is a degree of ambiguity about how judges will interpret them. If we are right in believing that claims disputes will increase in the years ahead, this is likely to form a major battleground between insurers and insureds and is already filtering through in the form of more common claim repudiations.

The situation will be exacerbated by the use of panels and facilities we discuss above, and the way in which smaller policyholder organisations are being asked to use online questionnaires in order to access them. While the questionnaires may indicate what a particular insurer is interested in, they are blunt instruments that often limit the policyholder to 'yes/no' answers. They are also unlikely to be deemed to void the stipulations contained in the Duty or Fair Presentation, or to remove the need to carry out a reasonable search prior to submission, or proactively disclose relevant detail beyond the questionnaire's scope. For complex organisations, with unusual risk profiles, they may well be wholly inadequate.

It is also worth noting that, at a time when businesses in the retail, hospitality and leisure sectors are having to react to frequent regulatory and operational changes resulting from the pandemic, the burden of disclosure is massively increased.

CHALLENGES WITH PROFESSIONAL ADVICE

When insurance is this unreliable, policyholders will naturally turn to their brokers for guidance and advice. Here, they face an additional hurdle that adds further complications. In a high profile report published last year (later brought to public attention by the Daily Telegraph and CityAM), Mactavish demonstrated that some brokers derived as much as 80% of their revenue from insurers, with only 20% coming from policyholder fees.

Much of this revenue is directly or indirectly linked to the volume of premiums, meaning that brokers may stand to profit as policyholder costs increase. Mactavish believes that this model presents astounding potential for conflicts of interest and seriously undermines the role of the broker.

As James Hartley of Freeths explained, there is increasing value in a coordinated and "joined up" approach between brokers and lawyers, so as to build a clear picture of which risks are insured/insurable and which are not. That level of support enables organisations to adopt a truly holistic approach to strategic risk management and risk transfer solutions.

IN CONCLUSION – CHANGE, UNCERTAINTY AND OPPORTUNITY

Our conversations revealed an increased focus on strategic risk management and an awareness that the world in which our leaders operate is going through immense change. While these issues may have been crystalised by the pandemic, it is far from the only cause of concern, in fact, as Covid-19 recedes in the years ahead, there are other challenges that will prove far more enduring.

While the appetite for better risk management is certainly there, the answers to the questions posed by the new operating environment are far from clear. It is particularly unfortunate that the insurance industry has not only failed to step up to a challenge which it is well-positioned to meet, but is actually retrenching by continuing with a model that has not been fit for purpose for some time. As one participant put it "what's the point, it never pays out anyway".

In the opinion of Freeths and Mactavish this situation will require companies to take new approaches based on a revised set of risk management principles. Based on our conversations and day-to-day work, we believe that those with board and senior leadership responsibility for risk should consider a number of key questions:

- Has the board developed an accurate picture of its principal risks and uncertainties? How much discussion is given to drawing up this framework?
- Are there clear channels for risk communication within the business, capturing both information from the ground up and the top down?
- Is risk management properly resourced and involved in strategic decision making?
- Does the business have access to expert and truly independent advisers?
- Does the company's leadership understand which risks are transferred and which are implicitly or explicitly retained?

In our view, there is a real opportunity is for organisations that focus on these questions and put in place effective structures will be both more resilient and more competitive in the years and decades ahead.

Mactavish

Mactavish is the UK's leading independent buyer of insurance on behalf of business policyholders. It has deep expertise in both the technical and commercial aspects of insurance and risk, and uses that knowledge to help its clients drive a fairer outcome from the market. In addition, the firm's claims resolution service works on some of the world's most complex losses, supporting clients and helping them achieve a fair settlement.

Mactavish has a heritage of driving legal and regulatory reform in the insurance industry and today, uses its voice to push for greater transparency in a notoriously opaque sector.

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Freeths are a top 45, full service commercial law firm with lawyers spread across the UK. We have a strong financial base with a turnover of £100+ million achieved in the year to 31st March 2021. Our growing firm has over 850+ members of staff. The Legal 500 and Chambers legal guides consistently rank our lawyers in their top tiers.

We are ranked 57th in The Sunday Times Top 100 Best Companies to Work For and Rated Two Stars in The Best Companies to Work For.

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