



International Association for the Study of Insurance Economics

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Navigating the Minefields in Search of Prosperity

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Navigating the Minefields in Search of Prosperity is a provocative heading for a world insurance congress but it is one I thought appropriate. We are emerging from an almost unprecedented financial crisis and we need to pick our way carefully forward towards prosperity because despite the increasing glow of light ahead, we are not out of the woods yet. Let me just dissect that for you.

The brunt of the credit crisis is over and following a period of very active crisis management and concerns about survival strategies, companies are looking forward with more optimism and getting ready to exploit a post-crisis world where new business opportunities and "prosperity" await.

I mention "minefields" because not everything that glitters is gold and it is very clear that there are potentially some nasty surprises that could hit this nascent growth within our industry as well as the wider world economy on the way to future growth and prosperity.

Finally, "navigation" implies both informed and carefully chosen direction and that requires leadership. We probably need active leadership in our industry more than at any point during the past years. My first boss asked me "What do asset managers do when it rains fireballs? Answer, they put on their steel helmets and crawl under their table." Too true, and I think we saw a fair deal of "crawling under the table" both within and outside our industry during the crisis. But we now need to stand up, switch gears and engage in the opportunities provided by this new paradigm. This will require forward-looking, creative and, yes, enthusiastic leadership.

I would like to navigate my own way through the topic by covering three distinct areas. Firstly, by touching on some of the most relevant features of the general economic landscape; secondly I would like to look at the regulation of financial markets both existing and those that are proposed, and finally I would like to consider the development of insurance.

General economic landscape

It is worth, I suppose, starting off with the good news:

- Despite some of the best efforts of asset bubblers and financial alchemists we did not destroy our global financial system;

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- Governments and central bankers actually did a good job in steering the financial system through the storm;
- Stock markets have been recovering in most countries since spring last year and although they remain somewhat jittery, they appear to be on a relatively firm footing;
- It seems that in most countries, the contraction of the real economy has bottomed out and indeed some are displaying signs of revival; and finally,
- While world trade is still below its peak, the past 12 months have helped the recovery and current monthly growth rates are again above trend.

...and on the downside, the minefields:

- The recovery, in particular of financial stocks, comes on the back of heavy losses and cheap liquidity;
- The recovery is helped by the fact that investors no longer have to contemplate a total meltdown of the financial system as potentially threatening scenario; and,
- There is no guarantee that the current above-trend global trade recovery will remain so robust and that future growth rates will be anything near their last decade peaks again.

Plus, the extraordinary performance of the world economy in the 1990s and the new century has profited from the stabilisation of emerging market economies and the tighter integration of dynamic regions such as the BRIC countries into the global economy. But can Brazil further develop its economy and keep inflation in check? Will Russia fulfil its promise as a reliable producer of raw materials and energy? Can India keep increasing its workforce quality and remain a source of technical talent? Will China remain politically stable and able to sustain its high growth? These are fundamental questions and we would have to answer “yes” to them if we believe that they are going to drive future business development in a dynamic way.

The current economic performance of the West is to no small degree the result of a financial system being pumped with cheap liquidity and massive government infusions—never before has so much money been pumped into financial markets so rapidly. What will happen when this recent high octane transfusion is withdrawn? One has to seriously worry about the effects of liquidity withdrawal.

Indeed, the result of the public interventions in financial and real economy markets has led to an explosion of government debt that is historically only comparable to the levels reached in times of war. Economic history suggests that massive peace-time increments in government debt levels tend to prove enduring and are seldom reduced in an orderly fashion. They tend to create a lot of financial stress and political instability, and will most likely lead to financially induced inflation thereby suppressing future growth rates.

In addition, I am very concerned about the level of government penetration in the financial sector. Not only the direct stake-holdings in so many financial institutions, which somehow need to be wound down, but also the explosive growth of central bank balance sheets. This is coupled with an apparently new creed that more micromanagement, if not direct containment, of the entrepreneurial spirit at financial firms is the right answer to the credit crisis—witness current regulatory discussions such as those on remuneration, etc.

It would be remarkable indeed if the laws of economic gravity were to suddenly reverse and governments turned out to be more efficient generators of growth and prosperity than functioning

markets. History most certainly tells us otherwise, but the temptation for politicians and regulators to meddle much more than would be sensible seems too great—at least for now.

The regulation of financial markets

First, the good news:

- We still have financial markets—this may sound facetious but I fervently believe that we have teetered on the brink of economic collapse at least once during this crisis;
- Banks are still allowed to operate in them—again, to my mind, the consequences of a more serious liquidity and solvency crisis were narrowly avoided;
- Cross-border financial business can still be carried out; and,
- Not all risks have to be collateralised 100 per cent.

You probably think me a serious pessimist or at least a cynic if I qualify the above as good news. However, we carried out some calculations during the height of the financial crisis as to how probable the markets considered a financial melt-down in which large countries such as the U.S. or some leading European governments would default: some relevant indicators shot up way beyond 10 per cent. So let's be happy that we still have functioning financial markets and that they look—at least today—essentially like the ones we had before disaster struck.

My personal view is that 99 per cent of what we do in financial and economic terms is right—or at least it is Pareto optimal: that means it cannot be substituted by anything that would allow better performance at the same risk level or similar performance at less risk.

However, there is 1 per cent that is very, very wrong.

This brings us to the minefields of future financial regulation. Do you believe that politicians and regulators know exactly which 1 per cent is so very, very wrong? Frankly, I have my doubts.

The reason why we should question at least some of the wisdom of the new masters of the financial universe—government bureaucrats—is that unfortunately they contributed their share to the financial crisis we are currently trying so hard to put behind us.

Don't get me wrong: I have little sympathy for large financial conglomerates that split off high-risk business into subsidiaries, choosing preferred supervisors that would not be able to supervise them appropriately, and then ignoring proper risk management in their activities.

And I have even less sympathy for financial firms that believe that slicing and dicing and packaging and repackaging risk to obfuscate any proper understanding of the underlying product might be a sound business model.

However, the amount of damage to our financial and economic infrastructure that stems directly and indirectly from government and regulatory action—and often also inactions—in the run-up to the crisis was considerable indeed, and is something that needs to be addressed too.

In principle I fear two sets of issues: firstly, the political pressure to be seen as proactive in the face of a major disaster, and secondly, the desire for easy solutions.

The former is a little bit like the response of the airline industry to the terrorist threat: generate a lot of fuss where the customer notices it, i.e. create some massive control mechanisms for passengers and their toothpaste, and leave the trickier issues for later, like the screening of all suitcases in a cargo hold or the quantities of flammable liquids available in duty-free.

The desire for easy solutions: my favourite example here is the reaction to the financial crisis that CEIOPS adopted last year when reconsidering the capital adequacy rules for the new Solvency II regime in Europe. (I am not focused on arguing the technical details of a European issue to an international audience here but using it as an example that does have wider implications for insurance.) Solvency II is a new set of very sensible regulations for insurance that has gone through various rounds of quantitative impact studies and which actually addresses some weaknesses that the financial crisis has uncovered. Now this project is succumbing to the allure of easy solutions.

- Despite the fact that there were no systemic threats emanating from insurance operations; and,
- Despite the fact that insurance companies have not failed their policy-holders during the crisis; and,
- Despite the fact that the insurance industry did not have to tap in any significant way government funds like the banks had to do so massively—see The Geneva Association’s SRI Report² for more detail;
- In spite of all of this, suddenly regulators felt that this industry requires considerably more capital. To do what? To survive exactly the type of real-life test we just went through with flying colours using the current capital ratios.

The risk we face in the area of financial regulation is real. Politicians need to act and to be seen to be acting. Not everything that will come out of this process will be efficient. A few of the current initiatives will probably cause more harm than good. And possibly, one of them might bear the fruit of the next crisis in it.

We need to be very vigilant as an industry that the right regulation is implemented. Politicians and regulators need to receive clear signals and support from us when they are addressing the correct issues and opposition and constructive criticism when they are not.

The development of insurance

There is a lot of good news here:

- We just went through the worst financial crisis in over 70 years and did not require massive government help;
- We could prove the resilience of our business model and that sophisticated risk management does not mean running a set of black boxes where nobody can understand the dangers and threats anymore;
- The credit crisis has not questioned the basic business model of the insurance industry—much in contrast to the banking sector;
- Insurance risk-taking and risk-underwriting work;
- There was, and is, no shortage of cover for life or non-life insurance;

² *Systemic Risk in Insurance—An analysis of insurance and financial stability*, March 2010: available for complimentary download at www.genevaassociation.org/Home/Credit_Crisis.aspx

- There is an unprecedented need for insurance and risk management solutions and customers continue to buy insurance; and,
- When it comes to asset management, wealth protection and old-age security, banks have lost an important advantage.

The credit crisis generated enormous interest in financial matters and resulted *de facto* in a public training course in finance and economics. The results are better financial literacy and a more widespread understanding of financial needs. This leads to an increasing realisation that financial planning is necessary and helpful, especially after people had stared into the abyss. The continuing risk-shift from public to private and the problems at banking institutions are opening up more markets for insurance. And finally, recovering growth rates will generate more future business and as the providers of economically superior goods (but not luxury goods in Veblen's sense), insurers stand to profit significantly.

So everything's rosy? Well, I was not invited to make you feel good at the beginning of such an important conference. So here's the minefield:

- We are not realising our potential. Both insurance density and insurance penetration are still offering a lot of room for improvement around the globe;
- We are not exploiting our strengths enough. There are many more opportunities for creative solutions and new insurance products. We also need to interface more closely with governments to create joint solutions and partnerships where purely private markets reach their limits;
- We neglect our future human resources. Insurance has failed to create an attractive image for itself and despite sporting some of the best working conditions of any industry; we are an also-ran for graduates in finance and an unknown for others;
- We have been slow and somewhat timid in pointing out how well insurance fared through the crisis. The Geneva Association has been an early and very vocal institution in this respect but these efforts need to continue and they require sustained company action;
- We have to put more distance between our industry and other financial services providers. Insurance is not banking and insurers are not banks—even if some companies started to carry out banking-type business that turned out to be dangerous and very expensive indeed;
- We need to educate politicians and non-insurance financial regulators and central bankers better about insurance. It is ignorance-of and not opposition-to our industry that creates the biggest risks for future development; and,
- We are too far away from critically important decision processes. When insurance companies are not even truly considered as useful partners for public discussions on the highest level as they are deemed systemically irrelevant then that is a major problem.

Note that I am making a fine but crucial distinction between being *systemically relevant* and a *systemic risk*. Insurance—due to its stabilising nature and the long-term horizon of its business—is systemically relevant but—as the credit crisis has shown—insurance activities are NOT threatening the stability of the financial system. Insurance can help set up more resilient financial systems and play a role that is potentially containing or even decreasing the fall-out from threats to financial stability emanating elsewhere.

And finally, we need to live up to our responsibility: an industry that accounts for more than 7 per cent of world growth and that controls more than 11 per cent of world assets needs to stand tall.

Insurance needs to project its unique knowledge and understanding of risk—of mitigation and adaptation, of management and development—into the public debates.

The most pressing challenges to modern societies and their social, economic and financial fabric are risk issues: from natural catastrophes to old-age security, from man-made disasters to financial markets, from terrorism to basic economic development—it is risk that plays a major role and it is insurance that is the ultimate risk industry.

Ladies and Gentlemen, thank you for your attention!