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Political risk and crisis management insurance

Opportunities for growth

July 2016

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Executive Summary

With perception of political volatility increasing around the world, Political Risk and Crisis Management insurance is becoming more relevant than ever. The challenging macro-economic environment, recent terrorist attacks in France, Belgium and other countries, growing cyber threats, and not least, political uncertainty caused by the recent EU Referendum vote demonstrate a clear demand-supply gap and a need for appropriate insurance solutions.

The overall Political Risk and Crisis Management insurance market size is estimated to be around $8.1bn[1], with almost all key sub-segments showing positive demand growth (particularly, in the cyber security segment) but this is strongly undermined by challenging macro-economic conditions around the world as well as continuous influx of alternative capital. We expect the Brexit discussions to have a short term domestic impact (driven in particular by expected lower economic growth) but minor consequences for global aggregate Credit & Political market demand. The full scale of the impact will depend on the outcome of negotiations between the UK and the EU.

The soft market environment and profitability challenges are unlikely to go away in 2017, forcing insurance carriers and brokers to find ways to innovate and seek partnerships outside insurance.

The growth might have stalled but not forever. There are three key areas that are likely to see significant developments over the next few years:

1. Emergence of products to support capital relief requirements for banking clients
2. Political Risk and Crisis Management insurance moving away from simple protection cover, with greater focus on prevention and response consulting services
3. Growing customer demand for solutions against the changing terrorism risk and cyber security challenges.

[1]Estimated market size in 2015

Contents

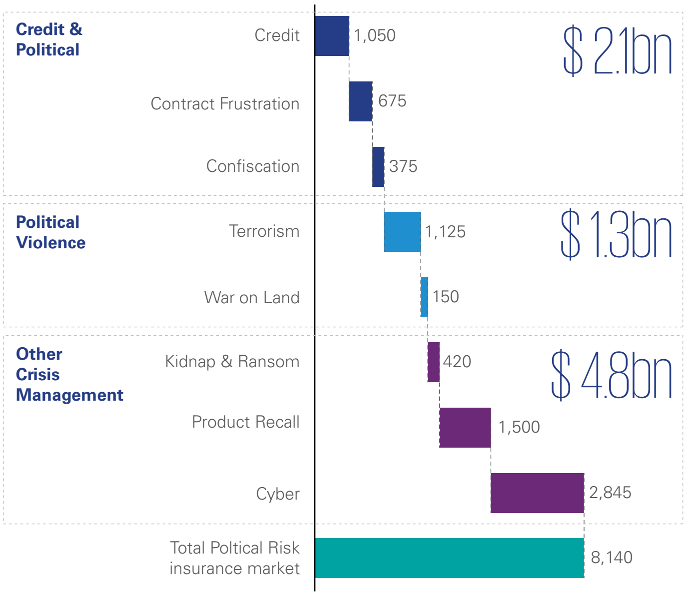
What is Political Risk and Crisis Management

Political Risk and Crisis Management insurance includes three major segments – (1) Credit & Political, (2) Political Violence, (3) Other Crisis Management risks, although specific boundaries are set in a slightly different manner by almost every market player. This is not a coincidence, as carriers are trying to align their underwriting capabilities and product offerings with the underlying needs of the end customer. Customers concentrate on whether a comprehensive solution can be found to protect their assets, people or profits, and are not interested how insurers classify their products. This has resulted in product offerings that span across political and non-political risks.

The estimated total size of the specialty Political Risk and Crisis Management insurance market was around $8.1bn in 2015 (see exhibit 1).

This includes the **Credit & Political**[2] risk segment that covers non-payment risk (contract frustration by governmental institutions as well as non-payment by commercial market actors) and confiscation of assets, as well as the **Political Violence** segment which covers terrorism, war and other similar perils. Additionally, other political risks (such as Kidnap & Ransom) are often merged with various non-political risks (such as Product Recall or Cyber security) in a broader 'Other Crisis Management' category which was also included in our analysis.

Exhibit 1: Political Risk and Crisis Management insurance market size, $mn



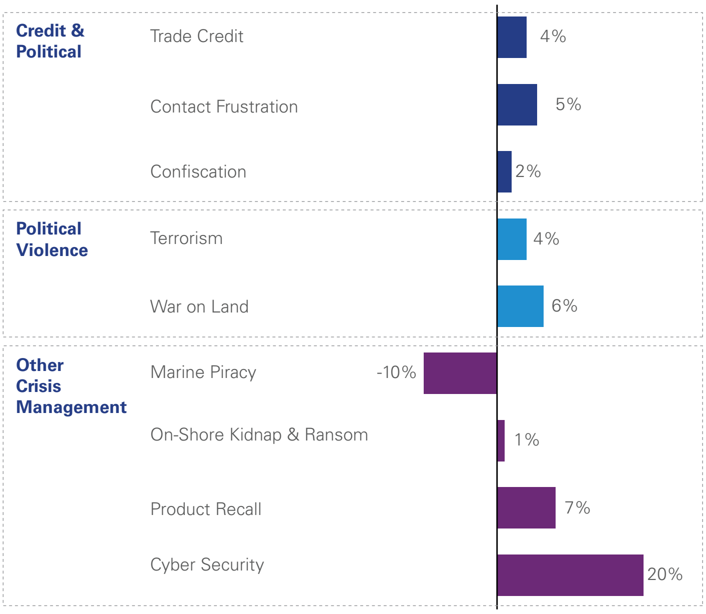
[1]Estimated market size in 2015
[2]We have only considered specialty 'Single transaction' type of business and have excluded 'whole turnover' business from our analysis.

Market is expected to grow but at a lower rate than in the past, as macro-economic conditions remain challenging

Demand for insurance is growing across segments

The current political and economic environment is driving demand for new products: the Non-Trade segment is recognising the benefits of political insurance, banks are seeking ways to transfer risk, and corporates are looking for protection against evolving terrorism and cyber threats. It means that even in the face of macro-economic challenges across the emerging markets, we expect a positive development of political risk insurance market over the next three years (see exhibit 2).

Exhibit 2: Expected annual growth rates across market segments (2015 to 2018)



[1]Estimated market size in 2015
[2]We have only considered specialty 'Single transaction' type of business and have excluded 'whole turnover' business from our analysis.

Credit & Political risk

The Credit & Political insurance market is expected to grow by around 4%, mostly driven by the Contract Frustration segment as insurance companies seek ways to participate in mitigating non-payment risks associated to export financing. As regulatory restrictions keep evolving, we expect higher demand from banks for capital relief mechanisms, particularly outside Europe. Limited growth is expected in Confiscation business as low commodity prices reduce incentives for national governments to take over assets and insurance companies are evaluating the risks of 'creeping expropriation'. It is expected that the overall growth will be lower than during the past 5-7 years when annual growth rates often exceeded 10%, as economic development is expected to stall in key emerging markets and the international trade flows are likely to stagnate in 2016 and only pick up again in late 2017 or 2018. Furthermore, a significant knock-on effect can be expected in case regulation governing capital requirements in banks were to change which is particularly relevant considering the recent EU Referendum vote. Any such changes could potentially lead to softening or hardening of demand.

Political Violence

According to the Global Terrorism Index , the total costs of global terrorism reached $52.9bn in 2014 which is the highest level so far and is an almost 350% increase from 2010. This figure does not include business interruption costs which are likely to be very high. We are seeing a clear trend for terrorism risk to evolve from mostly property damage related to events similar to the recent Paris attack where asset damage was limited whilst the estimated cost of business interruption according to various economists might reach $12bn. This changing nature of terrorism and the overall perception of increased political volatility, driven by the recent conflicts in Ukraine and Syria, will fuel significant increase in demand over the next three years.

Piracy and Kidnap & Ransom

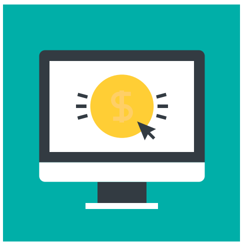
The Piracy and Kidnap & Ransom insurance market is likely to remain flat over the next few years. We are seeing a decline in the number of pirate attacks on the sea due to intensive naval patrols and defence strategies. As a result, we expect the Marine Piracy market to shrink from c. $105m in gross premium to c. $75m. At the same time, we expect a gradual increase in the On-shore Kidnap & Ransom market (c. 1% annually), as the risk increases in various geographies, particularly in Latin America.

Product Recall

In September 2015, the German car manufacturer Volkswagen was ordered to recall half a million cars due to allegedly installed software to evade standards for reducing emissions. Such incidents are becoming more prominent and we estimate that the Product Recall market will grow by around 7% annually, driven by tightening legislation in the US and Europe, and increased customer awareness of product quality. We expect growth across all segments, including Food & Beverage, Non-Food consumer goods, and Automotive.

Product Recall risk is starting to pick up in emerging markets. Insurers are still hesitant of taking on risks in India and China due to historically high number of product recall cases (including a case in 2008 when large quantities of milk powder had to be recalled in China after four infants died and 54,000 babies got hospitalised). It is likely, however, that the market appetite might start to increase in the next few years, as appropriate legal frameworks are gradually being put in place.

Cyber

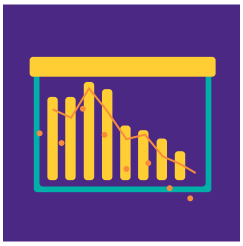


Cyber risk insurance is one of the fastest growing insurance segments, showing an impressive 40% annual growth rate over the last 5 years. The majority of cyber insurance business (c.85%) has historically come from the US due to more developed regulatory frameworks. This is likely to change, as Europe is expected to grow substantially once the General Data Protection law comes into force, making data breach notification compulsory.

Greater overall awareness of cyber risks, and the emergence of new markets make this segment highly interesting for carriers and brokers and we expect a further segment growth of around 20% annually over the next 3 years. One of the key opportunities for the insurance industry will be to understand the linkages between cyber security and other segments such as terrorism, and develop products that serve the emerging customer needs.

Growth and profitability challenges

Reducing insurance rates



An ongoing influx of alternative capital, combined with insurance carriers' appetite to increase line sizes and tenors, has created an overcapacity (particularly in the Political Violence and Marine Piracy segments) which is causing continuous softening of the market and pushing down insurance rates. Similarly, a lack of major loss events caused by terrorism or other acts of violence, has changed the overall behaviour of taking risk and market players have become more willing to sell high risk covers for low rates.

Even though market capacity is here in abundance, we believe it is unlikely it will endure forever. There are three drivers that might change the current dynamic in the longer term: (1) Rising interest rates making reinsurance returns less attractive relative to traditional investments; (2) Large CAT events, or several smaller CAT events occurring in a short time period; (3) A change in tax treatment or an increase in the regulatory capital requirements for alternative capital providers. The likelihood of these changes is uncertain but we expect some alterations as the world moves through economic cycles. The overall sentiment in the market is, however, that 2017 will be another year of decreasing rates which will put significant pressure on the growth of premium income.

Profitability challenges

We anticipate an increase in losses in the Credit & Political segment in 2016 and 2017, as low commodity prices have driven substantial increase in the risk of non-payment in projects related to oil and metal extraction. The unstable commodity markets will also have negative impact on trade finance related premium income and will push market players to change focus towards non-trade, non-commodity segments.

Other segments will also see profitability challenges related to higher loss ratios. We expect ongoing regulatory tightening of quality requirements for consumer products as well as growing customer expectations of product quality and safety standards. This will drive increased risk of products being recalled and higher losses for insurers.

These trends are prompting carriers and brokers to adapt their customer offerings to remain relevant in the changing marketplace.

Emergence of products to support capital relief requirements for banking clients

Opportunity

1. One of the key areas of innovation within the Credit insurance space is new products to guarantee a regulatory arbitrage opportunity for banks to offload risk to insurers. The financial guarantee type of product has been around for a while now in one form or another but what is new is the tight time limitations for the waiting period of the payment to the insured.

2. Such products provide banks with opportunity to optimise capital management under Basel III by offering unfunded participation in their portfolio of documentary trade finance, ECA finance, and structured commodity finance. The demand for the product has been growing fast in Europe and at a lower rate in the US and Japan, and is expected to take off in other geographies, particularly in Asia.

Challenge

1. The existence of the product is dependent on the regulatory frameworks, however, and any changes in Basel III or Solvency II requirements could potentially change the business economics of this opportunity.

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Growing customer demand for solutions against the changing terrorism risk and cyber security challenges

Opportunity

1 Another avenue of innovation is likely to be in the Political Violence segment. As terrorism risk shifts away from large explosions towards 'lone-wolf' shooter attacks, the demand for insurance is expected to change from property damage insurance to business interruption cover – for example, Air France-KLM recently announced that the Paris attacks led to a £52m drop in revenue.

2 Market players will see growing demand from businesses that were usually not interested in the standard property damage cover, opening up whole new potential revenue streams. The growing terrorism threat is also evolving into new digital channels – it is sometimes impossible to determine whether a cyberattack has been organised by a terrorist group or because of different motives, creating a need for more advanced cyber security product wordings and specialty cyber terrorism products.

Political Risk and Crisis Management insurance is evolving towards prevention and response consulting services

Opportunity

1 For some time now, insurance market players have seen a trend for customers to demand better levels of service beyond standard protection cover as they are seeking to prevent risks from happening and have an efficient response after major events. Insurers have responded by forming innovative partnerships with specialised Risk Intelligence and Crisis Response agencies.

Two typical products for such partnerships have been Kidnap & Ransom (e.g. Hiscox forming an exclusive partnership with incident response provider Control Risks to offer efficient incident management) and Product Recall (e.g. Allianz forming a strategic partnership with Red24 to manage product recalls or contamination and resolve emergency incidents). Other companies are following suit as customers have started to view such support services as a natural part of standard offering.

2 A similar trend has started to evolve in other segments, as customers recognise the added value of crisis management. We see a growing focus on terrorism insurance where risk managers are trying to find ways to assess and mitigate the potential risks.

3 Insurers are also trying to introduce support services in the Credit & Political segment (although mostly in the 'whole turnover' type of business), including AIG's partnership with Aronova in using real time IT platforms to analyse customer data and automate credit limit calculations and risk assessment. Another example is QBE, which is working together with specialist lawyers Simmons & Simmons to provide low cost legal advice to trade credit clients regarding the enforceability of their commercial contracts. It is remarkable that these services have been so popular even in the current 'soft market' environment and we expect the take-up rate to increase as and if the market hardens in the next few years.

Way forward

Insurance market players need to adapt to the changing market environment and re-evaluate their tactical approach and long term strategic options. The ability to be agile in challenging the traditional business and operating models will distinguish winners from losers and will allow carriers and brokers find ways to achieve profitable growth. Market players need to have a clear perspective on 'Where to play?' and 'How to win?' but it is not always straightforward and requires executives to consider a broad range of complex issues. Some of the questions one should ask are:

– How can we improve our response to the emerging customer needs and is your organisation equipped well enough to achieve that?

– Which markets and customer segments will be growing and which ones are likely to shrink?

– Are we spending enough time on product development and collaborating with other departments to build winning propositions?

– Are our innovation capabilities sufficient to create market leading solutions over short and long time horizons?

– Does your operating model and operational structure allow easy access to business in the European Union and elsewhere, particularly in the wake of the EU Referendum vote?

We believe that the winners in the future Political Risk and Crisis Management insurance market will be brokers and carriers that manage to develop deep understanding of emerging risks with strong data & analytics capabilities and offer innovative propositions that span across all key segments. This will allow them to charge premium rates for value add services rather than earning ever diminishing returns for standard insurance cover.

It is a choice between two paths – either you sit and wait and be disrupted; or you redefine the way you operate and win.

If you'd like to discuss further, please get in touch.

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