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Today's Key Issues and Opportunities

By Etti Baranoff⁺

This 15th issue of the Insurance and Finance newsletter is dedicated to featuring the key insights from the 10th Insurance and Finance Seminar on "Today's Issues and Opportunities" that was held in London, 4 November 2014. Each article in this newsletter is from the seminar's speakers. The seminar coverage article, provided on page 4 of this newsletter, supplements the articles with descriptions of this insightful event.

From the three panels and three keynote speakers, which included CEOs, Insurance executives and industry experts, we gleaned many challenges that lead to major opportunities.

In discussing the challenges, alternative capital and low interest rates emerged as the main challenges. All panellists noted that (re)insurers are challenged by the liquidity available in the markets due to alternative capital. The availability of capital has been generated from the prolonged period of low interest rates and the search for higher returns. Speakers emphasised that, at this stage, collateralised reinsurance and catastrophe (cat) bonds have dominated the alternative capital market. This alternative capital puts pressure on pricing and profitability, especially because of low catastrophe losses in recent years.

There are many positive aspects to the liquidity trend, showing the attractiveness of the insurance industry. In addition, since the liquidity is not coming with risk management expertise, there are many opportunities available for insurers to utilise and promote their expertise. Underwriting and risk-based pricing are in the insurers' domain and are valuable in the marketplace.

Furthermore, the pressure on underwriting and profitability requires the development of new fields and products. This could be done through the use of big data analytics in search of new trends and also by moving talents from profit centres to centres for innovation.

⁺ Research Director, Insurance and Finance, The Geneva Association.

All the speakers in the seminar noted that the industry was well positioned to take a leadership position in big data analytical patterns through models and new discoveries. One area already explored was “uninsured markets.”

The technical presentations by the industry executives showed that insurers are able to manage through the low interest rate environment with asset/liability matching and investments that support their products and products innovation. An example was provided by a U.S. insurer that was able to successfully create appropriate asset/liability management in order to take over pension liabilities of large corporations, despite the low interest rates.

Other challenges and opportunities discussed were on the assets side. Since insurers are also investors, they are increasingly less protected. Regulators have increasingly tended to protect the debtor, not the creditor. In addition, the extraterritorial reach of some national governments has become problematic for insurers. On the other hand, the position of insurers as long-term investors gives them opportunities for collaboration with governments regarding infrastructure investment and to enter uninsured markets.

The messages that came clearly from the industry were that insurers are suited to rethink their role in society as contributors to general safety, infrastructure and risk management. Our outside expert added a dimension relating to having “potentially better results with shifting investments to local businesses.”

The topics of regulatory risks and regulations centred around the challenge for a global industry to respond to national regulation and the unintended consequences of new regulatory initiatives for global systemically important insurer (G-SII) companies. As was the case in prior years, there were calls for the need to separate the insurance model from that of the banks.

In the area of modelling into insights and innovations that can prevent the next crisis, the speakers indicated the opportunities to use the expertise of insurers in modelling. This could add value to the assessment of past occurrences and give new insights and innovation.

Last, but not least was the topic of cyber-risk, which is challenging and provides great opportunities. The seminar’s participants kept emphasising the major need for the use of big data analytics and the best talents from hi-tech industries.

The rest of this newsletter includes a guest editorial by the Chairman of The Geneva Association Mike McGavick, who also gave the opening keynote speech. This follows with a more detailed overview of the 10th IF Seminar. The rest of the newsletter is dedicated to articles of participating speakers in the seminar.

I hope the readers will find this issue informative, enlightening and instructive. Many thanks to Prudential U.K. for hosting the seminar.

Guest Editorial: Global Challenges and Solutions

By Mike McGavick[†]

This is an extraordinary time for our industry, as we face a number of challenges putting the entire sector under pressure. As I see it, they fit into two separate baskets of challenge: the first, challenges facing everyone in the global economy and the second, those specific to our sector. And though different, they can be solved with the a few key solutions.

Global challenges

First, technology. With technology advancing, risks mutate rapidly. This is where the problem lies—the faster the rate of change, the more challenged our business model is. We’re used to long data sets to gain comfort in a risk, but new risks don’t have the same length of data associated.

[†] CEO, XL Group and Chairman of The Geneva Association.

Second, climate change. Many of the claims we're engaged in, are events that happen due to weather and climatic events. With this in mind, we know that there is a simple phenomenon about human beings: we like to live in places where geology is interesting—where the ocean meets the shore, where the river cuts through, where the mountains are. So we see climate change and other distortions as compounding the already fundamental problem that people like to live where geology is interesting and inherently unstable.

Third, longevity. It's obvious that the basic economics of how pension systems are funded have not kept up with our great success in the sciences and the way we have extended longevity. The population designs of the developed world are creating nearly insurmountable pressures and we're already starting to see signs of the same patterns in developing worlds. We have made great progress over decades in seeing that seniors enjoy a better life and now we're under economic pressure that's suggesting in the future they won't.

Sector challenges

First, globalisation. Any business can operate globally with the Internet, yet insurance mechanisms are set up on a national basis, making it increasingly difficult to create efficient solutions for global clients. This is a tension that exists for every insurer, and the cost of being global burdens the whole system.

Second, alternative capital. The challenge with alternative capital is that it's bent on hollowing out one specific line: the U.S property cat space. The results of this are that people are now seeking how to use alternative capital in other products and situations, as well as searching for new profitable fields while hoping that the alternative capital won't chase them out. There are so many uninsured challenges—hopefully we can bend this capital to come up with new solutions.

Third, consolidation of the broker community. For insurers, broker community control is a great challenge. Though the insurers service the clients and make the products, the control is weighted more heavily within the consolidated broker community.

Fourth, analytics. Despite being a data-driven business, most insurance companies have poor data systems—this is something that needs to change, fast. We need to harness what this trend can do for clients, or others who have more modern data will supplant us.

Fifth, regulation. So far, the approach that has been taken hasn't been appropriate to our industry—for banks, maybe, but not insurance. With this in mind, there's going to be a lot of change soon resulting in one good outcome and another that's still up in the air.

The good outcome is that regulators are trying to create greater global collaboration, which would help with the previous challenge of globalisation. Additionally, the promises of Solvency II that there would be regulatory deference to group regulators could be very positive for the sector.

The more uncertain outcome involves regulators requiring capital to be held very dearly. Each of the trends just reviewed demand greater innovation, which isn't possible if the price of capital is too high. The more determinedly capital is regulated and inefficiently it's used, consolidation will be encouraged over innovation.

Solutions

Now, after noting that this is a very challenged world, I want to shift to how we can get past these with a few key solutions.

First, innovation needs to be at the heart of the industry. We tend to develop products slowly, replicate them swiftly, and the profits erode for decades. That pattern can't continue. So how do we get our rate of innovation up?

Number one, we need to assign our best people to the innovation space, not just our most profitable areas of activity.

Two, we need to harness external data in a useful way, because internal data sets are not going to be up to the challenge. That means an underwriting mentality teamed with actuaries and finding public databases and resources to write and reshape products.

Three, take risks that involve adjacency. If we're willing to set part of our resources aside for something nontraditional, then we can really do some breakthrough work.

Four, we have to entice innovative people to join our industry. We need the people who are experts in complex fields to apply their skills in *our* world; their insight is an important factor to future innovations.

The second solution is rethinking our relationship with society, particularly governments. We have to discuss with them what social outcomes we want and how our products can lead towards that social good. Though we may not be used to it, this is a vital approach.

There are a number of major challenges both in the world abroad and within our own sector; however I think that these imperatives are the right ones for pulling us ahead into a new era of prosperity. We must change our approach to innovation and as we do, we must engage in deeper partnerships with governments to create solutions that are large enough for the challenges we face.

Overview of the 10th IF Seminar—Today's Issues and Opportunities

By Etti Baranoff*

The 10th Insurance and Finance (IF) Seminar was hosted by Prudential plc on 4 November 2014. The main topics discussed were the challenges faced by the industry such as low interest rates, alternative capital, regulatory risks, creditors' risks, longevity risks, climate risks and more. Against this backdrop of challenges, the participating CEOs, CFOs, CIOs, CROs, chief economists and outside speakers provided ideas of opportunities for growth. The main features were creativity, innovation, use of technology and benchmarking on the industry's expertise in handling risks.¹

After welcoming remarks by Anna Maria D'Hulster, Secretary General, The Geneva Association and Nic Nicandrou, CFO, Prudential plc, Mike McGavick, CEO, XL Group and Chairman of The Geneva Association, provided a powerful keynote speech delineating the main issues and opportunities of the insurance industry. His keynote presentation is provided in this newsletter as a guest editorial on page 2.

McGavick's address on the issues continued during the CEOs' panel that was led by Geoffrey Bell, Executive Secretary, Group of Thirty. The panel included—in addition to McGavick—Nikolaus von Bomhard, Chairman of the Board of Management, Munich Reinsurance Company, and Michael Butt, Chairman of AXIS Capital Holdings Ltd. Summarising briefly McGavick's presentation, which centred around the financial sector's challenges and opportunities in general such as technology, climate risk and longevity risks. He provided a drill down into the challenges unique to insurers: globalisation vs national regulation, the rise of alternative capital, consolidation of brokers, big data and analytics, and regulations. The unique challenges for the insurance industry require bigger innovation and encourage and trigger consolidation. As noted in the article, the opportunities lead to innovation in product development and efficient reliance on experts. The discussion of the industry's fundamental rethinking about its role in society flowed into the CEOs' panel discussion.

Continuing the keynote speech, Nikolaus von Bomhard added his perspective regarding issues on the asset side of insurers as relevant investors. He noted that a different challenge is the lack of protection of investors, since "everything is done to protect the debtor, but not to support the creditor these days—rules have changed and tax systems are changed". There is an extraterritorial reach—national governments stretch their reach. These issues complicate the operations of insurers. In addition, he discussed the "re-assessment of behaviour with the benefits of hindsight" in order to prevent the next crisis is a complex challenge for insurers.

* Research Director, Insurance and Finance, The Geneva Association.

¹ The one-day seminar included three keynote addresses and three panels beginning with the view from the CEOs' perspective, followed by more technical views of CROs and CFOs. The afternoon was devoted to views from outside beginning with the intriguing keynote speech by Davide Serra and concluding with a panel of outside experts.



Michael Butt added that “finding areas of growth is difficult and giving the shareholders proper return is tough”. He believed that a normalisation of interest rates would be helpful. In the area of alternative capital, he expressed concerns about “too much supply against the current demand.” Butt emphasised long-term vs short-term capital; economic losses vs insured loss and the fact that only 30 per cent of the losses are insured in the developing world. Even in the U.S., the losses from Sandy were not fully insured; when there is no insurance, coverage is provided by governments.

The discussion centred around the enormous pressures on being innovative, since mergers and consolidation are only the third choice when an insurer can no longer find means for growth. The CEOs were in agreement in putting more emphasis on the liabilities side: “Focus on underwriting profits must be number one under the current market conditions and smoother cycles.”

A light discussion ensued about the reach to society via TV on national levels. On a more serious level, von Bomhard addressed the importance of communication on a political level and the fact that now is a good opportunity to gain attention when governments are interested in applying the industry’s expertise in infrastructure and risk management.

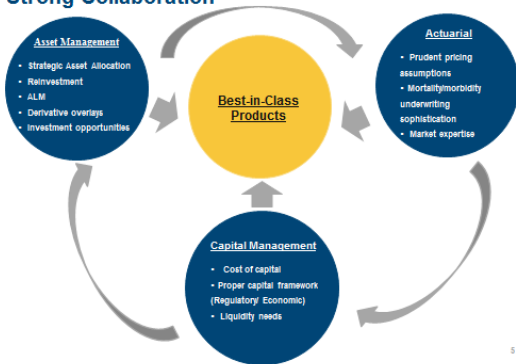
The key lessons learned were “that the art of underwriting is important and is the mainstay of the industry.” All CEOs agreed that now is the moment of opportunity for the industry to provide its unique expertise to governments and, through investments in infrastructure, to create social partnerships.

Following the CEOs session, Pierre-Olivier Bouée, Group CRO, Prudential plc gave the host company address and provided the background to the second session by noting the low interest rates and the fact that being a G-SII was driving unintended consequences for all stakeholders. He too saw the same opportunities with technology and exporting risk management expertise.

The second session of CFOs’, CIOs’, chief economists’ and CROs’ views delved more into the technical aspects of “today’s issues and opportunities.” The session began with Timothy Schmidt, CIO, Global Portfolio Management, Prudential Financial as the first speaker. Schmidt discussed the issues from a portfolio management point of view. For him, the number one risk is the asset/liability matching risk.

Schmidt noted that “when you get down to risks in the assets originations, work very closely with the products side— understanding the products and product development.” Key is to structure portfolios around the products. The challenge and opportunity is to create the best in class products under the key issues of “treasury rate in the U.S. and low interest rates.” Those have not taken the industry down. In the area of new opportunities, Prudential is in the pensions risk transfers or PRTs with about 4–5 mega deals where the pension provider transfers its liabilities to the liabilities of the insurer.

Successful Insurance Management Requires Strong Collaboration

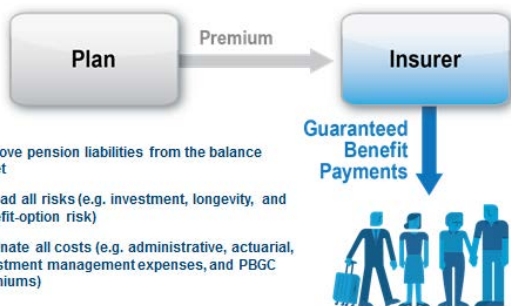


Pension Risk Transfer Product

- **Successful PRT product depends on portfolio management expertise:**
 - Create asset portfolio tailored to liability
 - Asset assumptions/reinvestment strategy
 - Transfer in-kind assets
 - Hedging forward commitment

Buy-Out PRT Transaction in the US

A **COMPLETE** de-risking solution for the plan sponsor



- Remove pension liabilities from the balance sheet
- Offload all risks (e.g. investment, longevity, and benefit-option risk)
- Eliminate all costs (e.g. administrative, actuarial, investment management expenses, and PBGC premiums)

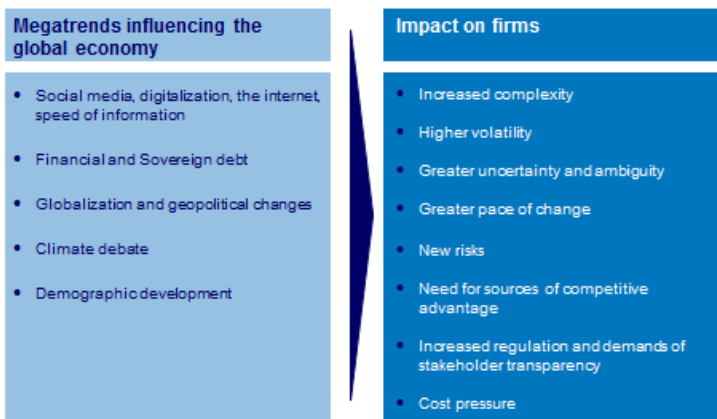


These PRTs include already retired workers such as from General Motors. The design requires the correct duration profile and asset transfer. Fundamentally, the investment assumptions need to be correct to accommodate the tightness between assets and liabilities.

Schmidt also related to Prudential Financial’s designation as a G-SII. The company is in discussions with the U.S. Federal Reserve about the designation and the capital needs for higher loss absorbency (HLA). They argue that the regulators should take the reserves into account as they are not marked to market and as long-term liabilities do not require liquidity.

Axel P. Lehmann, Group CRO, Zurich Insurance Group, followed and emphasised transparencies. His central talk was about risk as an opportunity. He covered key challenges with systemic risk designations; new forms of cash flow matching; opportunity in cyber risk, the ageing population and investment challenges. The following slide provides his summary of the megatrends:

Megatrends and challenges in the global scenario

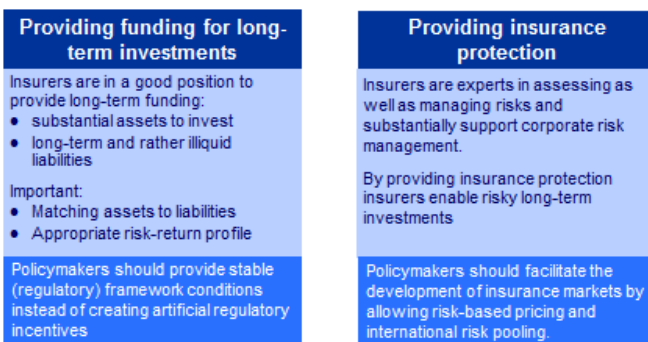


The readers are invited to view his full presentation at www.genevaassociation.org/media/908326/ga_10_th_if_seminar_lehmann.pdf

In the area of investment, Lehmann called on policymakers to ensure no interferences in insurers’ contributions to growth as shown in the following slide:

Long-Term Investments

Helping to address the need for long-term investments to foster a sustainable economic recovery and growth: The dual role of insurers



Kurt Karl, Managing Director, Chief Economist, Head of Economic Research and Consulting, Swiss Re followed with a discussion of alternative capital; claims development on the p/c side was very benign and caused a drop in pricing. His evaluation was that on the casualty side, the industry was in good shape. Such was not the case for the property side with low interest rates and benign U.S. hurricanes. A complete article by Karl is available on page 10. Briefly, he noted that there are expectations for an increase in interest rates. His assessment was that hedge funds would stay and reinsurers would keep providing larger services with the capacity and support in the underwriting, side since the collateralised capital was not providing the expertise. Since loss ratios

kept going down, it was difficult to forecast adverse outcomes. As a chief economist, he concluded that “there will be more pricing power in the next 2 years as alternative capital reached a limit on the pricing.”

Closing the panel was Benjamin Meuli, CFO, Catlin Group Ltd who provided a few insights from his career and his work at Catlin (now merging with XL). The text of his presentation is provided on page 13.

Briefly, he discussed alternative capital and projected that “pension funds will stay”. He indicated that “with alternative capital, there is a one-way correlation between catastrophe risk and financial markets ... What gets people into trouble is not lack of capital, it is lack of liquidity and those are not twin sisters.”

The afternoon was devoted to views from outside. Beginning with the provocative and inspiring keynote [speech](#) by Davide Serra, founding and managing partner, Algebris Investments, who gave ideas on two main topics: technology and regulation.

On the technology side, he pointed out the low actual insurers' spending for technology by insurers, while telematics proved to reduce loss costs (see pages 4 and 5 of Mr Serra's presentation).

Serra showed that the "possibilities of reducing claims or losses are massive, and telematics is strong in the U.S." He discussed examples about young drivers in the U.K. and the reduction in claims costs. Insurers are investing only 3.2 per cent of revenues in IT, while banks invest twice as much. Insurers' investments are two-thirds in legacy and one-third in innovation. This system is absolute, since there is no connection to risk management and sales force. Serra noted that Allianz and AXA are far ahead in the EU in investing in technology for analytics and big data. For driverless cars, Allianz is ahead of the game.

Serra's next intriguing challenge was in the area of growth despite regulatory limitations. He called for insurers to become small hubs of venture capital for innovative small firms that are too leveraged and would benefit from equity investments. With such equity, insurers would be giving money into the real economy for growth (see pages 9 and 10 of Mr Serra's presentation).

Serra recognised the limitation of Solvency II on equity investments in the EU and asked "Are EU regulators acting against shareholders/the economy?" and answered that, compared to the U.S., regulators are restricting such investments that are so necessary to grow the EU economy. Serra noted the following:

- 1) Balance sheets in the EU all look identical; all stress tests are the same; Basel III and Solvency II act as if they have nature on their own.
- 2) No one is financing their neighbours; everyone is financing the same large companies; insurance should be supplier of capital; insurance should finance more equity in SMEs with local management team or by setting up their own team.

Since everything that is private investment has a 25 per cent risk charge, Solvency II is a barrier to investing in EU SMEs. Serra called for differentials in regulatory charges for investing in local small and medium-sized enterprises (SMEs). (see pages 12 and 17 of Mr Serra's presentation)

The last session was devoted to "Views from outside: Industry's Positioning, Challenges and Opportunities". Mark Button, Senior Director, Standard & Poor's Financial Services Rating, gave a thorough [overview](#) of the insurance sector from a rating organisation point of view which is shown in details in his article contribution on page 14.

Bob Hartwig, CEO, Insurance Information Institute followed, and delved into the issues of alternative capital and its ramifications. His [presentation](#) is available in the Geneva Association web site. Hartwig entitled his presentation "Capital Punishment? The Challenge of Profitability and Growth in an Industry and World Awash in Capital" and explained how "the global hunt for yield pushed institutional investors into countless new areas—(re)insurance being one of them". During his talk, Hartwig analysed how the combination of accumulation of capital on a global scale and low yields impacted the reinsurance pricing environment. The [presentation](#) included many detailed slides that showed profitability patterns and challenges to the non-life industry.

Peter Gallanis, President, National Organization of Life & Health Insurance Guaranty Associations, U.S. (NOLHGA) enlightened the participants with the Choice Theory and the impact on regulations. The seminar concluded with the academic point of view by Martin Eling, Professor and Director of the Institute of Insurance Science, St. Gallen University, who pointed out added topics: 1) the return of the euro debt crisis; 2) managing under the new regulations; 3) adapting the insurance business model. Eling's contribution is available on page 18.

In conclusion, this short overview of the IF seminar provides only a brief and high-level description of the richness of the presentations and the content. For those presentations not included in this newsletter, the readers are invited to consult The Geneva Association [web site](#).

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. 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.

⁺ Group Chief Risk Officer, Prudential plc.



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.

The Global Economic and Re/insurance Market Outlook— Economic Outlook

By Kurt Karl⁺

Aside from the U.S., growth in many of the other major economic regions slowed into the middle of 2014. The euro area weakened significantly in the second quarter as Germany’s economy contracted. Nevertheless, euro area average growth in 2014 was significantly stronger than in 2013, due to the statistical effects resulting from a strong second half in 2013 and first quarter in 2014. Another bright spot is the U.K., with fairly robust growth in 2014. Growth in China has been a little lower than expected and Japan’s economy shrank more than expected in the second quarter of 2014 in the aftermath of a sales tax hike. Many emerging markets are strengthening, but the outlook has become more uncertain given the expectation that the U.S. Federal Reserve (Fed) will begin raising interest rates next year. Insurers and reinsurers premium growth will be close to nominal gross domestic product (GDP) growth in the advanced economies and a bit stronger than nominal GDP in the emerging markets.

Overall, however, the global economy is still expected to improve modestly in 2015, with slightly stronger growth in many countries, especially the U.S. The improvement in the U.S. will come from stronger consumer spending, investment and home building. Growth is also expected to improve in the euro area, but not in China, Japan or the U.K. Of the major emerging markets, Brazil and India are expected to have stronger growth, while growth in Russia

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could be negative, given the sanctions and drop in oil prices. The projection for slightly faster global growth in 2015 is consistent with International Monetary Fund (IMF) and World Bank (WB) forecasts. These institutions both have growth increasing by about 0.2 percentage points in 2015, to 3.5 per cent from 3.3 per cent this year (IMF) and to 3 per cent from 2.8 per cent (WB). The greatest downside risk is a major slowdown in the euro area leading to a deflationary period of stagnation.

Monetary policy is expected to tighten next year in the U.S. and U.K., with both countries raising their policy rates, and remains highly accommodative in the euro area and Japan. This divergence of monetary policies will very likely strengthen the U.S. dollar and U.K. pound against the euro and the yen. China continues to try to steer its economy towards economic growth with subdued credit expansion. This is not an easy task and the risk of a hard landing remains.

In this macroeconomic environment, yields on benchmark government bonds are forecast to rise at a more rapid pace in the U.S. and U.K. than in the euro area and Japan. As growth strengthens and the Fed raises rates, the yield on the 10-year Treasury note will climb to 3.5 per cent by end of next year and to 4.5 per cent by end-2016. Yields in the U.K. will rise to similar levels, but yields in the euro area and Japan will move up by less than 100 basis points by end-2016. Though rates will be rising, insurers and reinsurers face declining investment yields on their bond portfolios for a couple more years yet, as higher yielding bonds mature and are replaced with the current lower yielding bonds.

Re/insurance capacity

There have been two key factors which have recently affected reinsurance and insurance (re/insurance) capacity. First, the below average catastrophe year in 2013, which added USD 18bn to capacity, as well as the 2014 catastrophe year, which was also a below average cat year. In addition, it is key that there have been low North American hurricane losses since 2005, which is important for the alternative capital (AC) market. Much of the risk taken on by AC is North America hurricane risk, so this capacity has had a lucky run of low losses.

The second factor for capacity has been the benign development of claims on casualty business, resulting in major reserve releases. These have added to profits and capital in the industry. From about 2006 to 2011, this created a softening market with declining casualty prices. About 2011, the surveys of primary insurance in the U.S. indicated a slight move upwards, but this has recently been very mixed. Some markets have had price rises, some declines, so prices have been fairly flat overall. But, in any case, underwriting has remained remarkably disciplined. This could be due to the low investment yield environment. Since profits for casualty business is more dependent than property business for profits from investments, insurers and reinsurers have needed to be conservative in pricing the new casualty business.

Property cycle and AC

AC has grown rapidly in recent years. Overall, the size of the market is now about USD 59bn, compared to global capacity in reinsurance of about USD 570bn, according to Aon. To a certain extent, the low interest rate environment has driven capital into catastrophe bond funds, as investors—hedge funds and pension funds—in search for yield. The inflows need to be invested for the cat bond funds to obtain their fees, but there were simply insufficient cat bonds available. Thus, a new investment vehicle was created, collateralised reinsurance, and it is this type of AC which has been growing rapidly for the past few years.

AC has mostly affected catastrophe reinsurance prices in North America, since about 70 per cent of the overall AC market is based on North American hurricane risk. Prices are now close to technical pricing in both the AC market and reinsurance, so maintaining underwriting discipline is now essential for profitability.

On pricing, AC is helping to lower prices and this will continue at least through the January renewals. However, the pace of decline is expected to moderate. AC is also projected to be with us for some time to come, dampening the property cat pricing cycle. This is good for our clients, but not good for re/insurance profitability.

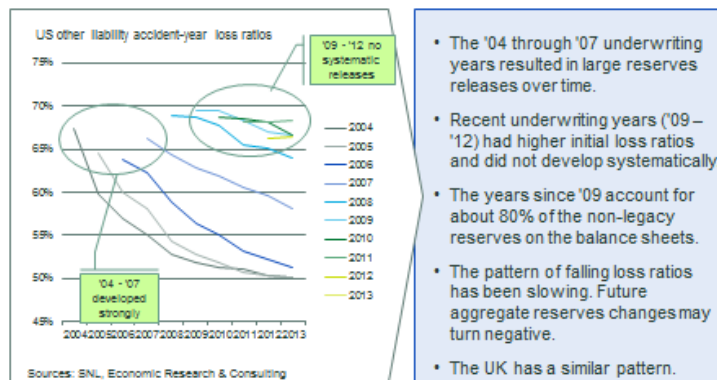
One concern about AC is that it will enter into market segments other than catastrophe property lines. It is difficult to see it getting into casualty lines, because of the long duration of the casualty liabilities, which would be challenging for a hedge fund to manage over several years. Nevertheless, Hedge Fund Re (a rated vehicles backed by hedge funds) is now targeting low volatility casualty business to get float for their hedge fund investment strategy.

The market for AC is untested: it has not yet had to react to a sharp rise in interest rates, nor has there been a major North American hurricane recently. As interest rates rise, there may be less capital flowing into the dedicated cat bond funds. A major hurricane event in North America would also likely discourage the pension fund managers, but perhaps not the hedge fund managers who now often have a cat risk team which is familiar with the cat modelling. On balance, AC is expected to be a part of the market for some time, though its pace of growth is likely to slow as interest rates rise.

AC appears to primarily compete with smaller reinsurers, which mostly provide capital to the market at a competitive price. Larger reinsurers with a full range of services, including training and support on actuarial, underwriting and claims activities, are likely to fare better.

Loss reserves are less redundant

More recent accident years could develop negatively if claim costs accelerate



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Casualty pricing cycle

Casualty prices began falling after 2006, but have been stable-to-up since 2011. This pricing pattern is unusual: normally, the price increases and drops are very steep. Typically, prices would decline until reserve releases turned into adverse developments, but this has not happened yet and still prices stopped falling.

The benign claims environment is expected to change over the next couple of years for two reasons. First, the underlying drivers of claims-cost escalation (often called claims inflation)—general inflation, wage gains and medical costs—are expected to be accelerating after a long period of moderation. This acceleration will stem from growing economies, tightening labour markets and increased pressure on medical services from an ageing population. Second, the development of accident year loss ratios implies that positive reserve surprises should be coming to an end. In the U.S. and U.K., where we have data, the 2004 accident loss ratio declined for a number of years as the industry was continually surprised by the low claims. These improvements are over. For more recent accident years, the loss ratios are not improving over time—they are basically flat. Thus, there are no new surprises from claims coming—the business has been priced about right, and the claims are coming in as expected. For more on this topic, please see our [Swiss Re sigma 4/2014](#).

Outlook

In conclusion, prices on casualty lines are expected to rise, given that claims are expected to increase and adverse reserve developments are likely to be over within a couple of years. The rise in prices is unlikely to be steep however, because claims cost increases and adverse development are both projected to be modest. The increase in claims should also boost demand for casualty insurance.

On natural catastrophe pricing, prices are expected to remain under pressure at the 2015 renewals, but the decrease in prices is expected to slow. The slowdown in price declines will be facilitated by underwriting discipline—given current price levels this is necessary—and also by reinsurers shedding capital through dividends and stock buybacks.

Views from Inside: Alternative Capital, Smart Modelling and Liquidity vs Capital

By Benjamin Meuli⁺

I look at the world from a slightly different perspective than some insurers, and one of the subjects where this may be the case is the debate regarding alternative capital in the insurance industry.

Of the two major classes of alternative capital—hedge funds and pension funds—I believe the pension funds are more likely here to stay. These are big institutions that are taking long-term, serious decisions to add diversification to their portfolios.

Many of the hedge funds, however, are being attracted to the insurance industry on the back of what I believe is essentially a tax arbitrage. If you can invest your money in the context of taking insurance risk, as a U.S. taxpayer, you do not pay taxes on the investment income in the same way. However, my personal experience suggests that building a business on the back of a tax arbitrage very rarely constitutes a successful long-term business plan. I wouldn't be surprised if this loophole is closed eventually and, if so, many of these hedge funds will likely disappear from the insurance industry.

I also think it is clear that not all alternative capital providers have understood the correlations involved in insurance. As a former banker who worked with insurance industry clients, I am well aware of some of the pitches that have been made to attract alternative capital into insurance. However, the reality is that there is almost certainly a significant "one-way correlation" between catastrophe risk and financial market risk.

We as an industry faced a series of major events during 2011, but none of these were anything like the potential 1-in-100-year events that we could conceivably face. For example, the Japanese earthquake/tsunami produced economic losses of approximately USD 200bn and insured losses on the order of approximately USD 30bn. If you think of a similar loss occurring off the coast of California, where a much greater portion of the economic risk would be insured, insurance and reinsurance companies around the world would be forced to sell assets to pay what could potentially be several hundred billion dollars of claims. You would also see uninsured property owners on the West Coast essentially giving back the keys to their properties to banks or lenders.

Such a scenario will have a major impact on the banking industry and might even lead the U.S. Federal Reserve to adjust monetary policy. In other words, a truly major insured event will have a big impact on financial markets, apart from the impact that will come from the financial sector's investment in the insurance industry. If we were to witness a so-called "tail event", some alternative capital providers will be surprised to see their insurance activities go south at the same time as they are having trouble with more conventional investments.

There are also questions over the ability or willingness of some of these alternative capital providers to pay claims. We are already seeing disputes arising from policies that have triggered losses. Hedge fund managers tend to have a relatively short-term perspective which may lead them to resist paying claims. On the other hand, as long-term participants in the industry, insurers understand the product they sell, and they know that you will be quickly out of business if you do not pay claims promptly and fairly.

But it's important to understand that my experience at Catlin² is to not see alternative capital as a type of "existential threat". On the contrary, at my current position, we want to work with it and we will be interested in seeing how much of it sticks around. I regard it a positive trend to attract a lot more capital in this industry in order to have the capacity to insure the risks of the future.

Another topic in which many of us are interested is the investment profile of property/casualty insurers. At my current position as a CFO, I cannot say, that we are going to beat the market, especially when you think of all the resources that the banks and hedge funds have. That would be a crazy thing to do.

⁺ CFO, Catlin Group Ltd.

² At the time of writing this article, I am an employee of Catlin, which is merging with XL.

However, I see a core competitive advantage which is the liquidity. Insurers have a lot more liquidity than many other investors. However, if we are to maximise the advantages that our liquidity provides, we must better explain to the regulators what we want to do with it.

There are differences between liquidity and capital, and for me, far too much of the current regulatory debate is still about capital. However, if you look back at the financial crisis, what got people into difficulty was not a lack of capital, but a lack of liquidity. You get in trouble when you are forced to sell assets and are therefore forced to take whatever price you can get.

As an industry, we must devise an approach for measuring and monitoring liquidity that is every bit as robust as the measures now being utilised to measure capital adequacy. We need to take this approach to the regulators, and we need to see whether they will buy into it.

At Catlin, when we examine liquidity, we look at all of the subsidiaries within our Group. We look at the worst type of 1-in-100-year event that could occur in relation to each of these subsidiaries, and then we look at how fast we expect to pay the resulting claims. We assume that, at the same time, we have a financial market crisis of the same magnitude as 2007 and 2008 so that we are forced to take a big haircut on the value of our assets. We also assume that our largest reinsurer and bank counterparty fails. We then model cash flows on a quarter-by-quarter scale to see if we have enough liquidity to survive in business. Even on this basis, we believe we have liquidity far in excess of what is required.

It seems to me that, with such a scenario in mind, regulators should not be concerned if we purchase fixed-income securities that are considered illiquid as long as we earn a spread that more than covers the cost of default and credit migration risk, and we hold them to maturity. However, we must prove this to the regulators, and we need to develop a language to do that. As an industry, this is an area where we have so far fallen short.

We must also continue to develop a much deeper dialogue with our regulators as I see "government risk" as the emerging risk that poses the greatest threat to our industry. We have seen several losses that have been inflated by government and regulatory actions far beyond what they should have been: the Costa Concordia accident and the redefinition of "hurricane" following Superstorm Sandy, to name two. Governments will continue to look to the deepest pockets to help pay when things go wrong, and, in a lot of cases, insurers will be those deep pockets. We constantly run the risk of our policies being reinterpreted by governments and regulators. Like any other form of risk, we can only price for this adequately if we understand it properly.

Policymakers Prolong Pain for Developed Markets' Insurers

By Mark Button⁺

In key developed insurance markets, insurers are feeling the downside of policymakers' ongoing efforts to repair the global economy. The dominant risk is that interest rates will remain "lower for even longer," continuing the overall low-yield scenario, together with the spluttering global economy. Developing market insurers continue to grow strongly, but face a range of different challenges. Compounding the uncertainty for all insurers is policymakers' simultaneous pursuit of improved solvency standards, the systemic importance designation, recovery and resolution plans, a global capital standard, and new product and conduct regulations.

Western European life insurance has joined global reinsurance with a more negative sector outlook

The Western European life insurance sector outlook was recently revised to stable-to-negative from stable. The global reinsurance sector outlook already moved in this direction in January 2014. Other sector outlooks are mainly stable (see table). The overall global impact is that near-term negative rating actions on individual insurers will likely outweigh positive rating actions.

⁺ Senior Director, Standard & Poor's Ratings Services. See the [presentation](#) at the Geneva Association web site.

	Current business conditions	Business conditions outlook	Sector outlook
North America			
Life insurers	Satisfactory	No change	Stable
Property/casualty insurers	Satisfactory	No change	Stable
Western Europe			
Life insurers	Weak	No change	Stable-to-negative
Property/casualty insurers	Satisfactory	No change	Stable
CEEMEA *	Satisfactory	No change	Stable-to-negative
Asia Pacific	Satisfactory	No change	Stable
Latin America	Satisfactory	No change	Stable
Global reinsurance	Weak	Somewhat weaker	Stable-to-negative

* CEEMEA = Central and Eastern Europe, the Middle East, and Africa.

This is partly reflected in the current outlooks on individual insurers, which have a negative bias. Ten percent of insurance ratings globally carry negative outlooks or credit watches, vs 8 per cent positive.

"Lower for even longer" interest-rate scenario prolongs insurers' pain in developed markets

As policymakers continue their repair work on the global economy, the prospect of interest rates remaining at their unusually low current levels for a further extended period is a daunting one for insurers. The moderate increase in long-term interest rates we expected a year ago did not materialise. Instead, new lows have been reached. In Germany and Japan, 10-year government bond yields are currently under 0.5 per cent and 0.3 per cent, respectively. U.S. government bond yields have again fallen below 2 per cent. The People's Bank of China has also cut interest rates for the first time since 2012 in response to slowing growth. Exacerbating the problem is the narrowing of credit spreads (U.S. investment-grade corporate bonds currently yield only 3.0 per cent, according to Bloomberg.)

In response, global insurers continue to reallocate capital to higher-growth regions. U.K.-based Prudential plc has transformed its profile since the financial crisis, with Asian profits moving from 1 per cent of its global total in 2008 to 30 per cent in 2013. U.S.-based Prudential Financial Inc. and MetLife are also stepping up their focus on Latin America, most recently in Chile. Japanese life insurers continue to diversify offshore, most recently with Dai-ichi's acquisition of Protective Life in the U.S. Large reinsurers such as Swiss Re and SCOR are deepening their focus on developing markets. Berkshire Hathaway is increasingly targeting Asia-Pacific. Lloyd's also is looking to expand in, and increase its understanding of, developing markets.

Insurers generally have repriced their products upwards, partly to reflect lower expected investment returns, while life players have increased their focus on less interest-sensitive products (unit-linked, variable annuity, variable life, pure protection, health insurance and asset management) and have lowered new business guarantees. However, life policyholders generally place a high value on guaranteed investment returns, even at today's lower levels, and insurers' success in quickly changing the balance of new business towards products with no/low guarantees has been mixed. The profiles of life insurers' back books (where the greater risks lie) take many years to reshape, and the lack of long-dated fixed-income instruments in many major markets gives rise to significant reinvestment risk.

In Europe, Germany—where regulators are reinforcing insurers' own actions—remains in the spotlight. The maximum guarantee allowed by regulators on new business was reduced to 1.25 per cent from 1.75 per cent on 1 January 2015. Furthermore, proposed new profit-sharing rules will restrict the distribution of unrealised investment gains to surrendering policyholders. These supplement the additional reserves (*Zinszusatzreserve* or ZZR) that had to be built for the first time in 2011. Although German life insurers continue to benefit from some flexibility in their crediting rates (the total investment return including the guaranteed portion) and a very stable flow of non-investment-related margins, their business model faces huge challenges. If these companies can't steer customer preferences away from traditional products, a continuation of low interest rates would likely reduce the sector's growth prospects, while the proposed reforms could reduce earnings prospects and financial flexibility.

The reinsurance sector is suffering from low investment yields on two fronts. The direct impact on their income is self-evident, but more importantly, the sector's overall returns in recent years have attracted new investors to catastrophe bonds and other nontraditional vehicles. This is increasingly commoditising the property catastrophe business. Pension funds have made large commitments, but have thus far deployed only a very small allocation of their total funds in the sector. As a result, reinsurers now face their greatest challenge of the past decade. Demand is static, and the soft market (marked by lowering premiums) is spreading to most lines of business. Scale is key for reinsurers to remain relevant, as is reducing dependence on commoditised business. In response, a new round of consolidation appears to be underway.

Insurers continue to search for investment yield. They are generally taking greater, albeit measured, credit and equity risk. Investment portfolios have not radically altered over the past five years, and are still dominated by high-quality, investment-grade, fixed-income, corporate and government securities. We do not expect radical change over the next five years, either. Policymakers have a particularly strong focus on infrastructure projects that have large global finance needs. We estimate that the gap between available public funds and actual global infrastructure spending will be about USD 500bn per year through 2030. Insurers are naturally attracted to this long-term asset class, and policymakers are attempting to facilitate their greater participation. Insurers are also steadily expanding their participation in private placements, mortgage loans, and lending to small and medium-sized enterprises (SMEs). To a modest extent, they are filling the financing void banks have left.

Growth is slowing in developing markets, but insurers face different challenges

Risks are more idiosyncratic in developing markets, although most face slower growth than in the recent past. Slower growth is easing capital pressures, but it remains a rating weakness relative to developed markets. Sector outlooks remain mainly stable, except for some CEEMEA (Central and Eastern Europe, the Middle East, and Africa) markets, which are negative. Growth levels that are still the envy of developed markets' insurers is the primary reason many global insurers continue to shift their regional emphasis here.

China leads the way among the larger economies in terms of premium growth. Its State Council recently announced an insurance penetration target of 5 per cent of GDP by 2020, from just over 3 per cent in 2013. This will require about 15 per cent annual growth in the sector, which we believe is feasible for the next two or three years at least, as the country's emerging middle class lifts demand. However, capital adequacy will still struggle to keep pace, based on our own analysis, and insurers will have to improve products and consumer awareness of risk protection. The finalisation of the China Risk-Oriented Solvency System (C-ROSS) is likely to make the market more sophisticated in its risk assessment and regulatory oversight over the coming few years. We expect it to be beneficial to the industry in the long run.

The Russian economy is operating amid extensive international sanctions that manifest in restricted access to Western capital markets, reduced foreign investment and uncertain business conditions. The drop in economic growth is causing premium volumes to fall.

The decline in oil prices and its potential effect on the growth of Russia, Kazakhstan, Azerbaijan and the Gulf Cooperation Council (GCC) countries are emerging risks for insurers. However, we haven't yet seen any significant reduction in government-sponsored infrastructure projects in these countries. The dominant risk in the GCC remains insurers' exposure to local equity and property markets, although this is mitigated by generally very high levels of capital.

The decline of local currencies against the euro and the U.S. dollar, particularly for Russian and South African insurers, is inflating claims costs because of the reliance on imported goods to service those claims. In response, auto and health insurers have increased premiums.

Economic slowdowns in Mexico and Brazil have hurt insurers' premiums. In Brazil, this is compounded by sluggish credit (and associated insurance product) growth because of its sizable bancassurance distribution channel.

Policymakers' risk aversion compounds the challenges for all insurers

The financial crisis has clearly led to risk aversion among policymakers, primarily in banking and then in the financial sector more broadly. Insurance has seen policymakers pursue improved solvency standards, the systemic

importance designation, recovery and resolution planning, the development of a global capital standard, and new regulations for products and conduct. The upheaval in the way insurers are regulated and supervised does not pose near-term threats to ratings, but it looks set to continue for the rest of the decade and creates a backdrop of uncertainty for insurers, for their investors, and for their ratings.

Policymakers are pursuing improved solvency standards around the world. This was already under way before the crisis in many markets, partly because of the developing International Association of Insurance Supervisors' (IAIS) Insurance Core Principles (ICPs). Post-crisis, the International Monetary Fund's financial sector assessments gave the ICPs even greater influence. We believe the ICPs are positive for the global industry, but we expect a significant increase in aggregate capital requirements as a result, which may force smaller insurers to consolidate. This may not be the case in some markets, such as Hong Kong, where the current requirements lack risk-sensitivity but are very conservative.

The early solvency modernisers in the 2000s were Australia, Canada, the U.K., and Switzerland. Hong Kong, China, and Mexico are among the more recent. Solvency II in Europe is nearing implementation in 2016 after more than a decade of development, albeit with a transition period stretching to 2032 that will soften its initial impact. The Solvency Modernization Initiative continues in the U.S., with particular focus on holding companies and own risk and solvency assessments (ORSAs). However, U.S. state-based regulators remain wary of market-consistent balance sheets and internal models, which are included in the plans of many other regimes. State regulators now have to contend with growing influences from the Federal Reserve, the Financial Stability Oversight Council, and the Federal Insurance Office. The regulatory equivalence feature built into Solvency II in Europe is influencing the new solvency regimes in markets like Singapore, Hong Kong, and China.

While insurers' systemic importance is clear, in our view, their systemic risk is less clear. The nine global systemically important insurers (G-SIIs) face potential capital loadings on their nontraditional noninsurance activities, with a methodology to be designed by the IAIS in 2015. They also face a new global recovery and resolution regime. While this is initially directed at G-SIIs, local regimes are likely to emerge as well. The G-SIIs and 40 or so other internationally active insurance groups (IAIGs) face a new global insurance capital standard (ICS), to be developed by the IAIS by 2016. Most insurers regard this timetable as aggressive, and one prominent regulator called it "reckless". It is not clear at this stage whether and how this will co-exist with local solvency regimes. The G-SII regime, associated policy measures, and ICS are partly transposed from banking regulation and are being orchestrated by the Financial Stability Board, rather than the regulatory community. Most insurers and many regulators question these measures' merits.

The impact on the competitive playing field is mixed. We believe most G-SIIs (and insurers designated as systemic under national regimes) would rather have avoided the designation because of the additional regulatory (and possibly capital) burden. However, it remains to be seen whether systemic insurers can market their unwanted "too big to fail" status as a positive factor in the eyes of their customers and investors. If they can, it could be positive for their ratings.

Most of the regulatory focus globally has been on solvency for the past decade. We believe that the emphasis will swing towards product and conduct regulation over the next decade. EU authorities have reforms in process that include the Packaged Retail Investment Products initiative and the new Insurance Mediation Directive (IMD), which could radically alter product design and distribution. The U.K. has already banned commissions payable to independent intermediaries on retail investment products because of concerns over conflicts of interest, and this is being considered in other European countries. The U.S. Department of Labor is proposing a less radical, but still controversial, move to expand fiduciary standards to those who render investment advice to retirement plans and individual retirement accounts (IRAs). Meanwhile, as consumerism and compensation laws spread around the world, the potential for more instances of damaging product mis-selling grows.

The insurance industry is also prone to direct political risk. This has most recently been demonstrated in the U.K., where the government removed the long-standing requirement to purchase an annuity on the grounds of freedom of choice. Conversely, in Australia the government is considering introducing such a requirement so that retirement funds are not squandered early in retirement, which would place a greater burden on society in the future, but will require reform to influence product design, tax policy, and consumer sentiment.

Global megatrends have a mixed impact, but will take a long time to crystallise

Global megatrends do not present immediate risk to ratings but could influence their direction in the long term. Ageing, climate change and technology fall into this emerging risk category.

Ageing populations should be a net benefit to the industry in the long term. The growth of ageing populations in most developed markets creates problems regarding pension affordability for governments and corporations. Individuals are increasingly responsible for providing their own pensions, and insurers are among the potential beneficiaries.

The frequency of extreme weather events, whether or not a direct result of climate change, is on the rise, and so are losses for insurers. The ratings impact of weather-related natural catastrophes so far has been limited because insurers have comfortably absorbed the losses. We take a favourable view of insurers that are considering the additional challenge that climate change poses in modelling extreme weather events and its implications for exposure management. An increase in the severity and number of extreme weather events could trigger negative rating changes, especially if they severely weaken capital. Over time, insurers should benefit in terms of demand as governments, corporations, and individuals buy more protection.

The rapid pace of technological change is both a threat and an opportunity. To take one "big data" example, car insurers around the world are increasingly using telematics, which monitors driver behaviour using a combination of GPS, sensors and mobile communications. As that practice becomes more widespread, it will begin to challenge the fundamental principle of pooling of risk on which the industry was built, because each policyholder will be charged based on their unique risk. The customary pricing of products based on actuarial analysis of many years of historical data will also likely be less important in the future as insurers will need to supplement such analysis with new disciplines and skill sets. Insurers will need to seize these opportunities while managing a range of threats to survive in the long run.

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

⁺ Martin Eling is Professor for Insurance Management and Director of the Institute of Insurance Economics at the University of St. Gallen, Switzerland. This article is based on a [talk](#) that he delivered at the Insurance & Finance seminar in London on 3 November 2014.

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.

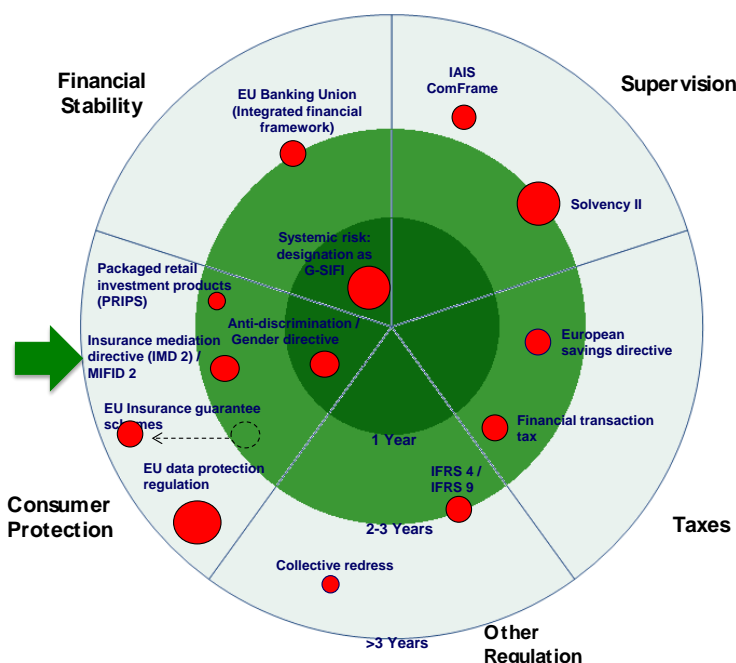
The third implication is inflation. We do not see inflation in the consumer prices at the moment, but we do have inflation in asset prices. One example is the real estate bubble in Switzerland. We also have inflation in asset prices if we look at the stock markets, many of which are at or near their 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 “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 SWI, 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)⁴ 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 Kojien and Yogo (2014)⁵ 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.

⁴ 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.

⁵ Kojien, R. S.J. and Yogo, M. (2014) *Shadow Insurance*, Swiss Finance Institute Research Paper No. 14-64. Available at <http://ssrn.com/abstract=2320921>.

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FORTHCOMING CONFERENCES OF THE GENEVA ASSOCIATION

2015

February

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| 19 | Basel | 31 st Regulation and Supervision (PROGRES) Seminar |
| 20 | Basel | 2 nd International Colloquium on International Capital Standards |

March

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| 6 | Zurich | The Geneva Association/IAIS High-Level Meeting, hosted by The Geneva Association (Board members only) |
| 16 | Sendai | The Geneva Association's Public Forum Event at the Third UN World Conference on Disaster Risk Reduction "Insurance as contributors to problem solving and impact reduction", co-organised with the Tokio Marine & Nichido Fire Insurance |
| 25 | Paris | 17 th Meeting of the Annual Circle of Chief Economists (ACCE), hosted by SCOR (ACCE members only) |

May

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| 13-16 | Singapore | 42 nd General Assembly of The Geneva Association, hosted by the Monetary Authority of Singapore (Members only) |
| 28-29 | Berlin | 16 th Joint Seminar of the European Association of Law and Economics (EALE) and The Geneva Association |

August

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| 2-6 | Munich | 3 rd World Risk and Insurance Economics Congress (WRIEC), organised by EGRIE in cooperation with APRIA, ARIA and The Geneva Association |
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October

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| 20 | Munich | 9 th Geneva Association Meeting of Chief Investment Officers, hosted by Allianz Investment Management (<i>CIO members only</i>) |
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November

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| 16-17 | Singapore | 12 th Health and Ageing Conference on "Insuring health-care for the elderly in Asia", co-organised with the Singapore College of Insurance |
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2016

June

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| 8-11 | Rome | 43 rd General Assembly of The Geneva Association, hosted by the Italian Members (Members only) |
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