

No. 15, February 2015

Current Strategic Key Challenges for the Insurance Industry

By Martin Eling⁺

Many economists have described the financial crisis as the largest disruption since the Great Depression struck the United States in the 1930s. If we keep this in mind, then the insurance industry is in really good shape. We have solid technical results, only little default risk and reasonable returns on equity in an area of 8 per cent to 10 per cent. Solvency ratios are also at a sufficient level. But we also know that this is only the tip of the iceberg. The important question to ask is what topics we have to look at today so that in five years we can still say “the insurance industry is in a really good shape”. In my opinion, three topics are of special interest. The first is the debt crisis in the EU and the U.S. The second is the amount and the complexity of new regulations. The third is how to adjust the business model of the insurance industry in light of this difficult environment.

The debt crisis is relevant for both the EU and the U.S. If we look at how the debt crisis will develop over the next five years, many people believe that the euro debt crisis will come back, especially if we look at the development of the public debt in the southern European countries. It is also clear that, although the debt crisis is not an insurance crisis, it has very strong implications for the capital-intensive business model, especially in the life insurance sector.

One of these implications is the low interest rate environment that we are experiencing, which clearly results from the expansive monetary policy of central banks. Another implication of the debt crisis is the economic slowdown that many people expect in the next years. We are now seeing an economic slow turn in Germany. Regarding the economic policy of Italy and France, many people believe that there will be a more intensive economic slowdown especially in continental Europe in the next years.

The third implication is inflation. We do not see inflation in the consumer prices at the moment, but we do have inflation in asset prices. One example is the real estate bubble in Switzerland. We also have inflation in asset prices if we look at the stock markets, many of which are at or near their all-time high at the moment. The final implication is the currency risk. For currency risk, we have a natural experiment presently going on in Switzerland. In 2011 the Swiss central bank introduced a lower bond to the exchange rate between the euro and the CHF (1.20 euro/CHF), but on January 15 the central bank announced that it would no longer hold. The following decline of the exchange rate resulted in a loss which is estimated to be CHF 60bn (i.e. approximately 10 per cent of the Swiss gross domestic product). Today, the Swiss central bank is the largest investor in German government bonds. Clearly, huge currency risks are coming with this development.

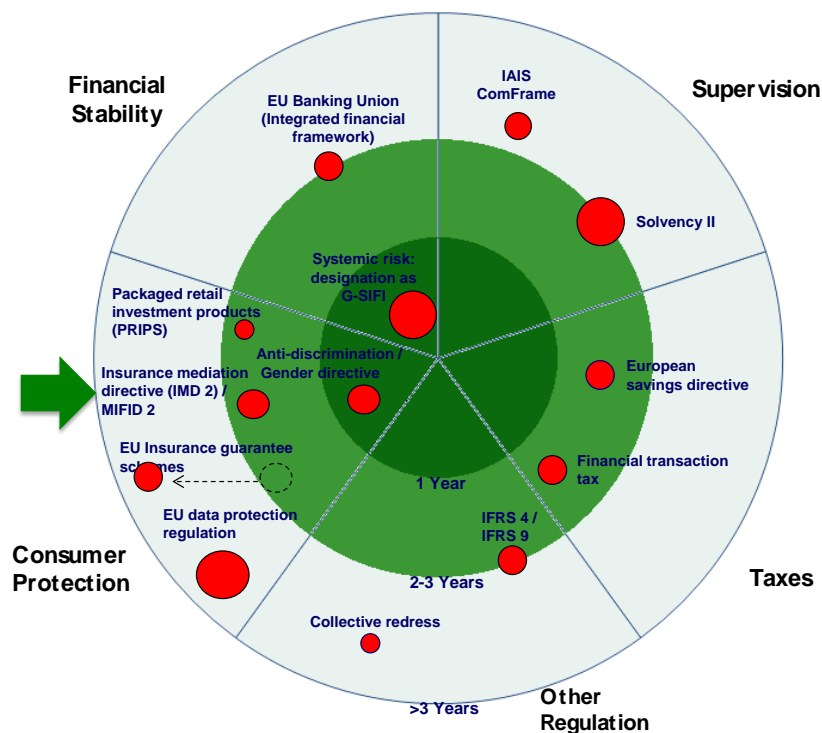
Most economists agree that as long as the institutional problems in the EU are not solved, the debt crisis topic will come back again. Most economists discuss two extreme scenarios in this case: either a prolonged period of low interest rates—the so-called Japan scenario—or alternatively, a sudden increase in inflation and interest rates, which I have termed the Argentina scenario. This will happen once that the tons of money that the central banks are now pushing into the market find their way into the real economy. The money is now still bundled in the financial markets (real estate bubble, stock market bubble). The question is then: which of the two scenarios is

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“preferable” for the insurance industry? Many people would say “none of the above”. Maybe a slight increase in interest rates over time is the preferred scenario, but we do not know whether this will happen.

My second topic is the huge number and complexity of new regulations. Figure 1 is already a little more than one year old; it shows current regulatory reform projects within the EU in five categories: financial stability, supervision, taxes, consumer protection and other regulations. We can identify three major trends in insurance regulation. First, the adoption of international and European standards; Solvency II is the most prominent example. Second, we have a shift towards inter-sector regulations (banking, insurance); “too big to fail” is an example. In Switzerland we also have the new regulation for liquidity, which also comes from the banking side. And third, we have a wave of new regulations in the consumer protection field. The bottom line across all these topics here is transparency. We will see an increase in transparency in the next years. Some of the topics mentioned in Figure 1 are especially meaningful. One example might be the idea that those producing or selling packaged retail investment and insurance-based investment products (PRIIPs) will have to produce key information documents (KIDs) to make it easier for retail investors to compare products to each other. But clearly there are also topics which are not very meaningful from an economic point of view. One example is the unisex rule of the Gender Directive; in the EU it is no longer legal to discriminate in insurance prices between men and women, although we all know that woman live longer, are better drivers, etc. Clearly this leads to adverse selection.

Figure 1: New insurance regulations in the European Union (source: adopted from Zurich and SVV, 2013)



In Figure 1 you see that regulation is already quite complex. But it is becoming even more complex over time. In Table 1, I show the effect of an interest rate decrease on asset reserves and equity. I am looking at the situation of medium-sized Swiss insurance companies which are active in several European countries. They have to fulfil the local statutory accounting and finance rules. Then they have the Swiss Solvency Test, although we have to keep in mind that there are temporary releases from the Swiss Solvency Test in place, so, for now, we have two different views on this model. They still have to fulfil Solvency I and will implement Solvency II. They have a rating from Standard & Poor’s. They publish their annual reports according to IFRS 4; at the moment we have Phase 1 with a market-consistent valuation only for the assets. When Phase 2 comes, the liability side is likely to be more volatile, closer to market values. Also, here you have to look at different models. If we look at IFRS 4, we also have to keep

in mind that IFRS 9 will come, which will also impact the volatility of the asset side. Finally, the company publishes an MCEV report.

Table 1: Effects of interest rates decrease on assets, reserves, and equity

	Assets	Reserves	Equity
Statutory GAAP	0 or ↑	0 or ↑	0 or ↑
SST	↑	↑↑	↓
SST with temp. reliefs	↑	↑↑	↓
Solvency I	0 or ↑	0	0 or ↑
Solvency II	↑	↑↑	↓
S&P Capital Adequacy	↑	↑	0 or ↓
IFRS 4 (Phase 1)	↑	0	↑
IFRS 4 (Phase 2)	↑	↑↑	↓
MCEV	↑	↑↑	↓

The point I want to make with Table 1 is the following: if you look at the effects of interest rate decrease on the value of assets, reserves, and equity (as residual), you can see everything: it can go up, it can go down, it can be 0. One fair question then to ask might be: at the end of the day, which model is the most important to you? You have nine models, leading to different results. If you had to pick one, which one would it be?

My third and final point is how to adjust the business model of the insurance industry, given this challenging environment. In today's non-life sector, there are a lot of technology topics like digitalisation, cyber risk and the opportunities arising from them. I look more at the life insurance business here, because I believe the problems are larger, especially in continental Europe. Tomas Hess (former Chief Economist of Swiss Re) said that, in life insurance, tighter regulation and low investment returns not only threaten the industry's profitability, but also several product lines and even the very business model. He also said that the whole business model needs to be rethought, and this leads me to wonder whether the classical life insurance business model is still viable. We see that all companies are shifting their product portfolios towards products with less intensive capital guarantees. Risk could thus be passed onto customers through risk-sharing products, maybe also in a non-socially optimal manner.

What are alternative answers to this development? Some market participants have suggested another way to transfer the risk, that is the use of shadow reinsurance. As Al-Darwish et al. (2011)¹ point out, an increased use of these risk-transfer mechanisms could result in more interconnected financial systems with opaque distribution of risks, possibly migrating towards less-regulated and supervised areas of the financial system. Another working paper by Koijen and Yogo (2014)² says that the liabilities ceded by life insurance to shadow reinsurers (that is affiliated and less regulated entities) grew from USD 11bn in 2002 to USD 364bn recently. If you look at those companies that use shadow reinsurance, they cede around 25 per cent of their business to these less regulated entities, which reduces their risk based capital by around 50 per cent. The default probability increases by a factor of 3.5. One might question whether shadow reinsurance is part of a viable business model. Of course, there also might be other arguments for shadow reinsurance such as tax optimisation. But shadow reinsurance reminds us a bit of recent bad experiences in the financial crisis.

¹ Al-Darwish, A., Hafeman, M., Impavido, G., Kemp, M. and O'Malley, P. (2011) *Possible Unintended Consequences of Basel III and Solvency II*, IMF Working Paper No. WP/11/187, Washington, DC: IMF.

² Koijen, R. S.J. and Yogo, M. (2014) *Shadow Insurance*, Swiss Finance Institute Research Paper No. 14-64. Available at <http://ssrn.com/abstract=2320921>.