MARSH

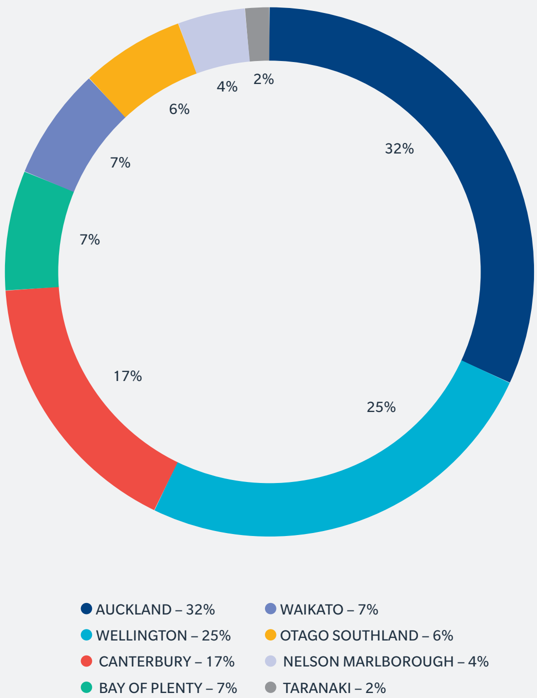
DIRECTORS' RISK SURVEY REPORT 2016

CONTENTS

SURVEY PARTICIPANTS

In the last quarter of 2016 Marsh conducted the 2016 Directors' Risk Survey, in partnership with the Institute of Directors (IoD), the third in the series of risk surveys. The 2016 edition of the survey is based on data provided by 415 IoD members. Overwhelmingly the majority of directors sat on the boards of private companies in New Zealand, reflecting the nature of our SME economy. We were pleased to see that 46 directors of publicly listed companies took the time to respond. The geographic spread also indicated a good cross-section of IoD members from around the country that was in keeping with their relative size.

FIGURE 1 Geographical split of members by IoD branch locations



FOREWORD

The events of the past 12 months have refocused the way companies view global risks. As highlighted in the World Economic Forum's *Global Risks Report 2017*, the world is undergoing multiple complex transitions: towards a lower carbon future; towards technological change of unprecedented depth and speed; towards new global economic and geopolitical balances".[1]

Following a year in which we witnessed escalating social and political instability, increased terrorism events, and several high-profile cyber-attacks, it comes as little surprise to discover that nearly two thirds of director's responding to the *Marsh Directors' Risk Survey Report 2016* perceived that 2017 will be riskier than last year.

The increasingly interconnected global risk landscape is impacting local risks more than ever with issues such as governance of the emerging technologies of the fourth industrial revolution, and China's shift from an investment-led to a consumption-led economy reversing the New Zealand/Australia worker migration patterns of the past 20 years.

2016 was also a record breaking year for New Zealand earthquakes with GeoNet recording 32,828 quakes, reminding us that unexpected natural catastrophes remain a significant risk. Almost 12,000 quakes have been recorded since the survey was conducted, due primarily to the Kaikoura event. At the time of the survey respondents ranked this risk number two for impact, just behind cyber-attack. No doubt this position would have been challenged had the survey been conducted post the Kaikoura event.

Technology-related risks top this year's lists for both external (cyber-attack) and internal (major IT incident) risks considered to have the greatest potential impact to businesses. This is a trend we are seeing in some other developed economies such as Australia, United Kingdom and the United States. Cyber-attack did not even rank in the top five risks in our 2013 survey showing the speed at which this dynamic emerging risk is changing, at least in the minds of directors. It comes as no surprise there is frustration at the perceived slow progress of affordable, practical insurance protection for cyber related risks as insurance companies struggle to adapt to the pace of change. There are deep concerns about the potential for losses that hyper-connectivity brings as cyber threats move from defending against website defacements, denial of service attacks and data breaches to more serious attacks on cyber-physical systems controlling physical assets and critical infrastructure.

An encouraging finding from this year's survey is that respondents are more confident that businesses have the ability to manage these risks, particularly high-impact risks.

The majority of respondents indicated a moderate or significant increase in board level involvement in risk management. Whilst health and safety legislation was sighted as the number one reason for boards increased involvement in insurance and risk management there is no doubt this will enhance the resilience of businesses overall risk frameworks and in the shadow of the aforementioned fourth industrial revolution that is a welcome side effect.

1. Source: World Economic Forum, *Global Risks Report 2017*, MMC Analysis

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32% of directors said they **DON'T** have a framework in place to manage the risk of a cyber attack.

PERCEPTIONS OF RISK IN NEW ZEALAND BUSINESS

The survey, asked participants to rank various internal and external areas of risk and comment on what frameworks are in place to manage these risks. Findings show the more confident a business is about their ability to manage risk, the more likely they are to think risk will increase. In addition, we asked participants to rank areas of potential business impact for the next 12 months and the following trends emerged.

CYBER-ATTACKS RANK AS THE BIGGEST THREAT TO NEW ZEALAND BUSINESSES

Cyber-attacks are perceived as the biggest external risk to New Zealand businesses for 2017. 79% of those surveyed rate the impact of a cyber attack on the organisations strategic growth, operational efficiency and legal/contractual compliance as medium or high.

Cyber-attacks are a growing, and very real threat to organisations; persistent warnings by domestic and foreign governments, regulators, and insurers, alongside the numerous high-profile cyber-attacks covered in the media, have made the risk almost impossible to ignore. It's little surprise that cyber-risks are now ranked as the number one concern to businesses in New Zealand. From July 2015 to June 2016, there was a 25% increase in the number of data loss incidents in New Zealand, and a worrying 47% increase in the value of those losses.[2] Total losses (as a result of cyber-attacks) are estimated to be between $300 and $400 million annually in New Zealand.

Today, it is difficult to bring to mind a type of business that does not depend upon IT to run critical business functions, and so, while the majority of respondents reported that mitigating cyber-attacks features on their risk register, it is worth noting that cyber-risk is absent for nearly one-third of organisations in New Zealand. There is a very real and growing threat that an unexpected cyber incident could blindside these organisations.

Obtaining a complete understanding of an organisation's cyber vulnerabilities requires not only having detailed knowledge on the risk itself, but also undertaking a complex and thorough review of internal systems, processes and policies to assess and identify potential exposures.

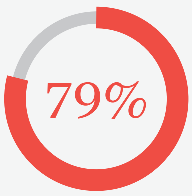
In the middle market, New Zealand companies are taking some action to mitigate cyber-risk but appear to be slower in making changes to review their systems and processes. There is a risk that they rely on cyber insurance as their sole risk management solution rather than taking the approach of larger and more mature companies, that are investing in more complex cyber-risk assessments, risk mitigation and risk transfer strategies.

SPOTLIGHT

New Zealand: Top Risks for Doing Business[3]

The *Global Risks Report 2017* identified large scale cyber-attacks as the greatest risk for doing business in New Zealand.

1. Large Cyber Attacks
2. Asset Bubble
3. Urban Planning Failure
4. Extreme Weather Events
5. Natural Catastrophe



of respondents ranked cyber-attack as a medium or high risk rating

2. Source: NZ National Cyber Security Centre – 2016 (www.ncsc.govt.nz).
3. Note: Respondents could choose up to five risks which they viewed as being most important for doing business in their country.

Source: World Economic Forum, *Global Risks Report 2017*, MMC analysis.

DISRUPTION FOLLOWING A MAJOR INCIDENT CONTINUES TO BE A PERCEIVED RISK MOVING FROM THIRD TO SECOND PLACE

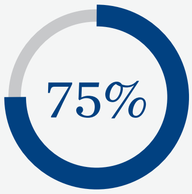
Natural catastrophes are a fact of life for New Zealand business and it is no surprise that disruption following a major incident continues to rank highly in the survey, and may have ranked higher if the survey was conducted after the Kaikoura earthquakes. The November Kaikoura earthquake clearly demonstrates the disruption that a major event can have on business even though physical damage may have been slight. In Wellington clients of all sizes were forced to evacuate premises for varying periods of time while inspections were undertaken to their premises and with damage to the port import/export businesses were forced to find alternative facilities. Any business that relied on supply chains that involved the rail/road links to Christchurch via Picton faced severe delays and substantial extra costs of finding alternative routes and methods.

With insurance only partially responding to the financial impact of these risks the fallout of the Kaikoura earthquakes underlines the importance to all businesses of a well thought through and tested Business Continuity Plan, a thorough understanding of the risk inherent in the supply chain and an understanding of how insurance will respond.

BRAND AND REPUTATION RISK

Reputation is at the heart of everything an organisation does, and must be protected when faced with a crisis. In New Zealand, 75% of organisations surveyed rated damage to brand or reputation as having a medium to high risk to their organisation. If we compare the year-on-year results of the survey, damage to brand or reputation has dropped from first to third place. This is likely a result of 68% of respondents indicating they have an effective risk management framework in place.

SPOTLIGHT



respondents ranked damage to brand or reputation by an event as a medium or high risk rating

73%

of people who are very confident in their business' ability to manage risk think risk is likely to increase.

INTERNAL RISKS

Businesses feel they are better equipped to manage internal risks than external risks and internal risks are perceived as less of a threat overall.

Respondents believe IT disruption to be the internal risk with the greatest potential to impact their organisation, with 75% considering it to be a high or medium risk. Inadequate succession planning and an inability to attract and retain talent– which are often combined in internal risk registers – came second and third, respectively.

Talent attraction and retention featured highly and is not surprising given New Zealand's small population and geographical isolation. This means that for many New Zealand businesses attracting and retaining talent can prove an issue.

The large majority of New Zealand businesses are small to medium sized and many do not currently invest in programmes to develop employees meaning many look for professional growth and development opportunities elsewhere. Many employees are lured offshore by increased employment opportunities that larger cities and companies can offer, specifically in certain sectors this can lead to shortages of talent. This is particularly notable in the Government sector with directors of Government agencies or entities ranking this issue far higher than public or private companies – at 71%, vs 54% and 56% respectively.

Diversity and inclusion is a consideration for employers at every level and investment needs to be made to implement effective development programmes to coach, mentor and support the growth of employees to retain talent and improve the diversity and inclusivity of workplaces.

Millennials present a significant shift for the New Zealand workplace. Currently making up around 1/3 of the workforce, and set to account for over 50% by 2025, millennials are already influencing the landscape of the New Zealand workplace: Their outlook on the workplace, what they want from a job and high use of social media and technology will have a big impact and employers will need to adapt in order to attract and retain employees.

Those companies seeking to retain their best talent should regularly engage with their employees to build an attractive remuneration and employee benefits package.

It's not just remuneration people are looking for though, they are looking for a different workplace, they desire skill development, interesting work, flexibility, inclusion, great organisation culture and leadership.

SPOTLIGHT

Top workforce trends impacting talent priorities

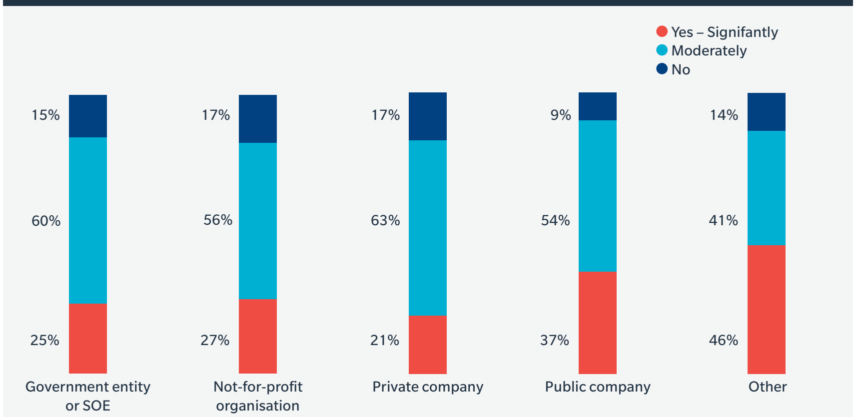
1. Rising competition for talent from emerging economies
2. Talent scarcity
3. Leveraging an increasingly diverse labor pool
4. Big data management
5. Multi-generational workforce
6. World-Sourcing (hiring talent from locations around the world)

Source: Mercer's 2016 Global Talent Trends study

HOW BUSINESSES ARE CURRENTLY MANAGING RISK

Findings revealed continuing interest and engagement at board level in risk management compared to previous years, with the majority of respondents indicating a moderate or significant increase in board level involvement in insurance and risk management. Public company boards have seen the biggest increase with 37% claiming a significant increase in involvement vs 21% for private companies and 25% for government entities.

FIGURE 2 In the last 12 months, has your Board's involvement in insurance/risk management increased?



A total of 82% of businesses surveyed have an effective risk management framework in place to mitigate business disruption following a major incident – the largest percentage for any one risk – suggesting that organisations in New Zealand, although not all, are in good shape to manage this risk. The confidence around an effective risk framework declines significantly with an increase in risk complexity or novelty.

WHAT ARE THE KEY DRIVERS FOR INCREASED ENGAGEMENT?

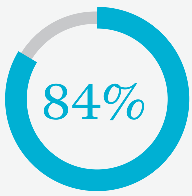
Health and Safety legislation was sighted as the number 1 reason for the increase in boards' involvement in insurance and risk management.

On 4 April 2016, the *Health and Safety at Work Act 2015* came into force, replacing the *Health and Safety Employment Act 1992*. Under the new Act, businesses of all sizes are required to have an effective strategy to develop worker engagement and safety practices. There is also a greater responsibility imposed on businesses and individuals to ensure compliance with health and safety processes. Directors are clearly concerned with their personal liability and the enforcement of new penalties for a breach of duty. The new Act provides more onerous duties and greater penalties, which are intended to motivate and ensure that directors take health and safety seriously.

SPOTLIGHT

Members who indicated increased engagement identified the top three reasons as:

1. Impact of new Health and Safety legislation on directors' liabilities
2. Greater perceived risks in current business environment
3. Board objective to become more actively involved in managing risk



respondents indicated their boards spent either a significant or moderate amount of time on risk management

The perception that greater risks are present in the current environment continues to be a key driver for increased engagement by the board. It is reassuring that the majority of respondents believe their organisations have sound or effective risk management practices in place to recognise and manage risks. Alarmingly one-third of organisations surveyed are still establishing a risk management framework. It would be interesting to learn the extent to which boards are becoming involved in discussions/decision-making around insurance and risk management. Ideally boards will be focussing on those risks that could materially threaten the organisation and the effectiveness with which they are being managed.

With boards proactively managing risk and becoming more accountable respondents have indicated a high degree of confidence of board's and management's ability to manage risk.

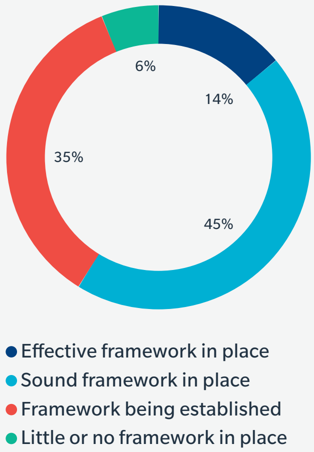
Boards should regularly receive a perspective from management on the key emerging risks and changes in the macro environment that have the potential to impact the company's strategic plan. This oversight of risk management should also include ensuring that there is an effective framework in place to identify, assess, manage/mitigate, monitor, review and report on all risks that impact on an organisation's ability to function.

FIGURE 4 CONFIDENCE IN BOARD'S AND MANAGEMENT'S ABILITY TO MANAGE RISK

As shown in Figure 4 the majority of respondents indicate a good or high level of confidence in the board and management's ability to manage risk, which is most encouraging, reflecting a risk based philosophy in many New Zealand organisations.

SPOTLIGHT

FIGURE 3
Please indicate if your organisation has an effective risk management framework in place to manage this risk



Public companies are the most developed in their **risk management** with not-for-profits being the least likely to have a framework in place.

THE FUTURE OF RISK MANAGEMENT

Directors' have a high expectation that risk will increase in the future.

TOP 5 RISKS THAT COULD IMPACT BUSINESS IN NEXT 12 MONTHS

1	2	3	4	5
Increasing influence of social media	Talent attraction and retention	Increasing corporate governance requirements	Earning volatility	Cyber-risk

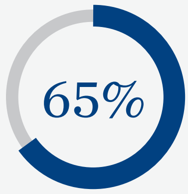
Nearly two-thirds of all respondents anticipate an increase in risk levels in 2017. This figure is noticeably higher than in previous years and signals an increased risk environment for the year ahead. In particular, 83% of public company respondent directors indicated that the risk environment will increase in 2017 vs 63% of directors for private companies.

It is a surprise to see that 62% of respondents envisage the increasing influence of social media having an impact on their business over the next 12 months. This result was ahead of talent attraction and retention (59%), increasing corporate governance requirements (55%) and cyber-risks (43%). Both governance (1st) and cyber-risks (2nd) were ranked as emerging risks in last year's survey. This result is possibly a reflection on how prevalent social media is for businesses in building brand and reputation. This highlights a need for good governance and it is reassuring that 60% of respondents indicated they have a framework in place around social media to manage risk.

Where there is risk there is also opportunity. Today's uncertain environment reinforces the importance of having a robust and proactive risk management framework in place to identify and mitigate risks but also to recognise and seize any opportunities they may present.

The lack of an effective enterprise-wide risk management strategy may be the biggest risk faced by some New Zealand companies. While the existence of a risk register may tick the boxes from a board perspective, if the risk management framework fails to identify new and emerging risk issues including poor or slow information flow to management (leading to bad decisions), poor systems or resources, or staff retention and morale issues, then things can unravel in very short order exposing directors to potential loss.

SPOTLIGHT



of all respondents anticipate an increase in risk levels in 2017

THE GLOBAL RISK LANDSCAPE

Since 2006, Marsh & McLennan Companies has collaborated with the World Economic Forum on its landmark Global Risks Report. Now in its twelfth edition, the report provides insights into key global risks, as well as the collective view of risk experts on the most significant threats to global prosperity over the next decade. This report is a critical document for leaders in all sectors.

The Global Risks Report is one example of existing material that can be used to challenge current thinking, approach risks broadly, and inform strategic decisions. You can download a copy of the report by visiting http://www.mmc.com/global-risk-center/overview/grc-global-and-emerging-risks.html

Key highlights from the report include:

GEOPOLITICAL TURMOIL

Profound social instability sits at the centre of the global risk landscape, and has been influenced most notably by rising income and wealth disparity and the increasing polarisation of societies. With populism and nationalism on the rise, businesses may also navigate a protectionist environment of tariffs and sanctions in 2017.

TECHNOLOGIES

Every new technology holds great potential, both in terms of its possible benefits and negative consequences. In 2017, businesses will face challenges from emerging technologies that include a broadening landscape for cyberattacks, economic risk from jobs lost to artificial intelligence, and governing risks related to drones, driverless cars, robotics, and more.

SPOTLIGHT

Three Ways to Use The Global Risks Report 2017 in your Organisation

The Global Risks Report uses charts, case studies, interviews, and a broad survey of other material to define, highlight, and explore the interconnections among risks. Its perspectives enable consideration of risks in a broad context and lay the foundation to better understand their potential impact. Here are three ways to consider using the report:

1. Validate your risk priorities: Compare and contrast your existing risk management and risk finance protocols to see how they align with the trends identified in the report. Are changes called for?
2. Generate conversation: Encourage leaders from operations and other areas to think how a specific trend may affect the business over the next several years. To do this you could:
   - Distil the report down to how it relates to your business.
   - Use it in different forums to provide context for leaders to consider how and when certain trends may affect their areas.
   - Make discussion of the report part of your regular risk governance process.
3. Assess time frames: Encourage business leaders to think about the time frame in which a particular trend may need to be addressed. The impact from some issues — water scarcity, for example — may feel as if it's years away when in fact your organisation could be affected much sooner.

Thank You

We have appreciated the insight and feedback gained from New Zealand directors who took the time to participate in this annual survey. In particular, we take onboard the comments you made about the need for the insurance industry as a whole to be more proactive in its ability to provide solutions that keep up with the fast-changing and challenging nature of the business environments you work in.

To that extent, at Marsh, we will certainly be working more closely with industry and professional bodies to look further ahead at what their risk requirements are and how we can provide more tailored and relevant risk solutions.

It is certainly reassuring, in the current tumultuous times, to see that board-level involvement in insurance and risk management has clearly increased over the past twelve months, at a time when nearly two thirds (65%) of directors believe the risk environment will worsen going forward. Our conversations with clients indicate that much of this may still be driven by the elevated consequences of the new health and safety legislation, but if that has acted as the catalyst for change, that is a welcome side effect.

Increasing board-level involvement in insurance and risk management is just part of the task facing organisations in New Zealand. There is still a great deal of work to be done by many to establish effective risk management frameworks that identify and assess risks and their potential impact to their business, as well as any opportunities they may present.

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For further information about this survey or any general enquires about your risk and insurance programme, please contact Marsh on 0800 627 744.

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