

Insuring intangible assets: Is the insurance industry keeping pace with its customers' changing requirements?



With developments in technology and the increasing value of intangible assets, does the insurance industry need to reassess the role it plays in protecting its customers against significant losses flowing from damage to these assets?

Tangible and Intangible Assets

A Harvard Business Review article from May 1981 described a more useful way of distinguishing goods and services as being to speak of tangible and intangible products. This concept is therefore relatively new to the 300 year old insurance market.

The tangible assets of a company are widely understood and easy to identify; they are the buildings, machinery and equipment – anything that you can touch and feel. The intangible assets are the parts of a company which are not physical in nature but are resources which are controlled by the company. These could include intellectual property, supply chain resilience, contacts database, business methodology, reputation and goodwill or the network through which the company conducts its business.

The significant development in technology over the past 40 years has seen the perceived value of intangible assets soar. From Amazon to Uber, the meteoric rise of technology driven companies, whose value is rooted predominantly in their intangible assets, has disrupted, and in some cases completely wiped out, longstanding businesses and business models. In less than a generation, technology has changed everything from the way we buy groceries to how we interact socially. Around the time of the Harvard article, intangible assets represented only a small percentage of a company's value. As at 2016, Forbes estimated that figure to be around 80%.

Take Amazon as an example: most of its value is not in its warehouses or its stock (though these are, of course, significant). It is in its reliable reputation, that its efficient network provides customers instant access to its website, to search its extensive supply network, for almost any conceivable product, which will be sourced at a competitive price and delivered from one of its warehouses to the customer in as little as an hour. The customer's belief that each step in this process will work reliably is what makes Amazon so successful.

These often incredibly valuable intangible assets cannot be destroyed in a fire or a hurricane. However, they can be damaged even in momentary carelessness. A 15 minute outage in BA's power supply, possibly caused by an engineer's human error, led to 75,000 customers being stranded and an estimated £150m damages bill. It is therefore increasingly important to a business that these assets are sufficiently protected in the event something does go wrong.

Insuring Intangible Assets

Insurance has developed by assessing the risk of a peril to a physical asset and underwriting that risk based on an analysis of data acquired from similar losses. Applying the same method to intangible assets, which are more difficult to quantify and in relation to which the effects of losses are less predictable, is more of a challenge. The industry already successfully covers some intangible assets, such as loss of supply chain, by means of business interruption insurance, though this is usually still linked to a physical loss. Such losses are easier to quantify to the extent that a comparison can be made against previous annual turnover and past performance.

One of the major concerns for risk managers is whether their businesses will be sufficiently covered in the event that significant damage is caused to one of their valuable intangible assets.

The area of cyber risks is a good illustration of this problem.

In the 1980s, when the internet was a closed-off community mostly used by academics, cyber threats were relatively unknown. By the late 2000s, the internet was an important part of every day life. Most businesses now had some form of online presence and relied on the internet and internet-connected systems to run their company. However, the internet is vulnerable. If a virus breaks through your fire wall, or accesses your system through a less secure company in your supply chain, your entire network is exposed. The rise of smart phones over the past 10 years provides a further unprecedented level of accessibility to a company's most valuable assets. Many employees now access their work email through their personal smart phone, which is unlikely to have the same level of security as their company's main network.

Any company of any size in any sector is at risk. A recent poll by Barclaycard showed that SMEs are more concerned about a cyber attack on their business than the effect of Brexit.

Whatever the type of attack (commoditised attacks, affecting millions of victims; targeted attacks, which have the highest chance of a significant financial reward; and high end attacks, focussing on few victims for very high reward), the legal and financial ramifications can be astronomical and commercially catastrophic.

Cyber risks insurance is available, albeit that coverage is provided on a broadly similar basis to other forms of insurance. Thus, coverage is provided for the cost of reinstating a computer system and database and associated costs, such as notification, forensic investigations and dealing with regulatory authorities.

Lloyd's of London has this week published a report, "*Counting the cost: Cyber exposure decoded*", concluding that a major cyber attack could generate losses to the businesses affected of up to £40.7bn. The scenarios set out in the Lloyd's report show that there is a substantial gap in the take up of coverage and in the event of a significant incident, as little as 7% of economic losses of the type insured by a Lloyd's policy would actually be insured.

However, the real point is that insurance is rarely even offered to protect businesses for loss or damage to their intangible assets arising out of a cyber-related loss.

Companies are improving their ability to analyse and value their intangible assets. Such businesses want to be protected against the risk of damage to those assets. The insurance industry, even if it covered such risks, would be unlikely to have the capacity to deal with such catastrophic losses. Few insurers would want to provide cover up to the limits required. Equally, few customers would be willing to pay a premium high enough to cover it.

How can the insurance industry adapt?

There are a number of ways in which the insurance industry could respond to the challenge of protecting intangible assets.

Pooling – Similar to Pool Re (which, consequently, specifically excludes damage caused by virus, hacking and similar actions), the industry could collaborate with the government to create a scheme that would cover losses to intangible assets, but underpinned by an agreement that, if the losses became so big that they exhausted reserves, then it could draw funds from the UK government to meet its obligations. This is a realistic possibility and would provide the resources required to protect against the significant losses described. However, as with the terrorist atrocities in the 1990s which precipitated the establishment of Pool Re, it may require a catastrophic event to take place before the industry would consider it worthwhile to develop the product.

Captive Insurer – As insurers internal to a particular group of businesses, captives could provide coverage at a lower rate of premium than the open market. One issue faced by an insured is that many insurance

products contain a number of exclusions, so businesses are not confident their loss would be covered. A captive could provide that breadth of cover. However, even a captive backed by reinsurance is unlikely to be able to provide limits of cover for the type of exposure under discussion.

Incentives for increased security – A significant issue for businesses is finding the capital to invest in better security for their intangible assets. Insurers could provide incentives such as reduced premiums for businesses that can show they have improved their security and therefore decreased the likelihood of making a claim. This is a long-term solution that would only work if an insured could demonstrate the ability to meet premium and remain claim free for a number of years. It would not protect businesses that require the capital assistance now.

Insurance Linked Securities – These are financial instruments whose values are driven by insurance loss events, usually providing substantial limits of cover. Investors underwrite the same type of risks that insurers and reinsurers do, collecting premiums and paying out losses as and when these materialise. As such, insurers are able to pass on unwanted accumulations of risk to the capital markets. As catastrophic losses are low-probability, they could be attractive to investors. However, investors will no doubt wish to take a cautious approach on premium, so this is likely to be a relatively expensive option.

Risk Management – Here the idea is that experts would be consulted before a crisis required them to become involved. Companies would have their risks assessed, systems updated and protections put in place before they suffered a loss. These systems would then be monitored and tested regularly, to ensure the greatest protection against suffering damage.

The one great opportunity for the insurance industry arising from the above is that insurers have the specialist knowledge and expertise to put these systems in place. Rather than paying a significant premium, an insured could use those resources to pay for expert consultants to assess their security requirements and bring their systems up to the standard required to minimise the risk in the first place. This would provide comfort to insurers who could continue to monitor the risk and charge lower premiums as a result, for the risks that they do actually take on in the traditional manner. The issue with this approach is that it would require a significant financial outlay at the start and negotiating who would be responsible for those costs could be problematic.

CPB Comment

Many of the discussed options have proved successful in providing the high levels of coverage required to cope with catastrophic losses to tangible assets. All have their disadvantages; however we consider that the final option presents the best opportunity for insurers to use their expertise and resources to meet

their customers' needs. Rather than looking at how to deal with issues of capacity, the industry could assist its customers to properly assess their risk and secure against future losses. In a more advisory role, insurers would be assisting the insured to put a lock on the warehouse door rather than pay to replace the equipment stolen from inside it.



Samantha Wilson
Associate
T: 0203 697 1906
M: 07780 221676
E: samantha.wilson@cpblaw.com



Stephen Carter
Partner
T: 0203 697 1902
M: 07887 645262
E: stephen.carter@cpblaw.com

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