NEWSLETTER
INSURANCE AND FINANCE

THE GENEVA ASSOCIATION

No. 15, February 2015

Managing Risks in an Uncertain World

By Pierre-Olivier Bouée+

Interesting times

It is an interesting time for the global economy. The market volatility that characterised last year looks set to continue, exacerbated by falling oil prices and, with the Eurozone slumping into deflation, the European Central Bank (ECB) is expected to start a programme of quantitative easing soon. Unsurprisingly, low growth and high unemployment in many countries are fuelling political uncertainty, including general elections in Greece and the UK that may threaten the integrity of the European Union (EU).

Low long-term interest rates in developed economies still pose a major challenge for life insurers. The long-term nature of our liabilities means that we naturally prefer an upward-sloping yield curve. At the moment, we are faced with a yield curve that is both at historically low levels and flat. This makes it difficult to find sufficient returns to meet our long-term commitments to customers – a difficulty that will only be compounded as the need for strong returns on savings grows with aging populations.

At the same time, our industry is dealing with the implications of a wave of new regulation, from Solvency II in Europe to ComFrame and the development of new capital standards for global systemically important insurers (G-SIIs). Regulators' focus on limiting risk is understandable, given the impact of the financial crisis. We must remember though, that good risk management is not just about preventing risk taking, it's about allowing a company to take informed, controlled and proportionate risks that are necessary to create value for customers, shareholders and the wider economy.

Insurers are expert risk managers

Volatility is nothing new. My own company, Prudential, was founded in 1848, a year of revolutions across Europe. We have served our customers through two world wars, the sinking of the Titanic and numerous global economic upheavals over the past 166 years. Today, we have around 25 million insurance customers in the U.K., U.S., Asia and Africa and $730bn of assets under management.

Indeed, our industry exists to help customers deal with uncertainty. We enable people to go about their lives with confidence, and we help the economy function, by offering long-term protection, savings and investment to individuals, to families and to businesses. In short, we take the worry out of risk.

The question is, what is the best way of managing risk in the current context? As Prudential's Chief Risk Officer, I am naturally sensitive to the negative effects of risk. But I believe it is just as important to enable Prudential to take full advantage of potential upsides. It is easy to forget that risks, when well-managed, can bring rewards. This is in line with the fundamental meaning of risk… If one refers to the origin of the word risk, one finds "risicare", an Italian word that means "to dare"… Too often, risk is seen as only negative; this is a mistake that one should avoid.

+ Group Chief Risk Offficer, Prudential plc.

This is why I see my role as helping the company to make the most of commercial opportunities, while maintaining its resilience and financial strength.

Prudential's response to the low interest rate environment

Take one of the most significant headwinds facing our industry: the low interest rate environment. At Prudential, we are limiting the downsides, and maximising the upsides, in three ways.

First, by a disciplined approach to new business. As a growth company, new business is important to us, but not at any cost. It must be profitable, which ultimately is a function of two things: the terms set at the point of sale and the quality of the management of the in-force book over the life of the product. Regarding the terms at the point of sale, we are maintaining our discipline. We have not lowered our internal rate of return or payback period hurdles for new business. We continuously and pro-actively adjust our product pricing and features to ensure we generate adequate risk-adjusted returns. And, true to our value-over-volume philosophy, we do not hesitate to walk away from business that does not have the right risk/ return profile.

Second, by protecting the value of our existing book. Insurance is as much about managing the in-force book as it is about writing new business. In this challenging and volatile environment, we have focused on cash generation and on containing downside risks. Our assets are defensively positioned and we adopt hedging strategies at local and central levels to ensure that our capital position can cope in the event of tail scenarios.

Third, by using diversification as a risk management tool. Naturally we do this only when we have a good understanding of the new risks taken to create diversification and the right people for managing them. At Prudential, we break down our earnings into spread income, fee income and insurance income, and we have been reporting on this breakdown since we introduced new disclosures in 2008–09. In the past seven years, we have focused on increasing our fee and insurance income, which are higher-quality earnings with less market sensitivity. The development of our health and protection business in Asia is at the heart of this approach, as is the highly profitable and capital-efficient growth of our asset management arms in both Asia and Europe. In the U.S., the launch a few years ago of Elite Access, our variable annuity without guarantees, along with bolt-on transactions such as the acquisition of REALIC, have further enhanced the diversification of our earnings.

Adopting a long-term approach

Life insurers are not only experts at risk management; we also have a uniquely long-term perspective. We fully understand the pressures of the short term, such as the market's focus on quarterly reporting and the impact of political cycles, however, the nature of our business model means that we must prioritise sustainable growth over short-term gain.

At Prudential we believe a long-term approach is the best protection against volatility. While we are highly disciplined about managing our existing business, we are also mindful that we are stewards for future generations of Prudential managers. Accordingly, we have a responsibility to position the company to take advantage of longer-term trends.

Take our experience in South-east Asia. Prudential began investing in earnest in the region in the mid-1990s when many other multinationals in the region scaled back their operations following the 1997 Asian financial crisis. We, however, kept on investing and now are reaping the rewards. Today, we are the largest life insurer in South-east Asia, with over 13 million customers in a dozen countries, making profits close to $2bn a year.

Clarity over our long-term strategy allows us to focus on the right opportunities, in the right markets. Last year, for example, we launched businesses in Ghana and Kenya, but we have been clear that we do not expect material gains from these operations in the short term. We are investing in the strong mid-term growth prospects of those countries.

Creating value for customers and shareholders

Prudential's long-term strategy, diverse earnings profile and disciplined approach to execution and capital allocation underpin our resilience. The most important driver of our success, however, is our focus on customer needs. The only way to create a sustainable business is to provide people with something that they value. This is what enables companies to manage their way through turbulent times. It is also what enables us to create value for shareholders. There is an increasing tendency to oppose the interests of customers and shareholders. This is a mistake. No product or service will last if it does not deliver tangible value to customers. By the same token, a product or service that did not deliver appropriate returns for shareholders would not attract the necessary capital.

At Prudential, we have been careful to focus on products that meet customers' needs, and maintain a risk and return profile that is attractive for shareholders. In Asia, we have focused on addressing the structural demand for health and protection insurance from the rapidly growing middle-class population—the "Asian protection gap." Since 2006, our health and protection APE has grown about 10 times from 8 per cent of Asia APE to 30 per cent today. As a result, underwriting earnings have grown very significantly and now represent more than two-thirds of our Asian earnings, making our Asian business higher-quality, more resilient and more cash-generative.

In the U.S., our product and service proposition is designed to meet the retirement needs of the baby boomers. We have transformed Jackson [National Life Insurance Company] from what was a pure play, fixed annuity house into a company with a market-leading presence in variable annuities and a growing reputation for product innovation, as demonstrated by the success of Elite Access, which delivered sales volumes of over £2.5bn last year, three times those achieved the year before.

And in the UK, our with-profits franchise has been a capital-efficient way to grow in a mature market while generating earnings and cash. In June 2008, we decided not to reattribute the inherited estate because we thought our with-profit fund was an excellent product with a strong future. PruFund, our flagship with-profits offering, has grown from less than £1bn in 2008 to more than £10bn today.

The need to get regulation right

Our long-term approach and expertise in risk management make life-insurers particularly well-placed to make the most of an uncertain world. Not only do we help our customers plan for better and more secure futures, but we are also an important source of the long-term investment that economies desperately need to grow and create jobs.

Take infrastructure. By 2030, the OECD estimates that $70 trillion in additional infrastructure capacity will be needed globally. The B20 Infrastructure and Investment Taskforce estimated in July 2014 that, with current policies, only around $45 trillion of this investment may be realised. Life insurers and pension funds can play an important role in meeting this challenge.

Because we typically buy and hold assets to maturity, we can also be a powerful source of stability, particularly in a downturn when we act as a counter-cyclical buffer, providing the buy side of the market when short-term investors are off-loading assets.

As an industry, we have worked closely with government and regulators to ensure that Solvency II recognises – and does not impede – our role as long-term, counter-cyclical investors. Now we are facing similar debates with regard to the application of the Financial Stability Board's proposed regulation for Global Systemically Important Insurers, of which Prudential is one. In seeking to limit risks in the financial system, there is a tendency among some regulators to overlook an even bigger risk – that of stifling the ability of our industry to finance sustainable long-term growth. We must continue to engage with regulators so that we are able to play our full role in a more diverse and resilient global economy.

The Renaissance thinker Michel de Montaigne wrote: "Not being able to govern events, I govern myself." That was good advice in the 16th Century, and it is just as relevant in the 21st Century. Life insurers might not be able to control interest rates, political turmoil or natural disasters, but we can understand and manage the risks. And, in doing so, create great long-term value for our customers, our shareholders and the societies in which we operate.