The biggest risks to the GCC's €1.2trn construction market

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News round-up: April 2015

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Why Crossrail is a triumph for risk management

Risk management has been central to the success of Europe's largest infrastructure project, owing much to sustained engagement with the board and management

At the end of March, Europe's largest construction venture, Crossrail, initiated the final stages of building a 42km tunnel network under London. Six years ago, the project began with the construction of eight new stations and servicing of 38 existing stations to accommodate the new railway. The completed railway will stretch from Reading and Heathrow to the west of the city, to Shenfield and Abbey Wood in the east.

The project is meant to increase London's rail capacity by 10%, with the first trains expected to run through the central tunnelled section in 2018. According to Crossrail, the new railway will bring a further 1.5 million people to within 45 minutes of the city centre. Moreover, the development is likely to support regeneration and add £42bn (€57.6bn) to the UK economy.

The size, complexity and high-profile nature of the project has placed greater pressure on the risk management function to ensure the project is delivered on time and within budget. That pressure was intensified owing to the poor performance of a number of large UK infrastructure projects in the years prior to Crossrail, such as the Jubilee line extension, which scarred the industry, according to Crossrail head of risk management Rob Halstead.

Underground risks

Supporting the numerous parties involved at the different stages of the development has proved a difficult task for Halstead and his team, and he says tunnelling beneath London's complex underground

(Continued on page 4)

Who was the best performing Lloyd's insurer in 2014

Most firms reported lower underwriting profits after a tougher year, but who came out on top?

The six listed Lloyd's insurers had a tougher year in 2014 THAN 2013. Natural catastrophe losses were still relatively low, but heavy competition, particularly in property reinsurance from the capital markets, put pressure on profits, according to StrategicRISK's sister title Insurance Times.

The average combined operating ratio across the six insurers studied was 88.2% – 2.5 percentage points worse than 2013's 85.7%.

Although the burden of claims from natural catastrophes was lighter, some large one-off losses still had to be contended with. In particular, the industry was affected by various of aviation losses, including the crash of two Malaysia Airlines airplanes.

The companies also received far less benefit from reserve releases from old underwriting years. Four of the six players suffered double digit percentage drops in reserve releases. This was generally because 2013 was a bumper year for releases, which could not be repeated in 2014.

Lloyd's insurers faced similar conditions during the year, but some performed better than others. Below is a guide to the top performers of 2014.

- Hiscox was the best-performing underwriter and the best at making money for its shareholders. Its 2014,

(Continued on page 7)

Is cyber security at third-party vendors a threat to your business?

Although firms know they should take their own cyber security seriously, they often overlook the one at third parties

As organisations have become increasingly aware of the significant legal and business risks posed by cyber security breaches, they have begun to devote substantial resources to identifying and eliminating internal vulnerabilities and to mitigating their exposure resulting from potential cyber security incidents. Organisations have found that they must address cyber security risk management from multiple angles, including investing in robust IT security systems, conducting employee training, considering the purchase of cyber security-related insurance policies, developing a data breach response plan and so forth.

An important, but sometimes overlooked, element of that process is third-party risk management. At a speech in February, Benjamin Lawsky—the superintendent of the New York State Department of Financial Services, which regulates many global financial institutions — observed that "a company's cyber security is only as strong as the cyber security of its third-party vendors". This article discusses some of the issues organisations should consider in seeking to mitigate their cyber security risk in connection with third-party service providers.

Take stock of existing vendor relationships

A first step is to ensure that your organisation has a complete understanding of who has access to what data. Does your organisation store information in the cloud? Does your organisation use a vendor to host its website? These days most, if not all, organisations provide some kind of data or systems access to at least some third-party vendors, whether the vendor be a law firm, a business consultant, a data storage provider, a printing services provider, a payment processor or even the manager of an office building's HVAC systems.

A well-designed contract will serve as a crucial foundation for a relationship with third-party vendors

Limit access and segregate data

Although it may be necessary to share some data or systems with outside vendors, such access should be only a need-to-know basis. The well-publicised and very costly credit card data breach recently experienced by Target Inc started with the theft of credentials granted to Target's HVAC vendor, Fazio Mechanical Services. The attackers infected the vendor with general purpose malware through an email phishing campaign. While many lessons can be gleaned from Target's misfortune, one of the most obvious is that the compromise of an HVAC vendor's credentials should never have led to the compromise of payment system data.

Review existing contracts

A well-designed contract will serve as a crucial foundation for a relationship with third-party vendors. If it has not already done so, your organisation should review existing vendor contracts with an eye towards mitigating cyber security risk. A number of contractual protections might help to manage such risk:

1. consider extending your own security standards to vendors. Contracts can include provisions requiring vendors to comply with specified security procedures
2. consider requiring the vendor to make representations or warranties regarding its cyber security practices or authorising your organisation to conduct audits regarding the vendor's ability to meet and sustain your security expectations
3. require that the vendor provide timely notification of any security incidents that it experiences. Such a provision might also define your organisation's rights to control any responses or disclosures to third parties in the event of an incident
4. control and limit downstream transfers of your data
5. require the vendor to destroy copies of your data in the manner you specify on termination of the relationship
6. consider how to allocate liability through indemnification provisions or limitations on liability based on the nature of the relationship and the sensitivity of the data involved
7. consider requiring the vendor to maintain cyber security-related insurance coverage. Relatedly, organisations should consider whether and to what extent data breaches stemming from third-party vendors fall within their own insurance coverage.

Develop a vendor management plan

After reviewing existing contracts, an organisation should consider whether such contracts can and should be renegotiated. Additionally, the organisation should develop guidelines for future contracts. These guidelines may include standard provisions such as those described above and may also aim to structure the analysis of when the benefits of outsourcing outweigh the associated risks.

The fact that Target's breach originated from a third-party vendor did not prevent Target for incurring enormous losses in the form of, among other things, litigation expenses and lost customer confidence. For that reason, the primary goal is to prevent an incident. If, however, an incident does occur, the robustness of an organisation's procedures and practices with regard to third-party vendors could help to limit its liability in subsequent litigation, which could include a shareholder suit against directors and officers or a customer or employee data privacy suit, or regulatory scrutiny. Indeed, regulators have begun to place increasing scrutiny on third-party relationships in the context of cyber security. For example, the New York Department of Financial Services will now examine banks within its purview on, among other things, their protocols concerning the cyber security of third-party vendors. Moreover, organisations should expect scrutiny regarding this issue to continue to increase.

Scott S. Balber is a partner and US head of investigations and financial services litigation and John J. O'Donnell is a partner in the New York office of Herbert Smith Freehills LLP. *(The authors thank David Leimbach, an associate at the firm, for his assistance in preparing this article.)*

The risk team drew together a set of risks in 2009-10 to engage the project's board with risk management issues from a strategic perspective

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Email: firstname.surname@nqsm.com

ISSN 1470-8167

Published by
Newsquest Specialist Media Ltd

30 Cannon Street, London EC4M 6YJ

tel: +44 (0)20 7618 3456

fax: +44 (0)20 7618 3420 (editorial)

+44 (0)20 7618 3400 (advertising)

email: name.surname@nqsm.com

Printed by Warners Midlands Plc

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Photos: Shutterstock, Crossrail

Newsquest Specialist Media

infrastructure has been a particularly risky process.

"The tunnelling has almost been concluded. The scale and complexity of the project meant there was a lot of risk regarding interfaces between different parties on the project," he says.

"A lot of infrastructure is underground, which must be protected when tunnelling underneath. In terms of risk, that presented us with a significant challenge at the early stages of tunnelling, owing to a number of critical infrastructures under the city."

Having embarked on building 42km of tunnels in the summer of 2012, Crossrail announced at the end of March that the final two 750m drives had commenced between Liverpool Street and Farringdon stations. Although some of the risk team will continue to support those managing the final tunnel drives and the construction of new stations, Halstead's main focus has now turned to ensuring the railway is built, tested, approved and handed over to its operator on time.

The task is further complicated by the ongoing disruptions to train services passing through London Bridge – the city's busiest station – after the government funded Thameslink Programme began redeveloping the railway operating system in September last year.

"Building the railway and bringing it into operation at the end of the job is a complex piece of work. We are looking ahead to help people [involved in the project] think about what the risks are when introducing a new railway and help them manage those risks," Halstead says.

Ensuring each stage of development is commenced on time and within budget on such a large scale may seem unrealistic to some. However, six years after construction commenced, Crossrail remains on time and on budget, despite its budget having been reduced by £1bn in the government's Comprehensive Spending Review of 2010 – a cut partly due to reduced risks associated with revised construction sequencing.

Board engagement

Halstead says the success of the project so far owes much to quality engagement with the board and senior executives on risk management matters, which has been impressively high from the start. Reporting to the programme controls director, Halstead meets with the independent board five times a year and with senior executives every four weeks to discuss the risk management agenda.

Although a heightened interest in risk management at board and executive levels may stem from high external pressures and expectations, Halstead says the onus is firmly on the risk function to sustain that interest and maintain engagement.

"No senior manager will say that managing risk is not important. Everyone knows that managing risk is important, but the trick [to improving board engagement] is giving senior management something to engage with that supports that aspiration," he says.

"Clearly, directors and executives are busy and have a high-level perspective of the project. Therefore it's important to respond to that and give them information to which they can relate."

The risk team drew together a set of risks in 2009-10 to engage the project's board with risk management issues from a strategic perspective. The list remains relevant and is still in use and Halstead believes initiatives such as this can improve and sustain board engagement with risk management.

"Risk management tends to be dry, with lots of risk registers, analysis and academic reports. What we have done here is provide a process and a set of tools that the senior team can understand and relate to in order to help them manage risk," he says.

"Increased board engagement requires the leadership to have the appetite [to engage in risk management], but the risk team also needs to give them something to sustain their interest and deliver value."

Halstead finds himself being consistently stretched by the board and executives and he recognises this as a positive endorsement for the importance of risk management. With risk management a key focus for the board, the Crossrail project is a triumph and an example of good practice for the wider risk community in terms of enhancing professional recognition for risk managers.

The biggest risks to the GCC's €1.2trn construction market

Senior construction risk managers highlight talent acquisition and retention and resource scarcity as the biggest threats to hundreds of projects currently under construction

Valued at $1.3trn (€1.2trn), the construction industry in the Gulf Co-operation Council (GCC), which comprises Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman, is a booming emerging market.

Hundreds of major projects are due to be completed between 2020 and 2030. So far, $935bn-worth of works are being executed, including mega projects; $81bn of business is out to tender; $211bn-worth of works are in the design phase; and $136bn-worth of projects are in the study phase, according to Middle East media firm MEED.

Among these new builds are plans for large cities and business districts, railway links, airports and luxury housing, which are all under construction to meet the needs of the region's rapid population growth (projected to increase by 30% to 53 million people by 2020).

Due for completion, for example, is the King Abdullah Economic City in Saudi Arabia. The project should cost $93bn and promises a 13.5km^2 central business district, 48km^2 of housing and 27km^2 of luxury resorts and housing. New housing is indeed a priority for the region and, in 2014, residential developments accounted for almost 42% of completed projects. Extensive, pan-GCC transport links are also being built to connect the region's states in the $30bn-Oman Rail network.

These numbers, however, do not take into account two mega projects: the World Cup 2022, estimated to cost €190bn, and the Dubai World Expo 2020, which is estimated to cost between €1.8bn to €3.7bn.

These developments create a positive outlook and should boost the economy, but from a risk perspective, exposure to business interruption (BI) is a major concern. Two major risks are likely to increase the possibility of BI: talent acquisition and retention and resource scarcity.

Fight for talent and resources

Philip Wood, insurance senior manager at Qatari Diar Real Estate Development Company, a firm managing the development of the Qatari Lusail City (encompassing 19 districts of new housing, shopping centres, schools, mosques, and other facilities) – says that because the GCC relies heavily on expatriates "companies are competing for skilled staff".

Indeed, in 2011, most people in the UAE and Qatar were foreigners – 87% and 84% respectively, according to a study by the Kuwaiti think tank Diplomatic Centre.

Frédéric Desitter, director of ERM at Qatar-based Sidra Medical & Research Center, adds: "One way to improve talent retention is to offer attractive terms and conditions, but this can go only so far. Other limits make talent acquisition and retention ever more challenging.

"There are, for example, limits in terms of the pool of skilled workers who have the knowledge, skills and experience to do the job across the world. Then, there are limits in terms of the number of skilled staff willing to leave their home town and set up base in a foreign country in order to take the job. So, businesses are competing for a limited pool of talent."

With billions of euros worth of construction projects due for completion in the next decade, demand for materials such as steel is high, posing challenges for the number of businesses working to the 2020 to 2030 deadlines. "The scale and pace of developments are a catalyst for risk," says Wood. "The GCC is undergoing so much development and there are many major construction projects that the availability of resources is scarce and, on the ground, the increased interface risk must also be carefully managed to avoid potential delays/bottlenecks."

Desitter adds: "Some companies may need to reconsider their plans and schedules if they are unable to get supplies on time."

Mitigation steps and future risks

Mitigating these two particular risks and any threats to a construction project will take a multilayered risk management approach. Wood outlines five key procedures.

First risk managers must conduct due diligence assessments on all the parties engaged in projects, including contractors and consultants.

Second, the risk team should take a "savvy" approach to the allocation of contractual risk. Next, supply chain management is vital, particularly where competition for resources is fierce and risk managers must be proactive in how they manage the supply chain. It is then advisable for the risk team to implement "additional layers of defence and control", in other words the "checkers should also conduct checks of other checkers [involved in risk and auditing]".

Last, risk managers should take advantage of any best risk practices.

However applying these mitigation techniques is not so straightforward in a market in which risk management is in its infancy. The main risk for the future is in how well risk management is supported and embraced throughout the GCC.

Risk management lags behind the region's growth, with few SMEs implementing risk practices. In recent years, however, larger companies have been investing in the function, with some building ERM framework into the business. Risk management is gaining momentum, but efforts to promote its benefits must continue, says Gregory Irgin, director and group risk, legal and reinsurance at Qatar-based UrbaCon Trading and Contracting – a company responsible for the building several hospitality, retail, and entertainment premises in the Qatar.

"The real concern is whether key risk assessments and mitigation techniques will be implemented, monitored and managed successfully throughout the [country's] organisations and not left exposed owing to varying factors such as lack of leadership and support at the top and application and understanding of the technique at the bottom."

Insurers should innovate to compete in the most challenging underwriting conditions in 15 years

Recent collapse in oil prices, record capacity levels, relatively benign loss records and reduced risk management budgets have contributed to some of the most competitive energy insurance underwriting conditions

Energy insurers must innovate more and offer buyers a wider range of new products and services in the face of mounting competitive pressure, record capacity levels and reduced premium income, according to Willis.

A combination of the recent collapse in oil prices, record capacity levels, relatively benign loss records and reduced risk management budgets have contributed to some of the most competitive energy insurance underwriting conditions for 15 years, according to the broker's *Natural Resources Market Review* (previously *Willis Energy Market Review*), published on 9 April.

With reference to the significant leap in underwriting capacity, the report states that the largest increases were in the upstream (where capacity increased to €6.43bn), downstream (to €5.12bn) and international onshore liability (to €2.24bn) markets.

From an underwriting perspective, the report says the collapse in oil prices and its consequences on exploration and production activity are likely to detrimentally affect premium income levels.

Faced with these competitive pressures, Willis urged insurers to provide wider coverage for clients. The broker said insurers that fail to do so face an uncertain future.

Willis Natural Resources Industry head Alistair Rivers said: "In this underwriting climate, we believe that the time has come for more innovation, for new products and services to be developed to attract the interest of the buyer. At Willis, we believe that it is the London market, as the traditional innovator of natural resources industry risk transfer products that should lead the way."

He added: "A recent pledge by the UK government to work with the (re)insurance industry to attract insurance-linked securities business into the UK – a move that the London market would welcome – could help inject some fresh thinking into the market."

Flexible coverage

The broker highlighted a number of areas where underwriters could offer more flexible coverage or new insurance products, including:

- repackaging of onshore terrorism cover into property programmes. Terrorism is still excluded from most property policies, despite the fact that it used to be included as a matter of course only a few years ago. Risk managers would clearly benefit from having terrorism cover rolled back into property programmes;
- deletion of cyber exclusions. "We still see very little sign of the energy markets being willing to delete the cyber exclusion (CL386) in their policy wordings despite a gradual softening of reinsurance market resistance to this exposure";
- increased sub limits for contingent business interruption (CBI) or supply chain risks. The sub limits for CBI or supply chain risks are still too low for most risk managers in the natural resource sector. Although there have been isolated incidents of higher sub limits being granted recently, buyers must usually shop around different markets to access the cover they need;
- a seamless product for onshore projects covering handover from construction to operating phases. The report said: "Over the years, we have seen disputes arise on a number of occasions when loss or damage has occurred at or around the time of the handover of a project, with both construction and operating markets denying liability – much to the consternation of the client. It seems to be logical for carriers to produce a seamless product that might avoid such coverage ambiguities in the future"; and
- increased flexibility of aggregate limits and retentions for natural catastrophe risks. Buyer appetite for natural catastrophe risk transfer products remains as robust as ever (especially for earthquake risks), the report claims, adding: "we are confident that if more capacity is made available in this area, insurers will benefit from a significant increase in their revenue streams.

Marsh commits to improving risk management and governance with new appointment

Marsh has appointed Sally Williams (pictured) to succeed retiring John Nicholson on its board as director of risk and governance.

Williams will lead the development and adoption of Marsh's risk management and governance policies across UK and Ireland activities.

She joins Marsh from National Australia Bank (NAB) Group, where she was head of risk, London branch, and a board member of NAB Europe Ltd. Williams was NAB's lead relationship manager for the branch with the Prudential Regulatory Authority and the Financial Conduct Authority. Before joining NAB in 2005, she was group director of risk at Aviva.

Commenting on Williams's appointment, Marsh chief executive UK & Ireland Mark Weil said: "At Marsh, we believe that embedding robust risk management practices and ensuring that colleagues perform to the highest ethical and professional standards are absolutely fundamental in a well-managed company.

"The strengthening of our UK board with the appointment of Sally, who is a compliance professional of the highest calibre, is testament to our continued commitment to adhering to these standards."

Williams added: "The global financial services industry remains under regulatory scrutiny following the financial crisis and firms are faced with meeting the challenges presented by this changing regulatory landscape. I look forward to building on the firm's best practices and ensuring that Marsh continues to be regarded as an integrity benchmark for the industry."

(Continued from page 1)

COR of 83.9% may have been up slightly on 2013's 83%, but it was still almost three percentage points clear of the rest of the pack. Hiscox's return on equity of 17.1% was enough to knock Beazley, which had the best ROE last year, off the top spot.

- Although it reported the best COR, Hiscox was also the most heavily reliant on prior-year reserve releases. Releases shaved 13.1 points from the company's COR – far more than for any of the other listed Lloyd's players. If reserve releases are stripped out, the picture looks different. Hiscox drops down to fourth place, and Catlin is the best performer by current year COR.
- Novae was the most improved Lloyd's insurer from an overall profitability perspective. Profit before tax jumped by 46.3% to £62.6m. The company's COR was also the least affected by the year's events. All six listed Lloyd's insurers suffered COR deterioration, but Novae's 0.7 percentage point blip was the smallest. The company also enjoyed a 29% increase in investment income.
- Overall, investment income was mixed at Lloyd's insurers given the different make-ups of their investment portfolios and which countries their invested assets are most exposed to. Beazley fared best over the year. Its investment income almost doubled to $83m (€78.5m) from $43.3m after falls in UK and US bond yields during the year boosted the value of Beazley's portfolio. The company also said its portfolio of hedge fund investments had an "excellent year".
- The fastest growing Lloyd's insurer by a margin was Catlin. Its gross written premium surged by 412.4%, outstripping even Brit's 9.8% growth. Expansion in difficult market conditions is normally a warning sign, but Catlin's underwriting performance has been consistently good, so it is unlikely that the company is chasing market share at the expense of profitability. Also, some of the growth came from foreign exchange movements.

Lloyd's insurers may have had a more challenging year in 2014, but they have come out well overall. Five of the six reported CORs below 90% and Novae, the only one not to do so, had a COR of just 91%, which would be the envy of many larger insurers.

The picture will change considerably next year, when the number of listed Lloyd's insurers will reduce to four following the acquisitions of Brit by Fairfax and Catlin by XL. It will be interesting to see how the remaining four perform.

Willis buys Mexico's leading broker Carsa Consultores

As part of the acquisition, the broker expects to migrate to a single Willis brand in Mexico over time

Willis has acquired Mexican broker Carsa Consultores as part of its regional growth strategy, in which Mexico forms a key market. The firm did not disclose the full details of the acquisition.

The move will support Willis Mexico's existing business, while also expanding its overall footprint, especially in the north-west region of Mexico, creating a new combined network of nine offices nationally.

The broker says that the Carsa team of 84 associates will bring new expertise to Willis Mexico in a number of areas, including actuarial services and affinity programmes.

Willis expects to migrate to a single Willis brand in Mexico over time. In Guadalajara, where Carsa is currently headquartered, Willis associates will relocate to Carsa's offices. In Mexico City, the existing Willis office will become the new home for Carsa's actuarial and government specialties teams.

Willis Latin America regional chief executive Luis Maurette said: "Mexico is a key part of our regional growth strategy and our investment there reflects our confidence in the country's potential. Carsa has a strong reputation in the Mexican market, with a culture and professional approach that aligns closely with Willis's own values-based approach to client service. It is a pleasure to welcome their talented team to Willis."

Willis Mexico chief executive Hilaire Damiron said: "Carsa has an extraordinary track record of offering a high-quality, custom-made service that we will merge into our value proposition and deliver to clients. We believe this acquisition represents an opportunity for significant future growth in Mexico as we deliver the full range of Willis's capabilities and risk expertise to our clients."

Carsa chief executive José Ruiz Torres added: "The Mexican market recognises the global reach of Willis and its outstanding achievements in the Mexican market in recent years. It is great news for our team and our clients. Carsa is proud of its heritage and success and is looking forward to growing further with Willis."

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