Insurance as a risk management tool in supply chain management

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With growing trade volumes, vessel sizes and government legislation, supply chain managers face increasing risks and liabilities in their industry. Insurance is an important risk management tool, but one that has yet to be fully utilised in Asia. For an effective insurance purchasing strategy, supply chain managers should be aware of the changing risk exposures, the breadth of cover available and the long-term benefits that insurance provides by protecting profitability.

Supply chain management, by the diverse nature of the business, is exposed to constantly changing and, in most cases, increasing risks and liabilities. Depending upon the geographical spread of the business, those risks are likely to range from political risks to business interruption and the more specific threats of piracy or theft.

The insurance market has always been keen to respond to these varying and changing risks, not only with more sophisticated products, but also greater expertise and knowledge. In the increasingly competitive environment that the trade insurance market has become, differentiation is a key driver for insurance solutions that can dovetail with existing covers and/or risk management devices already in place.

What remains constant and critical is for supply chain managers to be able to identify the risks and react to them positively. That requires a high degree of both understanding of the exposures as well as the resources required to implement the required risk management procedures. As part of that process, the involvement of the insurance market and its knowledge base can be invaluable not only to determine the possible solutions available, but as a cost-efficient external resource.

Changing Exposures

Supply chain managers have become more risk averse in recent times due in part to the falling cost of insurance, but also due to an increase in the understanding of risk and the constantly evolving legislative environment.

A gradual, but steady, improvement in the understanding of the liabilities of service providers and the courts' willingness to find new areas of liability or affirm previously held views has focused more attention on the involvement of insurance as a risk management tool. But, is there sufficient focus or understanding on this area?

There can be no doubt that it is difficult to maintain adequate knowledge of new risks and the evolution of existing risks. As the size and demands of the industry continue to develop, both in Asia and globally, so too does the list of potential losses that might arise.

One such example is the risk of accumulation brought about by the increased volume of trade. Accumulation arises where a series of shipments are in the same place at the same time, whether that be a warehouse, vessel or other conveyance.

For supply chain managers, this is a difficult exposure to monitor on an ongoing basis, yet can give rise to a significant underlying exposure in the event of just one single incident. Whereas this used to be predominantly the preserve of static risk insurers, due to the progress of, specifically, the shipping sector of the industry, it now has a broader effect across the supply chain.

As the size of vessels increase to meet the cost efficiency demands of global trade, so does the possibility of an accumulation of risk on those very vessels. The capacity of the 'Emma Maersk' and her 11,000 twenty-foot equivalent units (TEUs) is a forebearer of things to come. It is perhaps noteworthy to compare her with the recent losses incurred by cargo interests alone on the 'Hyundai Fortune' of potentially USD75m and the 'MSC Napoli' in the region of

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USD66m, both of which were unavoidable losses from the point of view of the supply chain managers unlucky enough to be involved.

But the issues of accumulation do not stop once the cargo is discharged from the overseas vessel. As trade volumes continue to rise, specifically to and from China, so consolidation and deconsolidation points become more congested and/or capacity increases.

If we add to the equation the risks of port congestion either through natural or man-made causes such as the recent strike in the US Pacific Northwest, those exposures can result from a number of causes making them difficult to predict.

Being able to calculate these exposures, with a degree of accuracy, requires a high level of risk management capability, which may not be viable within certain areas of the supply chain. It is, of course, difficult enough to manage risk successfully where all the information is available; where that information is not available, it becomes a considerable challenge.

The result of this is that there is only a limited level of protection for even the most sophisticated risk manager. Offsetting risk in the form of insurance should, therefore, play a pivotal role in the overall risk management strategy.

Insurance in Asia

To this end, the insurance market in Asia continues to grow as more and more insurers enter the arena, either as additional offices to bases in London or the US, or Asian headquartered and capitalised. The London and Lloyd's market is and will remain the epicentre for the complex risks that the supply chain management industry requires, but there is significant shift in knowledge as insurers place expertise on the doorstep of the risks they write.

Indeed, Lloyd's itself now has hubs in Singapore and Shanghai, allowing Lloyd's markets to utilise their capital based in London to set up at minimal additional cost in Asia. While the spread of insurance placements is often global, insurers are seeing a real benefit to a presence geographically alongside the risks they are writing.

This provides insurance buyers in the supply chain sector with the services and knowledge base that, all too often, remains under-utilised. While the insurance market is keen to provide this support, generally speaking it has not been considered a traditional option for the supply chain industry. This, though, needs to change if the supply chain sector is to benefit from all the available tools, including insurance, and meet the risk management challenges that Asia will continue to present.

Regulatory and Legislative Environments

The concern, however, has to be that Asia's trade volume is increasing at a pace considerably in excess of other markets, while regulation and legislation in many of the region's countries remain in their infancy. However, this has not dampened the expectation of clients of the supply chain industry in the region, who demand the highest levels of service.

Given the current pace of growth in countries such as China and India and the relative lack of focus on ensuring that the regulatory environment keeps pace with that growth, the protection of that exposure becomes ever more difficult. The changes in regulatory practice will take some time to gain traction and is, perhaps in part, contrary to the desire of those who wish to reap the benefits of the regional growth in trade.

This is likely to continue to have a negative effect on the ability of the supply chain industry to manage their exposures in the developing economies for some time to come.

However, the news is not all bad as insurers have an equal desire to be involved in trade to those regions and, to do that, they want and need to understand the risks involved. This is, in part, the reason for the increase in focused expertise being brought in or propagated in the region by insurers.

To properly understand the environment, they want to be accessible to their assureds and to the risks they face. Whether this proximity will give rise to a consequent increase of insurers' involvement in the risk management strategies of the supply chain industry remains to be seen.

At present, there remains a relatively low penetration of insurance purchasing in Asia but a change is unlikely to be driven by the regulatory bodies, even with the full support of the supply chain management sector.

Ultimately, an effective risk management strategy needs to be seen as an asset to any company before the costs involved will be accepted. That will require a fundamental change in thinking in some sectors regardless of the regulatory environment.

Premium versus Risk Management

An effective risk management strategy that is able to react to new risks and control existing ones can expect to have a long-term beneficial effect on the insurance costs.

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When this is compared to the falling cost of insurance even as trade levels continue to climb to some of the highest levels ever achieved, the actual costs of risk management can be eroded, in some cases, to a large degree.

This also gives rise to more specific options within the insurance programmes to create greater premium efficiencies as the risk management strategy provides more predictable results. Increases in self-retention of risk, for example, can mean a beneficial reduction in premium.

Other, significantly more sophisticated, products start to be made available as the risk management strategy becomes a key aspect of the profile of the insurance buyer. The equation between a reduction in claims experience and a reduction in premium becomes weighted in favour of the insurance buyer with a history of successful risk management.

The Impact of Unused Risk Management Tools on the Balance Sheet

Experience shows that, even where a strong risk management structure is in place the understanding and knowledge may not be filtering across to operational levels. This will reduce the ability of companies to extract the most from their risk management strategy and, ultimately, will have a negative effect on profitability. Put in insurance terms, opportunities to recover losses from insurers are simply not identified on an all too often basis. This can be either due to a lack of knowledge of the breadth of cover available or, perhaps, a perception that making insurance claims will increase premiums in the future.

With an otherwise effective risk management strategy in place, it becomes even more important. The reimbursements not only provide financial recompense, but provide the insurer with valuable knowledge of the operational or commercial risks that are occurring. More importantly, it tests the insurance to ensure that it responds as it should do when it is required. The cost benefit to the assured is clear, but the long-term risk management benefits of stressing the insurance purchasing strategy are perhaps not as obvious, until a significant loss arises.

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