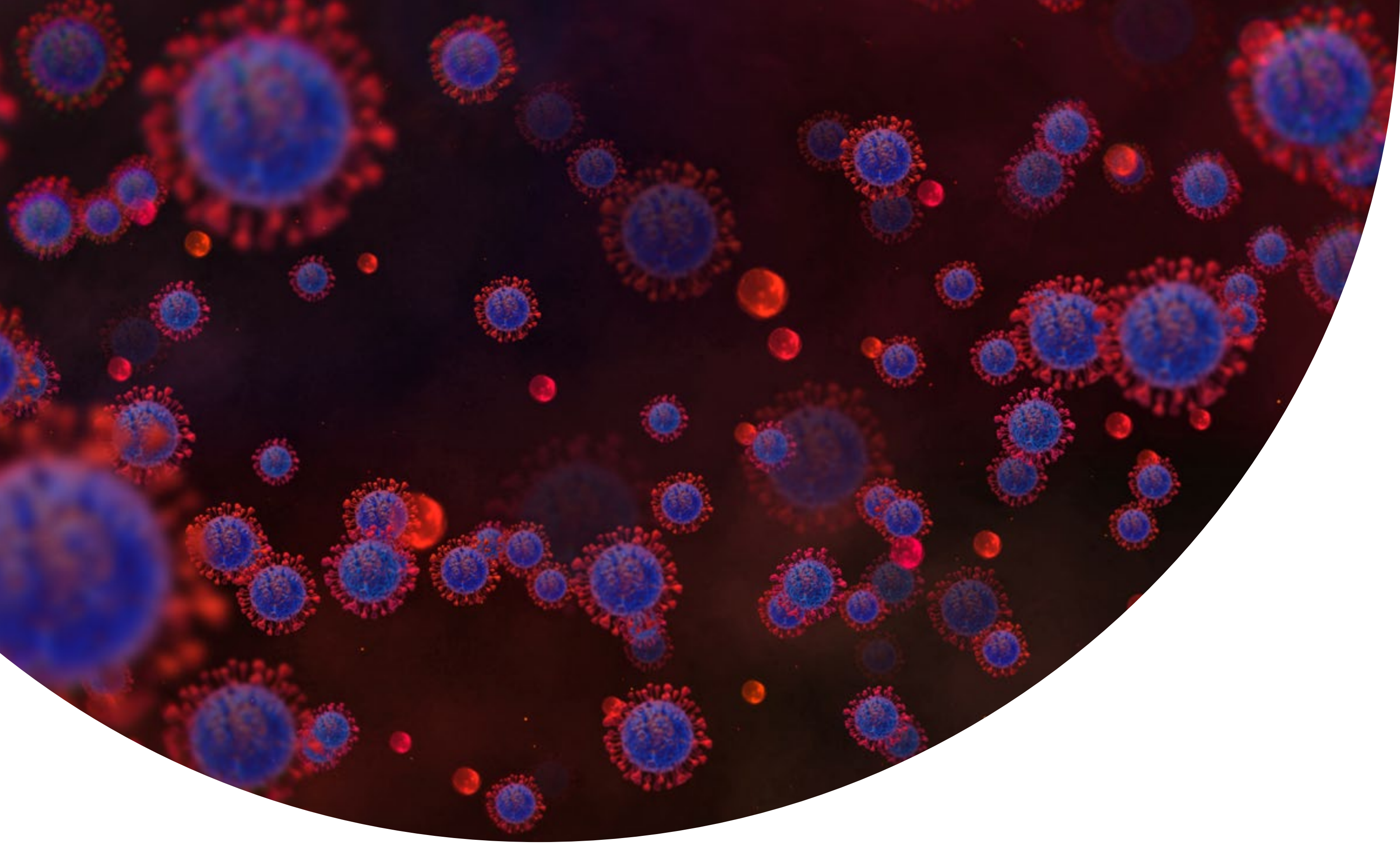
Mactavish

RISKY BUSINESS

ATTITUDES TO PANDEMIC RISKS IN THE BOARDROOM



INTRODUCTION

The insurance industry has faced considerable criticism for its performance during the Covid-19 pandemic, including from Mactavish. Even now, the owners and managers of businesses across the country are seeking to settle disputed claims through pressure groups and group actions. The FCA also launched a high-profile test case in the High Court to test policy wordings on behalf of policyholders. The judgement was handed down in September and, despite early reports of a victory for policyholders, there is growing awareness that most businesses will still face a long battle to get their claims paid.

Mactavish, along with other commentators, believes that many firms in the industry have played a less than supportive role in helping their customers through this crisis, but we also understand that in many cases policyholders did not actively seek cover for losses associated with pandemics. In this paper, we set out to explore the extent to which large corporate policyholders were aware of and prepared for events such as the Covid-19 outbreak, and to shine a spotlight on what we consider to be a fundamental failure of risk analysis and management.

METHODOLOGY

The data for this analysis was gathered from the annual reports of the constituents of the FTSE 100 as of 23rd March 2020, the date on which the UK government announced lockdown measures.[1] 97 of these FTSE 100 companies published annual reports in the 2019 calendar year.

As most reports are published in the first half of the calendar year, 88 of these companies have since published subsequent annual reports in 2020. The reports published in 2019 and the reports published in 2020 are considered separately.

For context, we remind the reader that lockdown in Wuhan, China began on 23rd January 2020 and lockdown in Lombardy, Italy commenced on 9th March 2020. In between those two dates, on 30th January 2020, the World Health Organisation declared Covid-19 a 'Public Health Emergency of International Concern'.[2]

UNDERSTANDING HOW RISKS ARE PRESENTED

Risk registers are an important tool for the management and oversight of risks at executive, c-suite and board levels within listed companies and their subsidiary divisions. The principal risks listed in registers - risks that, should they be realised, would have a material impact on the financial and operational health of the organisation - are summarised in the company's annual report, generally as Principal Risks and Uncertainties.

Topics included under Principal Risks and Uncertainties can be very broad, such as 'political risk', 'competition', 'catastrophe', 'reputation' and 'environment'. Crucially, the steps taken to manage or mitigate these risks are also recorded. For example, one firm highlights water availability as a key risk and then summarises their mitigation strategy:

Various projects have been implemented at operations most exposed to this risk, focused on: water efficiency; water security; water treatment; and discharge management; as well as alternative supplies. New technologies are being developed that will reduce water demand.[3]

MACTAVISH'S KEY FINDINGS

In 2019, only 13 FTSE 100 companies mentioned pandemics or epidemics as potential risks in their annual reports

Proximity bias conditions us to focus on risks that are topical rather than those which may have an immediate and material impact

In 2020, 82 of the 88 FTSE 100 companies which have published their annual reports so far have mentioned pandemics, epidemics or Covid-19 as potential risks

Annual reports – and by extension, company boards – are not accurately identifying risks, and therefore, failing to mitigate their likely impact

Perceptions of risk tend to emphasise the repetition of prior crises over future likelihoods

Institutional investors' increasing emphasis on sustainability, resilience and stewardship may be too narrowly focused

Whilst the Covid-19 pandemic is causing unprecedented responses from government agencies across the world, the risks and likelihood of pandemics (or widespread epidemics) are not unknown. Ebola, SARS, MERS, swine flu and bird flu have all caused significant economic disruption and fatalities within the last twenty years. In fact, influenza pandemics occur every 10-50 years and the World Health Organisation recorded an average of 187 epidemic events every year between 2011 and 2017.[4]

In short, the possibility of an epidemic impacting on a business is far from remote. Thus, the fact that only 13 FTSE 100 companies were informing their investors of their awareness of the risks posed by pandemics in 2019 could be deemed a mis-judgement, even without the benefit of hindsight.

HOW DID COMPANIES DEFINE PANDEMIC RISK IN 2019?

Only 13 FTSE 100 companies cited pandemics or epidemics as potential risks in their annual reports. The companies that did list pandemics or contagious diseases as a significant risk did not assess them individually but typically listed pandemics as an example of a type of risk e.g. a potential event 'causing significant network disruption' or a 'liquidity risk'.[5]

The most comprehensive reports provided summary details of their epidemic risk mitigation efforts, though they sometimes lacked specificity. We include one of the fuller examples here to give the reader a sense of how such issues are delineated and discussed:

The safety and security of our customers, employees and suppliers is of utmost importance. Failure to prevent or respond to a major safety or security incident could adversely impact our operations and financial performance. We invest in site level training to help identify hostile reconnaissance activities and to ensure we have an appropriate response should such events take place. The executive team also hold regular crisis management exercises to ensure we are prepared for such events.[6]

HOW ARE COMPANIES DEFINING THE RISK IN 2020?

In 2020, 82 of the 88 FTSE 100 companies which had published their annual reports as of 13th August have mentioned pandemics, epidemics or Covid-19 as potential risks.

The six companies that did not mention Covid-19 published annual reports in February or March 2020. The analysis of risk varies widely across different reports. Many companies seem to have underestimated the impact of the virus well into 2020. For example, one company did not mention Covid-19 at all under Principal Risks and Uncertainties (published 23rd March 2020) but put out an update on 3rd April 2020 stating that 'the COVID-19 pandemic will impact our previous guidance for 2020'.

Other companies exclusively discussed the Covid-19 outbreak in relation to potential disruption in the China and Asia-Pacific region. Indeed, one cruise ship operator's 2019 Annual Report, published on 26th February 2020, analysed in detail the expected change to share prices if Chinese travel restrictions due to Covid-19 remained throughout February. However, the report does not mention potential impacts outside of China or even on cruise ships, despite the report being published three weeks after the Diamond Princess was quarantined.[7] It is unclear to us why their scope is limited in this way, but we might speculate that their internal analysis was influenced by the SARS outbreak of 2002-3, which was largely a regional occurrence.[8]

Of the reports that do not localise the fall-out of the crisis to a national or regional level, they typically do so only to say 'there may also be impacts in other countries although the extent is not yet clear'.[9] This caginess is also apparent in later statements, with risk outlook predictions being accompanied by disclaimers such as this:

Certain statements made in this announcement are forward-looking statements. Such statements are based on current expectations and are subject to a number of risks and uncertainties that could cause actual results to differ materially from any expected future results in forward-looking statements.[10]

These disclaimers may be an entirely understandable attempt to protect the company from future accusations of misleading communications but the upshot of this risk-averse risk disclosure is that potential investors have very limited insight into whether or not companies have extensive and efficient business continuity plans in the event of a global pandemic, or widespread epidemic.

Some companies did provide more comprehensive analysis of the risks posed by Covid-19. For example, here is the description of the mitigation plan of one insurance company:

We have taken significant steps to reduce the sensitivity of our balance sheet to market/credit risks and have contingency plans which are designed to reduce as far as possible the impact on operational service arising from mass staff absenteeism, travel restrictions and supply chain disruption caused by a pandemic. We reinsure much of the mortality risk arising from our Life Protection business and hold capital to cover the risk of a 1-in-200 year pandemic event. We model extreme pandemic scenarios such as a repeat of the 1918 Spanish Influenza pandemic. In the Group and commercial insurance business we limit our potential exposure through our policy wordings. As an investment manager and investor, we engage with companies to ensure the responsible use of antibiotics to reduce the risk that antimicrobial resistance negate the efficacy of medical treatment.[11]

It would seem that the company in question invests in modelling pandemic risks and takes three clear actions as a result. Firstly, it transfers risk in its personal lines business through reinsurance, secondly, it seeks to ensure that its policy wordings limit its exposure, and thirdly, it makes investment decisions based (in part) on healthcare related sustainability goals. This could be said to imply a great deal of foresight and cross-functional planning and must require the deployment of not inconsiderable resources.

However, while this may be encouraging to shareholders and other stakeholders, it is important to note that pandemic (or similar) risks were not mentioned at all in the company's 2018 Principal Risks summary. It could simply be the case that the company felt that there were other much more important risks that needed to be recorded in the 2018 report (one example of risks that did make the cut that year was 'Outsourcing') and that there simply wasn't room to include pandemics, or it could be that there is some form of disconnect between how the risk is perceived in some parts of the business and how it is reported at board level. It would certainly be interesting to know if there are other macro-risk events that the company models and mitigates against, but that are not mentioned in its report – and if so, what those perils are. While it will never be possible to include every risk, it would be unfortunate if summaries of principal risks simply became a description of how companies responded to prior events as this would be a fundamental reversal of their original purpose.

Finally, the comment on investment strategy and anti-microbial resistance is an interesting one and an example of the deep relationship between broader corporate social responsibility aims and risk management reporting. While it is a praiseworthy approach, investors might also wish to know how their company's investment managers track and mitigate pandemic risks to their investment returns and whether they, as institutional investors, explore the extent of pandemic risk governance in their holdings. Afterall, one could postulate that these are more immediate and manageable concerns to the company's shareholders than the global problem of the overuse of antibiotics.

HERD IMMUNITY

The limited utility of descriptions of risk in annual reports becomes more apparent the closer you look.

Different companies, operating across a diverse range of sectors and geographies consistently describe precisely the same risks. Nearly all companies reviewed included concerns about 'macro-economic shifts' with limited description of what those shifts might look like, and what their likely impact might be.

Additionally, discussion of employee retainment/recruitment was identified by most companies as a key risk to their business, typically under the heading 'people' or 'talent'. Whilst these risks may be real to each company, there is an element of complacency – if the same risks are identified at each company, no company can be singled out as negligent. Conversely, failure to identify a key risk, such as a 'pandemic', is less likely to attract investor and media criticism if the majority of other companies also stay silent on the topic.

Moreover, much of the analysis of the risks is copied verbatim from previous years' reports. One company, which published their report in February 2020, made only one change in respect of the potential risks posed by epidemics. In 2019, the company published a list of factors beyond their control 'including escalation of terrorism or global conflicts, natural disasters and similar calamities'.[12] In 2020, the list was adjusted: 'including escalation of terrorism or global conflicts, natural disasters, epidemic outbreaks and similar events'.[13]

While FTSE 100 constituents may justly claim to be amongst the best governed and resourced in the world, the reality is that risk management at board level could still be significantly improved. Indeed, and perhaps understandably, risks tend to focus more on prior events than evolving issues and future possibilities. This is an inherently flawed approach as good risk management should be a question of anticipation and preparedness.

THE VIEW FROM THE TOP

These deficiencies in the processes behind identifying potential risks are not specific to the UK or to commercial organisations. Since 2006, the World Economic Forum (WEF), in partnership with major insurers and brokers, has published an annual global risk report, in which nearly one thousand decision makers from the public sector, the private sector, academia, and civil society assess the severity and likelihood of different risks.

These reports provide a valuable insight into the development of risk perception at a global level, and how this perception has evolved over time.

Our analysis of these documents supports two assertions. Firstly, risk identification is an inherently backward-looking process, shaped by recent events or the trending issues of the day. Secondly, there has been insufficient consideration of the increased risk exposure that is intrinsic to globalised economic models.

The first report, published in 2006, featured an in-depth analysis of a potential outbreak of bird flu (H5N1), going so far as to reference the transformative impact of the Black Death on society.[14] This was undoubtedly driven by contemporaneous concerns: avian flu was considered a significant health threat due to its spread through poultry and wild birds in Asia in 2003, and there were mounting concerns over the following years that a mutation could have deadly consequences for a significant proportion of the human population.[15]

The second report, published a year later, explored the scenario of a devastating generic pandemic event.[16] The scenario highlights the interconnectedness of different areas of risk: for example, how a pandemic's economic consequences can result in the failure of investment firms due to a sudden asset devaluation, or its political consequences in that its spread through both failed and failing states can change political structures, and instigate a public backlash against globalisation.

As time progressed, this corporate and societal memory of the likelihood of a pandemic faded, and was replaced with what were deemed to be more pressing concerns. These were financial risks, following the Financial Crisis of 2007-8, and by the turn of the decade, environmental risks, as climate change discourse and ecological concerns came to dominate the perception of potential risks, in tandem with evolving public consciousness and media focus.

This heightened awareness of environmental risk stands in marked contrast to the diminishing perception of pandemic risk, which, over the last decade, has consistently been viewed as below average in likelihood, and of moderate to high severity, depending on the year. Indeed, in the 2019 report water crises were deemed to be both more likely and more impactful than the spread of infectious diseases.[17] Whilst businesses have been focused on maximising the economic potential of globalisation, it is our view they have not sufficiently considered how global operations impact their risk profile. This is particularly damaging with regard to pandemics, where the potential for spread and further disruption grows exponentially in a fully integrated global economy. This is not simply a question of hindsight. In fact, Mactavish flagged the increasing interconnectedness and concentration of risk in a 2010 report that explored the fall-out from the last financial crisis.

Indeed, some influential voices were discussing these topics in 2019, they simply weren't heeded. In January 2019 the WEF brought renewed attention to these deficiencies in a paper published in partnership with the Harvard Global Health Institute. Outbreak Readiness and Business Impact: Protecting Lives and Livelihoods across the Global Economy details the role businesses must play in managing the threat and impact of infectious diseases on society. The paper, lead authored by the former Chief Executive Officer of Standard Chartered, Peter Sands, identifies similar issues in the way businesses conceive of risk. These include businesses employing a reactive approach when assessing and mitigating the risk of infectious disease outbreaks, and underestimating the likelihood and economic severity of a pandemic event - in part due to the globalisation of the economy. It also notes that a great number of businesses were relying upon insurances that would not provide cover in response to an outbreak, presciently foreshadowing insurers' widespread rejection of claims relating to the Covid-19 pandemic.[18]

Our findings betray either a reluctance or an inability to proactively approach risk identification or mitigation on an empirical basis. Clearly, businesses have failed to respond to Sands' call to arms to make 2019 'the year we step up to the threat epidemics pose to our companies and communities'.[19] Considerable costs are now being borne as a result of this failure.

ROOM FOR IMPROVEMENT

Our contention is that the issues raised in this report are the result of collective failures to understand and govern risk in both the corporate and social spheres.

Regulatory bodies and independent inquiries have sought to change this state of affairs, encouraging directors to take a proactive approach to their risk management. The 2007 WEF report suggests improving information flow between directors and those who deal with a given risk on a day-to-day basis. The Brydon Report, published last year, made several recommendations on the internal processes behind the reporting of risk as part of its assessment on the auditing of businesses. Among them is the implementation of 'a simple mechanism to enable the workforce to raise issues around risks and assurance'.[20]

Far from there being more cooperation between decision makers and subject matter experts, it is clear that businesses often lack formalised internal methods through which they can gain a better 'bottom-up' understanding of their risks. It is possible that the lack of formalised processes for information flow are precisely why so many companies take a 'top-down' view in their reports; sticking to macro-themes and discussing them in generic terms.

The Brydon Report also argues for the directors' depiction of risks to be published prior to the audit committee meeting, providing an opportunity for shareholders to alter the scope of the audit based on their views of the identified risks.[21] Whilst the facilitation of discussion between shareholders and directors is a noble goal, it will not necessarily incentivise directors to take risk more seriously. In fact, it is important to entertain the notion that boards may at present be incentivised to conceive of risk in a way which is detrimental to their business: if a proactive approach to identifying risk raises concerns about an aspect of a business' viability, investors may view that business as a less attractive proposition.

A thoroughgoing approach to risk management requires institutional and private investors to reward companies for placing risk at the core of the business strategy – and to actively support executives for their effective management of the downside. In light of the recommendations made in the Outbreak Readiness and Business Impact report, this approach should incorporate an organised, concerted effort from businesses to work with public bodies to strengthen society's preparedness for future outbreaks. This should fit neatly with the emphasis that many institutional investors are now placing on 'stewardship', 'resilience' and 'sustainability', particularly if the private sector realises its ability to limit the societal impact of disease outbreaks through its collaboration with civil society. However, we would suggest (and will explore in a future report) that the same problems that afflict FTSE 100 annual reports and the WEF survey findings will also influence the outlook of institutional investors, and that the concept of stewardship is too limited.

THE ROLE OF ADVISORS AND RISK PROFESSIONALS

Many of the companies on our list routinely hire external advisors to help them review their operations and set strategy, and nearly all will use a sophisticated multinational insurance broker. Brokers have spent much of the last two decades repositioning themselves as strategic consultants on risk in the broadest sense (both insurable and uninsurable) rather than as agents in a purely financial transaction.

The crucial questions here are: did brokers discuss pandemic risk with their clients, and if so, what did they advise? It may be the case that brokers attempted to educate their clients on these risks and found an unreceptive audience, or it may be that they simply didn't try. Either way their positioning strategy will now be tested and some policyholder organisations may come to question whether their brokers are truly providing the advice that they use to justify their fees.

However, even when a given company's risk advisors did provide guidance around pandemic risk, that guidance has clearly not survived its journey to senior leadership and into the annual report. One of the key questions that should be posed in light of these survey findings is how risk management is plugged into the corporate matrix.

Often, in our day to day work Mactavish sees a split between risk and insurance functions. While risk functions can be highly amorphous, insurance departments are increasingly administrative in their approach and focus. This in part reflects a downsizing trend that has been taking place over the last few years and that has left smaller departments with less time for strategic investigation. As a result, views of risk (and the inputs of professional advisers) can be fractured throughout an organisation. It is our belief that risk should be aligned around a single strategic vision, have clear inputs at board level and should be resourced in line with its importance.

CONCLUSIONS

There are a number of profound factors behind our findings and it is outside the scope of this report to explore them in full. However, we would suggest several important themes that require greater scrutiny:

- Perceptions of risk tend to emphasise the repetition of prior crises over future likelihoods
- Proximity bias conditions us to focus on risks that are topical rather than those which may have an immediate and material impact
- Principal Risks and Uncertainties sections of annual reports – and by extension, company boards – are not accurately identifying risks and thereby failing to mitigate their likely impact
- Institutional investors' increasing focus on sustainability, resilience and stewardship may be too narrowly focused

These issues may not in themselves wholly explain businesses' poor understanding of the likelihood or severity of the Covid-19 pandemic, but they are symptomatic of an institutional failure to approach risk in a truly professionalised and scientific manner.

As a starting point on that journey, we would recommend that any company looking to reappraise its approach to risk management should consider the following questions:

- How is risk defined in your organisation – is it a top-down process, bottom-up, or both?
- What empirical basis do you use to determine the materiality and likelihood of the risks you list in your report?
- Where does risk sit in your organisation? Is it centralised or is information isolated throughout a variety of silos?
- Are you appropriately resourcing risk functions in line with the importance of their role in promoting your organisation's sustainability?
- How does information flow from those risk functions through to the c-suite and board room?
- Are you accessing the right professional advice?

Put simply, without an overhaul in the corporate attitude to risk and an elevation of its role in business strategy, businesses will continue to suffer at the hands of the future, and what it holds in store for them.

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