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Special Issue on G-SII Designations and a Global Capital Standard for Insurance

By Etti Baranoff[+] and John H. Fitzpatrick[++]

This 12th issue of the Insurance and Finance (IF) newsletter goes to press on the eve of the 20th Annual Conference of the International Association of Insurance Supervisors (IAIS) in Taipei. As delegates gather for the conference, the global insurance industry and its stakeholders are digesting the implications of actions taken in July by the Financial Stability Board (FSB) and IAIS as well as the 9 October release by the IAIS regarding its decision to pursue the development of a global insurance capital standard (ICS) for the insurance industry.

To recap, on 18 July, the FSB issued a press release designating nine insurers as global systemically important insurers (G-SIIs). On the same day, the IAIS published important documents that describe the initial assessment methodology, the policy measures to be applied and a paper on macroprudential policy and surveillance.

Taken together the July papers represented a significant new reality for named G-SIIs, internationally active insurance groups (IAIGs) and for the insurance industry as a whole. Most importantly, to many observers it signaled the intent of the FSB to have a global capital standard for the insurance industry for the first time. On 9 October, the IAIS announced its intent to develop a ICS by 2016 for implementation in 2019.

This issue of the IF newsletter draws together a series of articles and editorials exploring this topic of the G-SII designations, their implications and consequences, and the latest news regarding the development of an ICS.

The FSB named the following companies as G-SIIs: Allianz SE, American International Group, Inc., Assicurazioni Generali S.p.A., Aviva plc, Axa S.A., MetLife, Inc., Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc. and Prudential plc.

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Insurers designated as G-SIIs will be subject to enhanced supervision, the requirement to have recovery and resolution plans (living wills), will need to adopt Systemic Risk Management Plans (at one time called Systemic Risk Reduction Plans) and demonstrate higher loss absorbency (HLA) capabilities, e.g. hold higher capital than required by ordinary prudential insurance regulatory standards.

John Fitzpatrick, Secretary General of The Geneva Association, provides a Guest Editorial addressing the apparent motivations and objectives of the FSB and IAIS in developing the first ever Global Capital Standard for insurance. In a sidebar John focuses on the root cause of the financial crash and suggests policymakers focus their attention on addressing the root causes of our recent pain. He also notes the extreme difficulty of trying to create a brand new capital standard in such a short time frame as suggested by the FSB and now the IAIS.

Paul Sharma contributes the next article, giving us his perspective on the assessment process, the activities policymakers are concerned with, the policy measures to be applied and the importance of sound implementation.[1]

The editorial is followed by articles from four CEOs on systemic risk in insurance. In his article "Insurers as SIFIs: A Case of Mistaken Identity?", Steven A. Kandarian, CEO of MetLife, writes a very clear essay questioning the premise that any life insurer could pose a risk to the financial system: "Domestic and international regulators have a legitimate role in overseeing the potential for systemic risk in life insurance companies, but the way to manage that risk is with an approach that focuses on activities rather than institutions. Such an approach would recognise that traditional life insurance companies are not inherently systemic. It would recognise that applying bank-centric capital rules to a few large insurers would result in competitive distortions and harm to consumers."

The article "What It Means to Be Regulated by the Federal Reserve" by Bob Benmosche, President and CEO, American International Group, Inc. (AIG), provides a different perspective by describing day-to-day life with the Fed. In his conclusion, Benmosche stresses that "it is vital that the insurance industry's global, federal and state regulators work in unison to arrive at a regulatory framework that is both robust and consistent. To that end, we look forward to continuing to work with the Fed and other regulators to develop an oversight model for AIG and other large insurance companies."

While reinsurers are not yet on the G-SII-designated insurers list, the article by Dr Dennis Kessler, Chairman and CEO of SCOR, entitled "Why Insurance in General and Reinsurance in Particular Are Not Systemic" sheds light on why regulators have difficulties in including reinsurers on the G-SII list. Dr Kessler emphasises that "reinsurance in particular is by no means a systemic threat—instead, it has stabilising virtues."

The final CEO article is by Michael Diekmann, Chairman of Allianz, who takes a slightly different perspective, arguing that, since insurance is not systemic, the objective of policymakers must be to create a higher level of policyholder protection for society.

Separate from the discussion of G-SIIs and a ICS is an article on the featured insurer of this special issue of the IF newsletter, Munich Re. An interview with Dr Torsten Jeworrek, as representative of Munich Re and his team, highlights the group's unique strengths, responsible operation, creativity, innovativeness and a visionary outlook.

A further article depicts the importance of technology in insurance, the ongoing, consistent challenges of which were underscored by the CEOs in the last IF seminar in London in December 2012.

We hope readers enjoy this 12th special issue on the first designations of G-SIIs by the FSB and the announcement of the IAIS intent to develop a first ever global capital standard for insurance.

[1] After writing this piece, on 20 September 2013, Paul resigned his positions as the Chair of the IAIS Financial Stability Committee, co-Chair of the Basel Committee on Banking Supervision's (BCBS) Macroprudential Supervision Group, and as Deputy Head and Executive Director for Policy of the U.K.'s Prudential Regulation Authority (PRA).

GUEST EDITORIAL

The FSB Objective: Never Waste a Good Crisis

By John H. Fitzpatrick[+]

We have had the benefit of two months-plus since the designations were announced by the FSB and we now have the 9 October statement by the IAIS announcing their intent to develop a global insurance capital standard (ICS) by 2016 for implementation in 2019. Let's take stock of where we are.

The essential facts of the July pronouncements by the FSB and IAIS can be summarised as follows: nine insurers have been named as G-SIIs; for G-SIIs, a "straightforward backstop capital requirement", on which higher loss absorbency (HLA) will be based, is required to be created by November 2014; for all internationally active insurance groups (IAIGs), ComFrame will have a "quantified capital standard", which will be supplanted by the new ICS.

When one considers these announcements in isolation, someone far from the machinations of Basel and the world's financial capitals could miss their significance to the global insurance industry. Yet taken together, there should be no doubt as to the significance of the FSB designations and IAIS pronouncements. The regulators themselves sense the importance of these announcements when Paul Sharma notes in his essay that "the development of the backstop capital requirements will be a significant step forward in the development of international insurance regulation."

In our view, it is clear what the intent of the FSB is. The central bankers of the world want a global capital standard for the insurance industry, and the IAIS has committed to develop it by 2016. It is difficult for central bankers to understand how it is that banks have had Basel I, II, and III, but insurers have never had a global capital standard. Central bankers have struggled with what has been viewed as the failures of global bank capital regimes and supervision, and, in particular, the failings of the most recent years that unfolded into the crisis in 2008. This experience strikes fear in a central banker's heart about an industry some do not know as well as their own and that has never had a global capital standard.

One could ask, innocently, why the insurance industry needs a global capital standard when it has already existing local capital standards that protect policyholders. Did this omission of a global capital standard cause the financial crash of 2008? Clearly not. Five years post the crash, we finally have some agreement on the root cause of this event—government policy regarding housing in the U.S.—and, separately, the causes of its recessionary cousin—the 2010 banking and sovereign debt crisis in Europe. For those interested in some background on the root causes of the financial crash of 2008, please see the side article on this subject below.

Logic suggests that the world's reform agenda would address the root causes of the crash, so we do not have to endure such a painful episode, hopefully, ever again. Determining the root causes of a crash and directly addressing these would seem to be the logical priority of policymakers going forward.

In summary, the evidence points to wrong-headed government policy as the root cause of, first the housing bubble and then its spectacular bust in the U.S. And government policy in Europe contributed its source of a bubble and bust, a monetary union without fiscal union which caused banks and others to flood the peripheral European markets with cheap financing. The wake-up call of the U.S. housing crash in 2008 led to the 2010 eurozone crisis where a dramatically sharp drop in financing to peripheral countries and other credits in the eurozone by banks and others forced governments to provide funding with austerity attached. Generally it takes governments to originate problems measured in the trillions. Of course, such losses were absorbed, not just by banks, but by savers, retirees, pension funds and, those insurers without a global capital standard. They did not originate the crash, but they suffered from the "common shock" of the deflating real estate asset bubble in the U.S. and the decline in asset values in Europe which produced a global recession, a first for our modern world.

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How the FSB planned to get to a global capital standard

The FSB has a broad mandate from the G20 finance ministers to "assess vulnerabilities affecting the financial system and identify and oversee action needed to address them." The FSB members do not want to have to use taxpayer money to bailout banks, securities firms or insurers ever again—to make the world's financial system more stable, a goal we surely endorse. In particular, the FSB wants a system where the failure of a financial institution cannot cause the failure of another financial institution, disrupt financial markets or disrupt the real economy, the essential definition of a systemic event.

As we know, the mission of the FSB does not explicitly include mandating a global capital standard for insurers operating in the world. And it can be hard to argue that the lack of a global capital standard for insurers, in and of itself, created or contributed in a material way to the financial crash in the world. AIGFP would still have happened if there had been a ICS. Nevertheless, not wanting to waste a good crisis, the FSB took action to get something it appears it has always wanted: a global capital standard for insurers in the world. And now the IAIS has committed to develop it.

The FSB had chosen to focus this effort on the nine named G-SIIs where they arguably had the power, through the usual G20 process, to encourage G20 member countries to adopt legislation required to be implemented by insurance regulators in each jurisdiction. Agreement among nine companies and their regulators, in theory, ought to be easier to achieve than among 50 or so IAIGs and their larger and more diverse set of regulators, or for that matter, achieving agreement among all the insurers in the world and their larger set of regulators.

Worth noting is the reported emergence of the U.S. Federal Reserve as a possible new member of the IAIS. It seems clear that the Fed's new role as a regulator of global insurance groups such as AIG, Inc. and Prudential Financial, Inc. and soon others under the Dodd–Frank law, qualifies it for membership in the IAIS. Also important is the Fed's role as chairman of the FSB's Standing Committee on Supervisory and Regulatory Cooperation, the relevant committee with oversight on insurance, in the person of Fed Governor Daniel Tarullo. Clearly the Fed has an interest, and obligation, to set capital requirements for global insurance groups and a leadership role on the FSB. Will this new power at the IAIS push the agenda of the IAIS closer to FSB objectives? We think, yes, it will.

What does the FSB want? Ultimately, no "too big to fail" companies. We actually think the FSB will succeed in insurance, not because they crushed large insurers with sanctions involving enhanced supervision, expensive recovery and resolution plans, and an excruciatingly high level of HLA, but because they will ultimately apply the right policy mix of regulation and supervision to the large insurers in the world, a world that needs balance sheets that can absorb the world's risks, both insurance and investment. We foresee a world where no G-SIIs exist. Why? Because, with the right policy mix, they do not represent a systemic risk to the world.

The FSB has mandated that the G-SIIs carry HLA, a capital requirement over and above existing prudential capital requirements designed to protect policyholders. It is clear that the FSB could simply ask the IAIS to develop HLA equal to a percentage add-on of the existing capital requirements of the activities that are considered systemically risky, activities that are subsets of the non-traditional non-insurance (NTNI) classification that regulators have created for this purpose. But that is not what they pursued.

The current strategy is to pursue the creation of an entirely new capital standard not in use anywhere in the world, a new base-level of capital, referred to on 18 July as a "straightforward backstop capital requirement" now known as BCR. This is to have a common, globally consistent base on which to calculate the HLA for nine global insurers. And by 2016, the IAIS intends to develop the ICS, which will presumably replace the BCR as a base for not just HLA, but as a new worldwide capital standard to be applied to all IAIGs and could in the future through the ICPs apply to all insurers everywhere.

The BCR has variously been described as a "minimal minimal" level of capital, "lower than most jurisdictions current capital requirements," and "somewhere between Europe's Solvency I and proposed Solvency II." The FSB mandate to the IAIS is to develop the BCR by Nov 2014, which, from a practical perspective, means the IAIS must approve the BCR by Sept 2014.

We struggled with this timetable when it was first announced and, two months on, we are more convinced than ever a new capital standard for insurers cannot be developed and proposed, impact assessments created, adjustments made and agreement reached by insurance regulators, and by insurers, all in time for consideration by the FSB and individual finance ministries by the G20's November 2014 meeting. This would set a land-speed record for a brand new capital standard to be set for any financial industry, much less an industry that has never had a global capital standard before. This timetable is made more problematic by the recent resignation of the chairman of the IAIS Financial Stability Committee, the appointment of an acting chairperson and news that a new chairman appointment could take several more months.

Getting agreement on a BCR, in any timeframe, is not an inconsequential matter. What could be the substance of a straightforward capital requirement? It will require the best talents in capital management from both insurers and regulators, with all attention, focus and best intent, to develop and agree on a standard that is fit for this purpose. Again, this will not happen in any overnight fashion, as the schedule handed down from the FSB implies.

Assuming agreement can be reached at some point on BCR, attention then focuses on the application and calibration of HLA, also not an inconsequential matter to the named G-SIIs, which may then include reinsurers, if any are named in June 2014.

And running closely behind is ComFrame, which must now include the ICS, replacing the QCS, which will apply to all IAIGs. Although no direct link between the BCR and QCS existed when announced in July, it may have been clear to policymakers that it would be dysfunctional for there to be no commonality between them. When announced, the QCS was not intended to replace existing local capital requirements. Apparently someone saw the serious complexity of the current multiple existing and proposed capital standards for insurance and concluded it was time to simplify this system.

Hmm...So now it is clear that the intent of the FSB was to drive the development of a global capital standard for insurance.

And, of course, while all this attention is paid to capital standards of BCR, HLA, QCS and now, the ICS, attention will need to be paid to the other consequences and measures to be applied to GSIIs: enhanced supervision, recovery and resolution plans, systemic risk management plans and, last but not least, to the new discussion on macroprudential surveillance and supervision in insurance.

By any measure, this collection of proposals is a prodigious pile of policy for insurers, and their regulators, to consider. The next time you see an insurance regulator or company CFO or CRO, express some sympathy for them as they attempt to manage this considerable agenda, in addition to their day jobs.

And consider it, we will. But always from a position of facts, evidence and research.

While The Geneva Association will respond to this prodigious pile of policy in a careful and thoughtful manner, it will also focus on what really matters for policymakers:

1) Do insurance company resolutions from around the globe evidence disorder or are they orderly? Did an insurance company failure cause the failure of another financial institution, large or small, or disrupt financial markets or disrupt the general economy?

This matters hugely to whether any insurer, doing insurance business, can ever be systemic. And if not, the case for designating insurers as "systemically important" crumbles to a point where no legitimacy exists for sanctions such as HLA. It may just be a tax, for being big, in a business where the law of large numbers and geographic diversification from operating globally clearly reduces risk.

2) What is the right policy mix of supervision and capital and liquidity requirements to minimise the risk of another AIGFP-like situation?

It is clear the world needs precise answers to these important questions and others, so that there is an insurance industry that can perform its traditional function, enabling global growth by taking on insurance and investment risk in a sustainable fashion.

I am reminded of U.S. Senator Daniel Patrick Moynihan's famous quote, "Everyone is entitled to his own opinion, but not his own facts."

Facts should drive policy and, as we at The Geneva Association evidence the facts, it may still do so.

A Short Digression into the Root Cause of the Financial Crash

Logic suggests that the world's reform agenda would address the root causes of the crash so we do not have to endure such a painful episode, hopefully, ever again. Determining the root causes of a crash and directly addressing these would seem to be the logical priority of policymakers going forward.

The good news is that there is finally, five years after the financial crisis, some common understanding of the root causes of the 2008 crash in the U.S. and separately, the causes of its recessionary cousin, the 2010 banking and sovereign debt crisis in Europe.

First, it should be acknowledged that many actors made mistakes, including financial institutions such as banks, mortgage brokers, securities firms and insurance companies. Individuals also made mistakes believing that real estate values only go up and taking on too much leverage in the form of mortgages, credit card debt and car loans. Banks, large and small, made some loans that made sense only in a rising economy, securities firms around 2005 started securitising weaker credits, mortgage brokers pushed some very questionable loans into the system, etc. Some claim that it was under-regulation by Republicans (as then-candidate for president Barack Obama termed it), or the breakdown of Glass–Steagall, or the greed of investment bankers that was the root cause of the crisis. All these things existed and surely, taken together as a group, would have created a recession of some significance. However, the evidence suggests that the magnitude of this recession has as its root cause the long-standing U.S. government housing policies that fuelled one of the greatest asset bubbles of all time and, as night follows day, one of the biggest financial crashes of all time.

From 1938 to 1992, Fannie Mae (and since 1968, Freddie Mac) bought and packaged prime home mortgages without much financial distress through several economic cycles, no small accomplishment given the government policy of an extremely low capital requirement of 2.5 per cent of held whole mortgages and 40 bps of securitised mortgages. In 1992, the U.S. Congress mandated that mortgages be bought from low and medium-income borrowers. The purpose of the mandate was to make home mortgages available to lower-income borrowers so they could share in the American Dream of home ownership. The problem was that there were not enough prime mortgages in this sector relative to the congressionally imposed mandate. So increasing amounts of subprime mortgages started to find their way to Fannie Mae and Freddie Mac's balance sheets, and from there, through securitisations, into investor balance sheets all over the world. This extraordinary availability of mortgage financing, in particular to lower-income borrowers, caused all real estate values to rise, but most particularly, lower-income housing values. Importantly, these rising values allowed subprime borrowers who got into trouble the ability to sell their houses at a gain or refinance, so defaults on subprime mortgages were amazingly low compared to what institutional investors would have expected. Few investors looked beyond the amazingly low default rates which convinced them to pile into these subprime mortgages in a very big way. Private market securitisations added to the enormous appetite for subprime and Alt-A mortgages by investors, causing real estate prices, in the low income sector and generally, to rise even farther.

In 2004, the U.S. Congress demanded that Fannie Mae and Freddie Mac do even more for lower-income Americans and increased the requirement to purchase even lower-income mortgages. This fuelled a great and final phase of the asset bubble as home prices in America marched ever upward into 2006.

When real estate prices finally started their early modest descent in early 2006, investors, analysts and policymakers failed to recognize the severity of the problem. Federal Reserve Chairman Ben Bernanke famously testified on 15 February 2006 that "housing markets are cooling a bit. Our expectation is that the decline in activity or the slowing in activity will be moderate, that house prices will probably continue to rise". Actually, as readers of this newsletter would know, only too painfully, real estate prices in the U.S. went on to decline by 42 per cent as measured by the Case–Shiller Index. Low-income real estate and subprime real estate dropped by much more.

One of the reasons investors, analysts and the Federal Reserve chairman got it so wrong was that Fannie Mae and Freddie Mac's disclosures of their subprime exposure was materially understating their real exposure witness the following U.S. Securities and Exchange Commission (SEC) December 2011 news release:

SEC CHARGES FORMER FANNIE MAE AND FREDDIE MAC EXECUTIVES WITH SECURITIES FRAUD

Washington, D.C., Dec. 16, 2011—The Securities and Exchange Commission today charged six former top executives of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) with securities fraud, alleging they knew and approved of misleading statements claiming the companies had minimal holdings of higher-risk mortgage loans, including subprime loans...The SEC's complaint against the former Fannie Mae executives alleges that, when Fannie Mae began reporting its exposure to subprime loans in 2007, it broadly described the loans as those "made to borrowers with weaker credit histories," and then reported ... less than one-tenth of its loans that met that description.

Clearly, Bernanke had bad information, as did the rest of the marketplace. This is what caused such a large, sharp downward market adjustment to asset prices due to the reported rise of real subprime defaults in 2008.

In summary, while many actors made mistakes that would have caused a recession of some significance, wrong-headed government policy was the root cause of the housing bubble and bust in the U.S. Generally it takes governments to originate problems measured in the trillions. Of course, such losses were absorbed not just by banks, but by savers, retirees, pension funds and those insurers without a global capital standard. They did not originate the crash but they suffered from the "common shock" of the deflating real estate asset bubble.

One could ask, was the financial crash equally as severe in countries that did not have large government-sponsored enterprises (GSEs) affecting housing? The answer is no. Canada and other large countries without such large governmental support for housing did not suffer as badly in the crash, although suffer they did from the size of the U.S. crash and the first worldwide recession that followed.

So much for history on the U.S side.

Of course, Europe contributed its source of a bust, a dramatically sharp drop in financing to peripheral countries and other credits in the eurozone by banks and other institutional investors. Nothing focuses the minds of investors on an unsustainable situation better than big trouble elsewhere. It still took two years for the eurozone crisis to fully unfold to the world. Much has been written about the folly of a monetary union without a fiscal union. So we will spare readers a detailed explanation of the bubble this government-created policy unleashed and its subsequent, predictable and equally spectacular bust in 2010.

Global Systemically Important Insurers: Milestones, Myths and More Work

By Paul Sharma[+]

Introduction

On 18 July 2013, the Financial Stability Board (FSB) published the inaugural list of global systemically important insurers (G-SIIs) and the IAIS published its updated Assessment Methodology and Policy Measures document. This marks a significant step forward in the FSB's agenda for addressing the risks posed by systemically important financial institutions (SIFIs). It is also a milestone for the IAIS, which, for the last two years, has been developing the identification methodology and policy measures. This article summarises the work done on G-SIIs so far and discusses the work that is yet to be done. Along the way, it also dispels some myths about the framework for addressing G-SIIs.

Identification and designation

The designation of G-SIIs was made by the FSB and national authorities based on analyses and advice from the IAIS—the centrepiece of which is a ranking of globally active insurance groups in terms of their systemic

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importance. The ranking is a weighted aggregation of indicators across five categories, with the greatest weight going to non-traditional/non-insurance (NTNI) activity (45 per cent) and interconnectedness (40 per cent). This weighting reflects the widespread consensus that it is the sizeable presence of these features that is more likely to lead an insurer to be systemic. The remaining categories of size, global activity and substitutability each carry a 5 per cent weight.

At present the cohort of G-SIIs comprises life and composite insurers. The G-SII status of, and mitigating measures for, major reinsurers will be finalised in July 2014.

The identification and ranking exercise will be performed annually with the next version of the list expected in November 2014. It will therefore be an ongoing feature of the regulatory landscape, but not an unchanging one. While the methodology requires and will maintain a core stability, it will continue to be refined over the coming years. Its evolution will be driven in part by improvements in the data as both the IAIS and participating insurers gain experience with the data required and put in place better systems to capture it. Developments in accounting and reporting standards should also influence the quality of data.

The methodology will also evolve as our understanding of the nature of systemic risk posed by insurers improves. The Supervisory Judgement and Validation Process (SJVP), which involves the IAIS analyst team talking with supervisors and potential G-SIIs, provides a necessary qualitative overlay to the quantitative ranking. But perhaps even more importantly, it serves as a built-in learning and feedback mechanism to improve the methodology. For example, in the recent designation round's SJVP, in discussing data and results with supervisors and firms, the IAIS learned a lot about how different G-SII candidate's systemic activities were and were not picked up in the methodology, and were able to refine the methodology accordingly. As the insurance business model evolves over the coming years, we expect further such refinements will be necessary.

Non-traditional/non-insurance activity

A fundamental, yet somewhat slippery concept underlying the methodology and the policy measures is that of non-traditional insurance activity (the NT part of NTNI). This brings us to myth number one.

Myth: activities or products that have been done or offered by insurers for a long time and in which they have much experience are traditional and cannot therefore be considered non-traditional.

The dividing line between traditional and non-traditional activity is not the line between that which has been done by insurers for many years and that which has not. Rather it is the line between activity which would likely cause dislocation in the financial system or disrupt economic activity upon distress or failure and that which would not. To help insurers and supervisors think about the traditional/non-traditional divide in a way which encourages adherence to the spirit rather than letter of the exercise, the IAIS has developed three principles:

1) Products that provide credit guarantees to financial products such as securities, mortgages and other traded or non-traded instruments—whether principal or interest—can be considered NTNIs.
2) Policies or products that expose the insurer to substantial market and liquidity risk and require a more complex risk management practice by the insurer in order to hedge those risks and may require substantial, complex and dynamic use of derivatives, can be considered NTNIs.
3) Investment and funding or other capital market activities that result in maturity or liquidity transformation, leverage or imperfect transfer of credit risk such as repo and securities lending, beyond that justified by the scope and scale of conducting traditional insurance activities, can be considered NTNIs.

These principles require G-SIIs and supervisors to exercise judgement in their application. The IAIS will be looking to refine these principles and for ways to ensure their consistent application as it and others gain experience in using them. To that end, further dialogue with industry on NTNIs over the coming year will be important.

Policy measures

Mitigating the risks posed by SIFIs—including insurers—requires multiple measures; none alone can be relied upon to reduce the expected impact of distress or failure to an acceptable level. This reality was recognised in the FSB's trio of SIFI policies[2] which have been developed and tailored to reflect the peculiarities of the insurance business model. *Enhanced supervision* and *higher loss absorbency* are intended to make G-SII distress or failure unlikely. *Improved resolution* is intended to render the unlikely manageable.

Higher loss absorbency

Of the three policy measures, by far the most controversial is higher loss absorbency (HLA). Certainly, beyond designation itself, it is what industry has been most keen to discuss. This brings us to myth number two.

Myth: higher loss absorbency requirements mean G-SIIs must raise and hold more capital than they do at present.

It is important when thinking about HLA to maintain the distinction between *required* capital and *actual* capital held. Most—if not all—insurers aim to hold capital well in excess of their regulatory requirements. There are of course several motivations for this: the desire to avoid supervisory intervention and the benefits of a good credit rating (to secure funding at reasonable cost and to attract policyholders) being two of them. It is entirely possible that the HLA uplift may not threaten a G-SII's capital buffers and so not necessitate it raising and holding more capital.

Further development of the higher loss absorbency requirements will proceed in two stages. The IAIS will first develop *straightforward* backstop capital requirements that will apply to G-SIIs and will be a foundation for developing HLA. Although challenging, especially given the deadline of summer 2014, we anticipate the development of the backstop capital requirements will be a significant step forward in the development of international insurance regulation. And given industry and regulators' concerns that HLA in the absence of a global standard could potentially exacerbate the un-level playing field that exists in terms of capital requirements, any move towards levelling the playing field should be welcome.

The HLA requirements themselves will be announced by end 2015 and will come into effect from January 2019. While the final form and calibration of HLA is not yet known, the intention is to focus HLA on NTNI activity and to give "credit" where such activity has been effectively separated from the rest of the group. Drawing an analogy to a hospital ward illustrates this: traditional activities are not the patients that would introduce a highly infectious disease, but they would be highly susceptible if a disease were to be introduced. Quarantining the likely source of the disease—the NTNI activities—would limit the effect of an outbreak: hence the desire to structure HLA to encourage separation.

G-SIIs could benefit from enhanced supervision and resolution

The enhanced supervision and resolution measures, while less controversial, are no less important than HLA. They build on recommendations and Key Attributes developed by the FSB with alterations/extensions to fit the insurance business model.

Having been designated, G-SIIs—in consultation with their supervisors—must complete several key tasks under these two measures: the development of systemic risk management plans (SRMPs) and recovery and resolution plans (RRPs). While industry has not unambiguously embraced the prospect, development of RRPs can benefit G-SIIs in a number of ways. It will require a G-SII to consciously consider its optimum structure and evaluate the simplest structure that can achieve its business objectives. Developing RRPs will also require substantial information and analysis, possibly beyond that currently produced. Filling these gaps can provide G-SIIs the opportunity to increase their understanding of their own businesses' strengths and vulnerabilities. And finally, the collective process of developing RRPs should result in G-SIIs and their supervisors achieving a greater mutual understanding of the G-SIIs' businesses. It is also an opportunity to develop better, more open communication and working relationships between G-SIIs and their supervisors and among the different jurisdictional supervisors. Development of SRMPs will also contribute to these benefits. SRMPs should describe how a G-SII will manage, mitigate or reduce its systemic risks and will involve similar analysis and consultation between the G-SII and its supervisors.

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2 See the FSB paper: *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions*.

Sound implementation is key

Implemented well, the trio of G-SII measures should go a long way towards mitigating the systemic risks they pose. But sound implementation will require robust analysis, vigilance and willingness on the part of supervisors and G-SIIs, both to ensure effectiveness of the measures within jurisdictions but also consistency of implementation across jurisdictions. To help ensure this outcome, the IAIS is planning a peer review process. Getting to this current point—with G-SIIs identified and a policy framework in place—is a significant achievement, but it is not sufficient to meet the challenge of G-SIIs. Only with bold and diligent implementation will the policy measures reduce the risks posed by G-SIIs and increase the resilience of that part of the financial system they occupy.

Insurers as SIFIs: a Case of Mistaken Identity?

By Steven A. Kandarian[+]

As of this writing, the Financial Stability Board (FSB) was preparing to name the first global systemically important insurers (G-SIIs), and the U.S. Financial Stability Oversight Council had recently designated both AIG and Prudential Financial as systemically important financial institutions (SIFIs), subject to appeal. Is the traditional life insurance business, in fact, systemic?

Life insurers are in the business of insuring against one of the most significant risks that individuals and their families face—the loss of income from death, disability and retirement. Our job is to take on, pool and manage risk, a vital function that individuals cannot perform for themselves. It is also a function where bigger, generally speaking, is better: the larger the risk pool, the more manageable the liabilities.

Under the existing system of insurance regulation in the United States, the life insurance industry has a long history of properly managing risk. In fact, there has never been a systemic event in the traditional insurance space. Now for the first time, the federal government is proposing to undertake prudential regulation of the life insurance industry, or at least a part of it. Similarly, the FSB is expected to propose the first ever global "policy measures" for those firms designated as G-SIIs.

Life insurance is not systemic

I believe three essential truths should govern the debate over regulation of the life insurance industry. First, the traditional life insurance business did not cause the financial crisis. Second, imposing bank-centric regulations on certain life insurance companies—however well-intentioned—would negatively affect the availability and affordability of financial protection for consumers. And third, there is a better way to regulate potentially systemic activities in the life insurance sector than by naming just a handful of companies as SIFIs or G-SIIs.

Understanding why life insurers are not systemic begins with recognition of the critical differences between insurance and banking. Generally speaking, banks borrow short term and lend long term—for example, by taking liquid, short-term deposits and investing in illiquid long-term assets such as mortgages. Life insurers have a different business model. We generally write long-term policies and invest premium dollars in long-term assets to make good on our obligations when they come due. What banks call maturity transformation we call a maturity mismatch.

Liquid liabilities are the kind that can run out the door during a crisis. That is why panicked depositors would line up around U.S. banks to withdraw their money in the days before the Federal Deposit Insurance Corporation (FDIC)—and why we still see bank runs in parts of the world today.

The liabilities of an insurance company are very different. We make payments to customers over many years, as with annuities, or when an insurable event occurs, as with death or disability claims. That is why you will not see a

[+] CEO of MetLife.

"run on an insurer" the way you see a "run on the bank". That is also why life insurer insolvencies take place in an orderly manner over time.

One of the concerns during the crisis was the tendency for financial firms to "fail messily", as former U.S. Federal Reserve Vice Chairman Alan Blinder put it. Yet, because life insurance liabilities are paid out over decades, insurance supervisors are able to manage the receivership process with a minimum of disruption. This does not mean that life insurance companies cannot fail. What it does mean is that the traditional business of life insurance is not systemic.

The Dodd-Frank Act defines a SIFI as a company whose failure "could pose a threat to the financial stability of the United States", while the FSB defines a G-SII as an insurer whose "failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries." Simply put, there is no evidence that any traditional life insurance company meets these tests.

As readers of this newsletter are aware, The Geneva Association recently compared the 28 largest global banks and the 28 largest global insurers on potential indicators of systemic risk. The findings are instructive.

Looking at size, as measured by total assets, the largest insurer would rank as only the 22nd largest bank. Or consider credit default swaps. Gross notional CDS protection sold was US$632bn for the average bank, compared with just US$4bn for the average insurer. For the *largest* bank, the figure was US$2.7tn. For the largest *insurer*, the figure was US$23bn—or less than 1 per cent of the amount sold by the largest bank. There really is no comparison.

With regard to MetLife specifically, the data are equally compelling. In our derivatives book, counterparty exposure to MetLife, net of collateral, is insignificant as a percentage of counterparty total capital. The average exposure in the event of a MetLife default is one-quarter of 1 per cent of a derivative dealer's total capital. The *largest* exposure is three-quarters of 1 per cent of total capital—simply not large enough to create systemic risk.

This is not to deny that life insurers may engage in activities that, if not appropriately regulated, are potentially systemic. It is simply to say that, as an institution, MetLife does not pose a threat to the broader economy. In fact, I cannot see how a single firm would be brought down by its exposure to MetLife.

The wrong capital framework

Under the Dodd-Frank Act, firms designated as non-bank SIFIs will be subject to so-called "enhanced prudential standards". As drafted by the Federal Reserve, these standards are based on the regulatory capital model for banks, where high leverage, illiquid assets and short-term liabilities require large capital cushions to absorb losses.

I recognise that the bank capital framework is familiar to the Fed, whereas the state-based insurance capital framework is not, but no amount of "tailoring" will ever make bank capital standards fit a life insurer's balance sheet. Bank capital rules were established to protect depositors. They were not designed to ensure that a life insurance company can meet its long-term policyholder obligations.

Applied literally to a life insurer's balance sheet, Basel III would constrain the availability and affordability of financial protection for consumers. Faced with unnecessarily large capital requirements, life insurers would either have to raise the price of the products they offer, reduce the amount of risk they take on, or stop offering certain products altogether.

As Anna Paulson of the Federal Reserve Banks of Chicago wrote in March 2012, "Insurers are in the business of sharing risk with individuals [and] businesses. Regulation that makes it more expensive for insurers to do this means individuals and firms will [either] hold more risk, or pay more to achieve the same level of insurance."

For example, under a literal application of Basel III, an insurer's variable annuity business would cause a sharp increase in risk-weighted assets and a reduction in capital ratios, a result disproportionate to the risk life insurers bear in making variable annuity guarantees. It is hard to see how life insurers living under Basel III could remain in the variable annuity business, which would push risk and cost back onto a population in need of retirement income solutions.

To test our assumption that higher capital requirements would raise costs for consumers, we asked the consulting firm Oliver Wyman to analyse the impact of applying Basel III banking rules to certain life insurance companies. Because higher capital charges would require affected firms to raise prices or reduce benefits, unaffected competitors would respond by raising prices as well, given their limited capacity.

Oliver Wyman estimated that the ultimate cost to consumers would range from approximately US$5bn a year to US$8bn a year, either in the form of higher premiums and fees, or lower retirement benefits. At a time when government social safety nets are under increasing pressure and corporate pensions are disappearing, sound public policy should preserve and encourage competitively-priced financial protection for consumers.

Banking regulators have shown a strong ability in the past to recognise the important differences between banks and insurance companies. For example, in 2001, the National Association of Insurance Commissioners (NAIC) and the U.S. Federal Reserve formed a Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage. In their report they stated, “Banking and insurance industry supervisors use very different approaches for identifying and addressing exposure to risks and losses, and to setting regulatory capital charges. The divergent approaches arise from fundamental differences between the two industries, including the types of primary risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities.”

Banking regulators should continue to recognise those fundamental differences as the prudential rules for non-bank SIFIs and G-SIIs are being finalised. As Michael McRaith, Director of the U.S. Federal Insurance Office, said in a 13 June congressional hearing, “I absolutely agree that the insurance industry should not be subject to bank capital standards.”

A better way

Rather than name a handful of life insurance companies as SIFIs or G-SIIs and subject them to additional layers of regulation, a better approach would be to target those *activities* that caused the financial crisis in the first place. Under an activities-based approach, regulators are more likely to capture systemic risk *regardless* of the size of the firm.

An activities-based approach is also consistent with how regulation of the life insurance business is evolving internationally. For example, the IAIS recommended to the FSB that only non-traditional, non-insurance activities—so-called NTNIs—should come under heightened prudential standards. While there certainly will be debate as to which activities qualify as NTNIs, there should be agreement that an activities-based approach would eliminate regulatory “gaps” and provide protection against another financial crisis by subjecting *all* potentially systemic activities to regulatory scrutiny.

Conclusion

The life insurance industry is one of the only sources of guaranteed income that individuals can never outlive. Our role as a provider of income protection should be encouraged, not discouraged. Domestic and international regulators have a legitimate role in overseeing the potential for systemic risk in life insurance companies, but the way to manage that risk is with an approach that focuses on activities rather than institutions.

Such an approach would recognise that traditional life insurance companies are not inherently systemic. It would recognise that applying bank-centric capital rules to a few large insurers would result in competitive distortions and harm to consumers. And it would recognise that preserving robust competition in the life insurance sector is the best way to maximise the availability and affordability of products for those same consumers regulators are trying to protect.

What it Means to be Regulated by the Federal Reserve

By Bob Benmosche[+]

AIG's designation as a systemically important financial institution (SIFI) happened recently, yet our relationship with the Federal Reserve Bank of New York (Fed) is not new. We have been actively working with the Fed in one capacity or another since the latter part of 2008—from the Fed's vital role in AIG's turnaround, to the regulatory efforts aligned with AIG's status as a savings and loan holding company.

AIG shares the Fed's commitment to upholding the highest standards of corporate governance. For us, it is also about having a company that is sound and secure, and that can withstand significant stresses and still meet our obligations. We owe that to our customers, shareholders, employees and broader society.

Let me tell you what it means for AIG to be regulated by the Fed and why we believe it is important to have an open, transparent relationship—not only with the Fed, but also with all the insurance regulators our subsidiaries work with across the globe.

Federal Reserve: creditor then regulator

As a global insurer operating in over 90 countries, AIG is no stranger to regulation. The businesses that make up AIG work with roughly 130 insurance regulators in the U.S. and around the world.

AIG is also no stranger to the Fed. The Fed was our creditor before it was our regulator and worked closely with the U.S. Treasury during the financial crisis to help AIG resolve its liquidity issues, as well as to provide financial flexibility.

AIG repaid the Fed in full in January 2011 and, in September 2012, after the U.S. Treasury's ownership stake in AIG fell below 50 per cent, we came under Fed supervision as a savings and loan holding company. During the period leading up to that, we began preparing for Fed supervision.

I want to emphasise that the actions we took to be "Fed ready" were also actions that AIG needed to take as a company, because it is just good business to be disciplined in everything you do. They were part and parcel of the rebuilding of AIG, complementing transformational initiatives already under way, and all of AIG was engaged in the Fed preparation process. We upgraded practices related to management oversight, governance, transparency and reporting to help AIG manage its business more effectively and efficiently, as well as to meet the Fed's regulatory standards.

However, we do not see this as a one-time process. As AIG's business and the Fed's supervisory programme both evolve, we are committed to being on a path of continuous improvement.

Importance of Fed supervision

AIG is a very large company with a large amount of resources at the holding company. Regulation of insurance company subsidiaries—including requirements for capital and liquidity tailored for insurance companies—is not a substitute for holding company regulation. We believe that all large financial services companies need well-regulated holding companies.

Before the financial crisis, there was no single supervisor examining and regulating all aspects of AIG, and only limited regulation of our group capital and liquidity management. There was no one regulatory body overseeing prudent capital and liquidity management actions during the crisis.

AIG therefore recognises and respects the importance of regulation. From the start, our attitude has been to welcome the Fed as a consolidated regulator overseeing the totality of the company.

One of the concerns people have around the world is who is minding the store. People need to be comfortable that AIG is well-run and has excellent risk management, and that we can support our insurance companies and live up to all of our obligations and promises if a problem arises.

[+] President and CEO, American International Group, Inc. (AIG).

It would be an important statement to customers and to the financial markets that AIG has met the Fed's standards for liquidity and risk management. It would say to the outside world that when AIG says it is strong enough to live up to its promises, the Fed—an independent third party beyond the rating agencies and outside accounting firms—agrees.

The day-to-day

AIG has the same philosophy about working with the Fed as we do with all of our regulators: being transparent, factual and fully cooperative. Open and direct communication on both sides enables us to work effectively and efficiently with our regulators. As I have said to our employees, we cannot resolve a problem if we are not candid about what the problem is.

We are committed to doing everything we can to enable the Fed to learn about us, see how we operate and observe how we as a management team interact, challenge each other and make decisions. Not a day goes by but that we do not have some interaction with the Fed—whether we pick up the phone to give a heads-up on some development, or a member of the Fed team calls us to ask a question, or they attend meetings such as updates with senior leaders on risk, business and regulatory issues.

It is also important for us to ensure that there are no surprises for the Fed. Before anything affecting the strategic direction of the company is made public, we notify the Fed so that they do not hear any announcements about AIG (positive or negative) through external sources first.

Superstorm Sandy is a good example of keeping the lines of communication open—even when the electric lines were down. Sandy flooded five of our office buildings in New York City and affected 11,000 AIG employees in the tri-state area. Yet the people of AIG—despite flooded homes, no power and heat, no access to their offices and a gas shortage—reached out to clients and kept business running smoothly.

The Fed supported us in our response and recovery efforts—allowing AIG to focus first on our employees and policyholders by, among other things, making accommodations such as conducting meetings by phone instead of in person. Throughout it all, we made sure that the Fed and our entire regulatory community received regular updates on our actions, including our business continuity efforts and claims response.

Significance of being a non-bank SIFI

As expected, in July 2013, AIG received notice from the U.S. Treasury that the Financial Stability Oversight Council (FSOC) had made a final determination that AIG would be supervised by the Board of Governors of the Federal Reserve System as a SIFI under the Dodd-Frank Wall Street Reform and Consumer Protection Act. AIG did not contest the designation and welcomes supervision by the Fed.

While the framework for oversight and all of the rules have not yet been completely defined for non-bank SIFIs, we expect that this designation will mean additional regulatory requirements, including heightened prudential standards.

To be successful, this new regulatory framework needs to be based on a precise understanding of the unique characteristics of the insurance industry, the benefits of the parent holding company/insurance subsidiary model and the proven regulatory system that oversees the operating businesses within that model. It must be premised on a clear understanding of the fundamental differences between the insurance and banking industries, and their respective risk profiles.

The framework must also take full account of the direction in which global regulators are proceeding to identify and impose obligations upon global systemically important insurers. Moreover, it is vital that the insurance industry's global, federal and state regulators work in unison to arrive at a regulatory framework that is both robust and consistent. To that end, we look forward to continuing to work with the Fed and other regulators to develop an oversight model for AIG and other large insurance companies.

I think that AIG's brand promise best captures our outlook on the regulatory horizon: "Bring on tomorrow."

Why Insurance in General and Reinsurance in Particular are Not Systemic

By Denis Kessler+

This article summarises and complements an article by Denis Kessler to be published in The Journal of Risk and Insurance.[3]

The traditional model of (re)insurance lacks the elements that make a financial institution systemically important. (Re)insurers that have stuck to this traditional business model have successfully weathered the crisis, even playing a stabilising role. Unfortunately, this is not sufficiently recognised in the current debate on assessing systemic risk in the (re)insurance sector, and the FSB recently designated nine insurers as "systemic". While it plans to assess the systemic nature of reinsurance by next year, it is important to dispel ill-founded fears.

By their very nature, (re)insurer failures pose very limited systemic risk

The failure of a (re)insurer is a relatively rare event and, when it does actually occur, it poses very limited systemic risk.

The main reason explaining why (re)insurer failures rarely spread to the rest of the financial and economic system is the way in which (re)insurers fail. The failure of an insurer is, in general, an orderly and lengthy process that stands in sharp contrast to a typical bank failure. A failing (re)insurance company does not interrupt its contracts overnight, but continues to settle its claims. In most cases, the portfolio is sold to another (re)insurer, as multiple buyers can generally be found easily and quickly. Claims continue to be settled in an orderly manner. The length of the process, along with regulatory provisions, cause supervisors to intervene early on in the process, in order to protect the policyholder.

Another crucial point is that the settlement of claims is guaranteed by the (re)insurer's assets. Regulatory requirements and core professional practices compel (re)insurance companies to hold assets of sufficient quality and liquidity to match cash outflows generated by the company's liabilities.

Furthermore, liabilities are not redeemable on demand like bank deposits, but require a triggering event, the probability of which is independent of the state of the economy—earthquakes are not more frequent in a recession, for example.

More importantly, claims can normally be paid by asset sales, since the maturity mismatch is limited, compared to that generally found in banking. This is mainly because an insurer's core business does not involve maturity transformation, in contrast to that of a traditional bank.

Moreover, in some jurisdictions, a proportion of assets must be "tied" so that they are invested securely, in amounts that precisely match the reserves.

(Re)insurers tend to diversify rather than concentrate risks

The essence of (re)insurance is to diversify risk, through risk sharing and other mechanisms: a (re)insurer's portfolio consists of a large number of uncorrelated risks to keep simultaneous pay-outs at a minimum. The benefits of risk sharing are amplified by diversification with risks taken across a wide variety of countries, sectors and types of policyholders.

Finally, insurance pools cover exceptional risks such as nuclear catastrophes, terrorist attacks and environmental liability. Claims triggered by these exceptional events are shared by all members of the pool, with governments often providing guarantees above certain thresholds.

+ Chairman and CEO, SCOR.

3 Thanks to Kathrin Hoppe for her help in summarising the article.

(Re)insurers keep most of their risks on their balance sheet

In (re)insurance, risks are kept in general on the balance sheet: there is very little moral hazard generated by the dissociation of origination and distribution activities that has recently bedevilled many banks.

One should bear in mind that reinsurance/retrocession always involves only a partial cession of risk, with an average of more than 90 per cent of the risk staying on the ceding (re)insurer's balance sheet.[4] Consequently, (re)insurers carefully and thoroughly screen each and every risk before accepting it.

Those insurers who did have material off-balance sheet exposures were actually undertaking banking activities, such as the writing of credit default swaps (CDSs) for speculative purposes. Some observers might object that the growing use of derivatives by the profession could have destabilising effects. However, this argument misses an essential difference in the way banks and (re)insurers use derivatives, in that many regulators tend to provide (re)insurers with a powerful incentive to use derivatives for hedging purposes.

- **The nature of "leverage" used by (re)insurers in their core activities does not create systemic risk**

Traditionally, banks are highly-leveraged institutions. They finance their assets by borrowing from the markets (investment banks) or from depositors (commercial banks). This makes them particularly vulnerable to crises of confidence. In such cases, a bank has to liquidate its assets at a price potentially well below their fundamental value.

To a certain extent, (re)insurers could also be considered as leveraged institutions. Their assets are only partially self-funded, inasmuch as the bulk of their funding comes from reserves. However, contrary to deposits and wholesale market funding, reserves are not instantaneously puttable and thus cannot be redeemed on demand by policyholders.

Of course, this is not really the case for life insurance, which may be viewed under some circumstances as a savings product with puttability features. However, many mechanisms limit the extent to which a life insurer could experience a sudden and massive withdrawal of funds. Moreover, reserves are usually longer term than the inter-bank or wholesale market liabilities typically used by banks.

- **There is very little liquidity mismatch in core (re)insurance activities**

The very nature of (re)insurance ensures that there is very little liquidity mismatch. By contrast, banks, which borrow short term and lend long term, are extremely vulnerable to market liquidity suddenly drying up.

The story is totally different in the case of (re)insurers. The maturity of their assets usually closely matches that of their liabilities: (re)insurers have a long liquidity position.

- **The traditional (re)insurance model passed the recent crisis stress test**

Thanks to the strengths of its traditional business model, the (re)insurance industry weathered the financial crisis of 2007–2010 with far greater success than other financial institutions.

It should be noted that the insurers that did suffer significantly during the crisis had business models widely different from those of traditional insurance. More than 90 per cent of public rescue funds devoted to the U.S. insurance sector were channelled to insurers with material banking activities.[5]

Another breed of insurers, the monolines, also paid a high price for deviating from the traditional model of risk diversification. Monolines insured undiversified and highly leveraged credit risk portfolios, which were concentrated on structured products, i.e. miles away from the traditional (re)insurance business model.

In contrast to the above-mentioned specific categories of insurers, (re)insurers with traditional business models incurred limited losses and played a stabilising role in the crisis by maintaining positive asset investments.

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[4] The Geneva Association (2010) *Systemic Risk in Insurance, An analysis of insurance and financial stability*, Special Report of The Geneva Association Systemic Risk Working Group, March, p. 25.

[5] Harrington, S.E. (2009) "The Financial Crisis, Systemic Risk and the future of Insurance Regulation", *The Journal of Risk and Insurance,* 76(4): 785–819.

Reinsurance in particular is by no means a systemic threat—instead, it has stabilising virtues

Reinsurance and retrocession have an overall stabilising effect on the insurance industry by shielding insurers from financial difficulties when large losses occur.

Of course, reinsurance and retrocession introduce some interconnectedness among insurance institutions. Since systemic risk usually arises from the propagation of localised shocks to the rest of the financial system through interconnectedness, regulators might focus on reinsurance when addressing systemic risk. However, reinsurance and interbank interconnections widely differ by nature. In the interbank market, risk is strongly concentrated due to a network of very short-term, bilateral exposures, which are significant compared to bank equity.[6] Hence, the failure of a single bank can generate multiple bankruptcies. Most banks are indebted to the very same banks to which they have granted loans. Thus, when a single bank or group of banks fail, other banks may fail in turn, which creates a downward spiral of losses.

The structure of the (re)insurance market is different. It is hierarchical, in the sense that primary insurers cede a single risk to many other reinsurers, which in turn often cede it to different retrocessionaires. But insurers and reinsurers do not usually take back the risks they have ceded. Feedback loops, wherein reinsurers pass a single claim back and forth, thus amplifying its original size, tend to be extremely rare.[7]

For that matter, reinsurer failures also tend to be rare events. In the last 20 years, while several major natural and man-made disasters have occurred (9/11, Katrina), the reinsurance industry has proven its high resilience. What is more, when a reinsurer fails, portfolios are usually sold to other reinsurers, thereby preserving the cover offered to insurers.

Thus, a reinsurer's failure rarely triggers the default of primary insurers. During the period spanning 1969–2009, only 3.2 per cent and 2 per cent of the financial losses of direct non-life and life insurers, respectively, were caused by reinsurance failures.[8] According to a recent study by the *Autorité de contrôle prudentiel* on the French market, the simultaneous failure of all reinsurers would not entail the failure of any insurer.[9]

Conclusion

There is a legitimate desire on the part of regulators to prevent a recurrence of the kind of systemic event we experienced a few years ago. However, putting (re)insurers in the same basket as banks and other financial institutions is misguided, since neither insurance nor reinsurance companies create significant systemic risk, provided they operate within their traditional business models.

In the methodology regulators have developed, too much emphasis is likely to be placed on the absolute size of institutions. This is a problem because what actually generates systemic risk is not size per se but *undiversified* size. Aside from the shortcomings of this methodology, designating systemically important insurers is counterproductive because it constitutes an obvious source of moral hazard. The market may consider that institutions declared as G-SIIs have received a "bail-out certificate", thus providing an incentive to take unreasonable amounts of risk. Such institutions might also benefit from a "flight-to-quality effect" which might increase their size still further compared to the rest of the market. Instead, the focus should be placed on better monitoring of non-core activities and on increased cooperation between regulators.

This is true for insurance companies as well as for reinsurers. The fact that the FSB has postponed the decisions on reinsurance to 2014 is testimony to the fact that reinsurers do not pose any acute or urgent risk to the financial system. Regulators should use this additional lead-time to rethink their approach through an ongoing, in-depth dialogue with the industry.

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6 Upper, C. (2011) "Simulation Methods to Assess the Danger of Contagion in Interbank Markets", *Journal of Financial Stability*, 7: 111–125.

7 International Association of Insurance Supervisors (IAIS) (2012), *Reinsurance and Financial Stability*, special report, July.

8 *Ibid*., p. 12.

9 Frey, L. Tavolaro, S. and Viol, S. (2013), *Analyse du Risque de Contrepartie de la Réassurance pour les Assureurs français*, Débats Economiques et Financiers No 4, Paris: Autorité de contrôle prudentiel (ACP), April.

What Insurers Should Learn from the Publication of the Initial List of Global Systemically Important Insurers (G-SIIs)

By Michael Diekmann[+]

The financial crisis of 2008 has led both politicians and regulators around the world to reconsider a number of policy issues. One of the most burning was the topic of systemic risk and of its appropriate regulation, which became a truly global issue for the first time in 2008 and which—true—for the first time was no longer limited to the traditional banking sector.

Consequently, global financial regulators, in particular, the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (Basel Committee) and the International Association of Insurance Supervisors (IAIS), have, in the aftermath of the global financial crisis, analysed this issue carefully, focusing on the identification and regulation of global systemically important financial institutions (G-SIFIs), which the FSB defined in 2010 as those companies "whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity."[10] Key characteristic therefore of a G-SIFI at that time, from the FSB's point of view, was its ability to cause significant spill-over effects to other financial institutions and its ability to cause a chain reaction within the wider financial market.

While the Basel Committee delivered the regulatory framework for global systemically important banks (G-SIBs) in 2011, it has taken the IAIS until July 2013—much longer than anticipated—to analyse systemic risk in the insurance sector and to develop the assessment methodology and a set of supervisory measures for G-SIIs. This delay was caused, among other things, by the fact that, up to 2008, insurance groups had never played an active role in a systemic crisis and that the IAIS therefore had to do a lot of fundamental research, to which the insurance industry has also contributed extensively. One of the conclusions which the IAIS has drawn from this research was that there is no evidence of traditional insurance either generating or amplifying systemic risk within the financial system or in the real economy, but that only certain non-traditional and non-insurance activities could be a source of systemic risk[11], a conclusion which was shared and supported by the global insurance industry. At the same time, however—and fully aware of the fact that size and global reach lead in insurance to diversification benefits and therefore add to a company's stability[12]—the IAIS has continued to use size and global reach as indicators for systemic risk in its assessment methodology. It was therefore no big surprise that the initial list of G-SIIs, which was recently published by the FSB, comprises a number of the largest insurance groups in the world.

The extensive research done by both the IAIS and the insurance industry over the last couple of years demonstrates that even the default of the largest traditional insurance groups in the world would not cause any significant spill-over effects and a direct contagion of other financial institutions, i.e. a "systemic event" as defined by the FSB in 2010. We acknowledge, however, that a default of such an insurance group could in a worst case scenario affect millions of policyholders or a significant share of a country's population and that one could also label such an event as "systemic". One should note, however, that in the latter case the term "systemic" is used in the context of policyholder protection, while it was used by the FSB originally in the context of financial institutions and financial market protection—which is a very different issue.

The publication of the initial list of G-SIIs by the FSB, as well as the most recent pronouncements made by the FSB, therefore clearly reflect, from our point of view, that politicians, regulators and the public have—because of the event of 2008—changed their mind with respect to the level of security which they pursue, that this holds for all

[+] Chairman of the Board of Management, Allianz SE.

[10] Financial Stability Board (FSB) (2010) *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines*, p.1.

[11] International Association of Insurance Supervisors (IAIS) (2013) Global Systemically Important Insurers: Initial Assessment Methodology, 18 July, p. 9, para.15.

[12] *Ibid.*, pp. 12 & 19.

sectors of the financial services industry and that they are therefore striving to further increase the stability of the largest insurance groups, irrespective of whether the default of a large traditional insurance group could ever lead to the contagion of banks, insurers or other financial market participants.

The publication of the initial list of G-SIIs therefore calls upon insurers to acknowledge this change in society's expectations and to act accordingly. It is now up to the designated companies to continue the dialogue with the insurance regulators and to engage actively on how the proposed policy measures should be designed in detail and how they should be implemented. This holds in particular for the capital requirements which the IAIS has envisaged, but also for a number of the other measures, where it will be essential to come up with solutions which are not simply copied from the banking sector, but which appropriately reflect the peculiarities of insurers' business. The key challenge in the upcoming months will therefore be to make sure that the regulators achieve with the supervisory measures their objective while avoiding any unintended consequences—e.g. the creation of competitive distortions—and while avoiding any unnecessary burden for the affected insurers.

FEATURE INSURANCE COMPANY

An Interview with Dr Torsten Jeworrek about Munich Re

By Etti Baranoff and the Munich Re Team[13]

In April 2013, I had the privilege of conducting a phone interview with Dr Torsten Jeworrek as representative of Munich Re and his team. It was a most enjoyable and illuminating discussion about the world's largest reinsurance company, the hallmarks of which are stability, responsible operation, creativity, innovativeness and a visionary outlook, as the many objects of international contemporary art exhibited at company business locations attest. I hope readers enjoy learning about Munich Re as much as I did.

What are the special qualities of Munich Re?

In the reinsurance field, Munich Re operates in virtually all classes of business. We offer efficient reinsurance of standard risks with significant protection against peak risks, such as those from large natural catastrophes, thanks to our exceptional capacity and top security. Knowing our clients' needs, we also devise individual risk transfer solutions with them to meet their diverse requirements. In doing so, we demonstrate expertise and an appetite for complex risks, and provide state-of-the-art know-how by constantly expanding the limits of insurability. Additionally, our know-how on the reinsurance side enables us to selectively grow in specialty primary insurance, where underwriting and special risk expertise are at the core and where we can leverage our strengths, for example, in operations like our U.S. affiliate Hartford Steam Boiler or the business unit Corporate Insurance Partner.

What sort of size are we talking about in terms of premiums, number of employees, geographical diversification, etc.?

In the financial year 2012, the reinsurance business field performed very favourably, with written premiums totalling €28.2bn and a consolidated result of €3.1bn—both figures clearly surpassing our target. The property-casualty segment contributed €17.1bn in gross written premiums, including €3.8bn stemming from specialty primary insurance. Our life reinsurance operations account for €11.1bn of premium income. In the past year, 11,000 employees were able to offer reinsurance solutions and products to more than 4,000 clients on five continents.

[13] Thanks to Able Michael and Forster Jana Grit for their continuous help.

Figure 1: Munich Re's reinsurance business worldwide—offices and affiliates

Source: Munich Re.

Can you list a few of the highs and lows in Munich Re's history?

Munich Re has a long tradition dating back to April 1880 when Carl von Thieme founded the Munich Reinsurance Company. Von Thieme devised a new strategy: independent of insurers, the company would be able to spread its risks across all geographical regions and classes of business, and operate efficiently with standard treaties and in close partnership with its clients. The strategy worked—business in Germany and the rest of Europe grew rapidly, which helped Munich Re to become the world's largest reinsurer.

In 1906, the first major loss of the 20th century occurred: the earthquake in San Francisco. The loss to the economy came to US$520m, an inconceivably high figure in those days, with Munich Re's share amounting to 11 million marks. The company acted fast to settle losses on the spot and so gained its reputation as a reliable reinsurer. This was mirrored in a saying that became popular after the catastrophe: "Thieme is money", referring to Munich Re's founder Carl von Thieme.

The two world wars posed a serious threat to the company's existence. Assets were lost and activities by German reinsurers outside Germany were prohibited until 1950, thus rendering a geographical spread of risk impossible. With the resumption of international business, Munich Re began a period of renewed expansion.

As the number of natural catastrophes began to rise, the Geo Risks Research unit was set up in 1974 and soon became an indispensable resource for politicians, scientists, industry and insurers worldwide.

How did the corporate structure and corporate governance evolve through the 20th century and in the first decade of the new millennium?

Our business is the professional handling of risk. We create value by using our extensive risk knowledge and sophisticated underwriting techniques to make risks from many different areas of private and economic life manageable. The end of the 20th century was a period in which Munich Re repositioned itself, progressing from being a classic reinsurer to becoming a provider of solutions across the insurance industry's entire value chain.

The new business model is a combination of primary insurance and reinsurance under one roof.

In 1997, ERGO Insurance Group was created, in which Munich Re's primary insurance operations are concentrated and which is now represented in over 30 countries, focusing mainly on Europe and Asia. Since 2009, Munich Re has concentrated its international health expertise in primary insurance, reinsurance and risk management in its new business segment, Munich Health. Munich Re's global investments amounting to €214bn are managed by MEAG [Munich Ergo Asset Management GmbH], which commenced operations in 1999. This branch of our operations also makes its expertise available to private and institutional investors outside the group.

Can you say a few words about Munich Re's financial results over the past five years?

The sovereign debt and financial crisis and the resulting massive capital market turmoil of recent years coupled with the ongoing low-interest rate environment pose considerable challenges for the insurance industry. On top of this, we had exceptionally severe natural catastrophes in the fiscal year 2011, making it the highest-ever loss year on record. Against this difficult macroeconomic background, Munich Re Group has achieved remarkable financial results mirrored, for instance, in a considerable rise in shareholders' equity from €21bn in 2008 to over €27bn in 2012. Our dividend payments have also increased from €5.50 to €7 per share in the same period. On top of that, we exercised further share buy-backs between 2008 and 2011 with a total volume of €3.4bn. As a consequence, the total shareholder return—consisting of share price performance plus capital return—has not only been one of the highest compared to our peers, but also one with the lowest volatility. On the assets side of our balance sheet, we do not take any unreasonable additional risks and only allow investments which are clearly liability-driven and based on our defined risk appetite. Moreover, we have made significant cutbacks in the proportion of investments held in equities and also considerably reduced the influence of value fluctuations by taking active hedging measures. The fact that we have been able to manage the financial market crisis confirms so well that we are on the right track.

What are Munich Re's unique attributes?

We are an underwriting company and that is the area where we have a huge array of knowledge and a high level of expertise. Since an in-depth understanding of risks is the basis of our business, we permanently invest in understanding our risk exposures. Our know-how in capital management is unique and our value-adding services are always closely connected to our core reinsurance business. Munich Re's top financial security and significant capacity are acknowledged in the market and help us to be successful in writing profitable business. Thanks to our presence in all relevant markets, we have achieved an invaluable proximity to our clients, which enables us to provide all the products and expertise we have in the group. It is essential for us to truly understand our clients' needs and proactively offer tailored solutions. This makes us a prime partner for our clients.

How does Munich Re manage the cultural differences in its global operations?

One of Munich Re's key assets is its highly qualified workforce with a large, global underwriting community at its core. Operating according to a decentralised business model with offices spread over all continents, cultural differences are inevitable. We see the diversity resulting from these differences as an opportunity to create a vibrant and productive collaboration between different mindsets, mentalities, backgrounds and areas of expertise. Our highly experienced managers are a key factor in creating for all employees an environment in which their individual expertise and experience help us to deliver the outstanding results we need to maintain our position as market leader.

How does Munich Re contribute to the community through social responsibility activities?

Corporate responsibility, by which we understand a forward-looking and responsible approach in all our activities, is an integral part of our corporate strategy. Besides the responsibility of every single employee, we have defined three focal points for the group: Firstly, to enhance the integration of ecological and social aspects in both our investments and our insurance business, coupled with transparent and responsible corporate governance. Secondly, we focus on our efforts to protect natural resources through our environmental management system and achieve carbon neutrality for the whole group by 2015. And the third focal point is our social commitment. We have underscored our approach to corporate responsibility by signing up to international guidelines. First and foremost among these is the UN Global Compact (UNGC), which we joined in 2007. Guidelines for investments geared to sustainability criteria are provided by the Principles for Responsible Investment (PRI), which we implement via our asset manager MEAG. In recent years, Munich Re has played an active part in developing the Principles for Sustainable Insurance (PSI) of the United Nations Environmental Programme Finance Initiative (UNEP FI). To us, corporate responsibility also means assuming responsibility for the community in which we live and work. The foundations we have set up—such as the Munich Re Foundation, Schinzler Foundation, the ERGO "Youth & Future" Foundation—play an important part, and they contribute substantially to sustainable development throughout the world.

Do you have a special enterprise risk management (ERM) system in place? What are the internal controls and the philosophy behind this system?

Accepting risks is our business, and our risk strategy defines the scope of the risks we assume for our clients and shareholders. The objectives of our enterprise risk management are to protect and generate sustainable shareholder value, to ensure a high degree of confidence in meeting claims and to protect Munich Re's reputation. To ensure that our risk management operates efficiently and effectively, we have established specific risk management functions and committees. Our Integrated Risk Management division supervises risk management group-wide with the support of decentralised structures in all units. It identifies large risks on both sides of the balance sheet, monitors and limits possible accumulations. The Integrated Internal Control System set up in 2008 plays an important role in this regard, as it harmonises the different approaches, while ensuring that the risks assumed are dealt with in the appropriate manner. An important success factor is the range of value-based methods and processes we use to write, control and manage our business. Our most important performance indicator in this context is return on risk-adjusted capital (RORAC), which relates the profit earned to the required risk capital, allowing all activities in the group to be geared to economic value added.

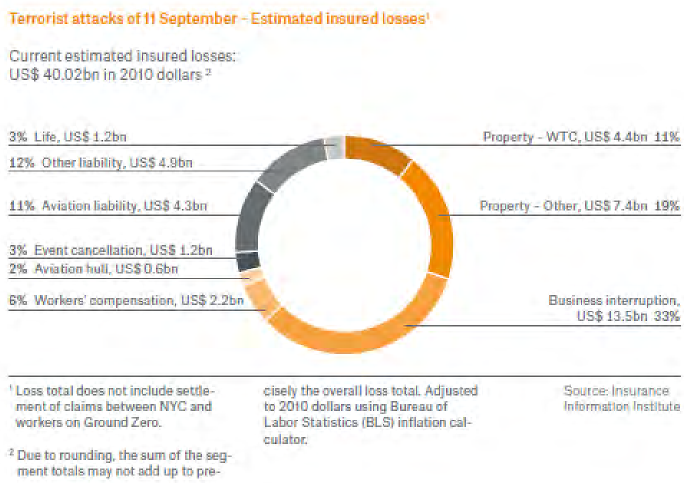
What are the new risks on Munich Re's risk map?

Our early identification of risks also covers emerging risks, i.e. those that arise as a result of legislative, sociopolitical, scientific or technological changes and are therefore liable to have unmeasured or unknown effects on our portfolio. Hence, we follow a multidisciplinary approach, utilising the expertise and experience of all our specialists, including geoscientists, engineers, biologists, underwriting experts, lawyers, economists, sociologists and actuaries. Detailed analyses and assessments of topics such as nanotechnology, pandemics and IT risks are routinely prepared by a dedicated unit for "emerging risks" in place since 2011.

What was the impact (on Munich Re) of 9/11?

What happened on 11 September 2001 fundamentally changed the world of insurance. It became clear that a single event could cause losses affecting a range of different classes of business—an accumulation that had not been considered possible before. The overall insured market loss from the terrorist attacks totals nearly US$40bn (adjusted to 2010 dollars) and constitutes the biggest terrorism loss to date. With a claims burden of US$2.2bn, 9/11 is by far the largest man-made loss event in Munich Re's history.

Figure 2: Terrorist attacks of 11 September—estimated insured losses

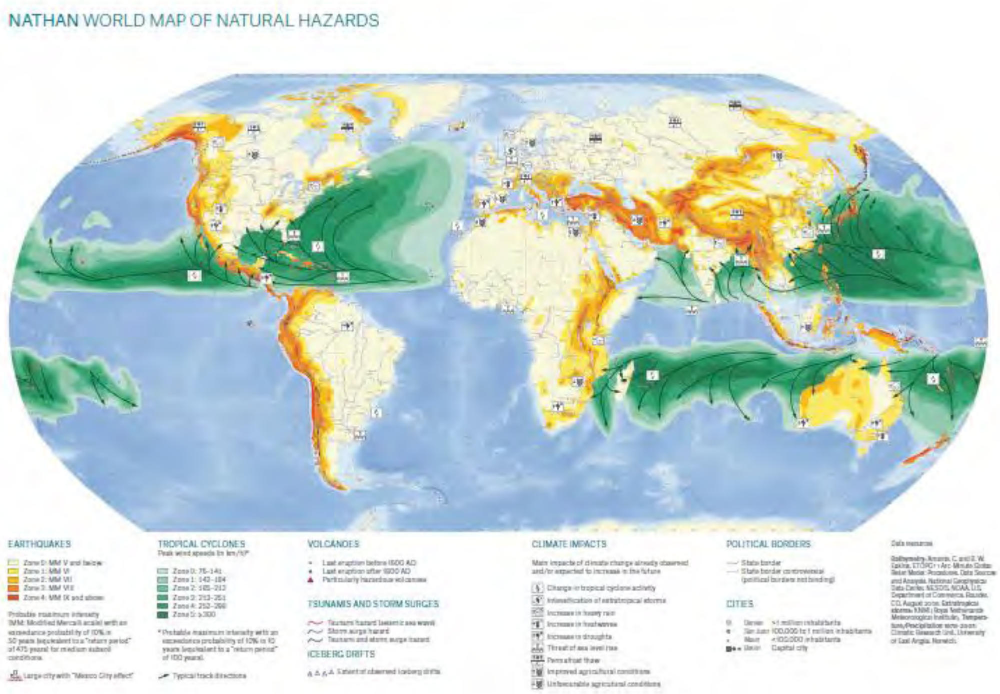


Source: Munich Re.

What has been the impact (on Munich Re) of the natural disasters around the world in the last decade?

The global (re)insurance industry has seen new record losses from natural disasters, both in terms of individual events and annual aggregates. As an example, the years 2005 and 2011 were each hit by insured catastrophe losses exceeding US$100bn. So far, the costliest individual insurance event was Hurricane Katrina in 2005 with total claims of more than US$60bn and a Munich Re share amounting to some 3 per cent of this. The year 2011 was marked by an unusual accumulation of natural catastrophes with earthquakes in Japan and New Zealand and severe floods in Thailand. This led to a €4.5bn loss burden for Munich Re. The sheer dimension of the potential impact on risk carriers' balance sheets makes it clear that technical expertise and a risk-adequate allocation of capital are indispensable preconditions to managing these risks profitably and sustainably. For Munich Re, the reinsurance of natural disasters is a core business segment. We continuously invest in our cat modelling expertise and implement the latest scientific research findings. This includes, for example, findings on natural climate oscillations and non-stationary behaviour of meteorological parameters, which are then included in risk modelling and business processes through our Corporate Underwriting or Integrated Risk Management units.

Figure 3:



Source: Munich Re

How does Munich Re's "corporate art" reflect its business model?

Source: Munich Re Art Collection © Jonathan Borofsky
Photo: Jens Weber, Munich.

Integrating art into our working world and making it accessible at global business locations remains an ongoing objective at Munich Re. Since the mid-1990s, the focus of the Munich Re Art Collection has been on international contemporary art.

To give an example, the "Walking Man", in front of the Munich Re office building, strides forward with long steps, seemingly unstoppable. The purposeful stride and body language suggest a will to set out in search of new horizons and a determination to progress in the original sense of the word.

This is why we think, the "Walking Man" reflects in many ways our vision and strategy.

And finally, do the top executives at the world's largest reinsurer sleep well at night?

I sleep perfectly well at night since I firmly believe we have done our homework at Munich Re and are thus well positioned to face any upcoming challenges.

Technology Trends at Specialty Lines Insurers

By Matthew Josefowicz, Martina Conlon and Steven Kaye[+]

Synopsis

This article provides a look at current technology capabilities and examples of specialty lines insurers' recent initiatives in various technology areas, and examines some of the shifts that technology is driving in the market.

Introduction

On a year-to-year basis, insurers' IT strategies are primarily concerned with addressing known issues: improving speed-to-market for new products and product changes, channelling capabilities to provide better broker and policyholder experience, and improving data management and analytics to drive better performance.

At the same time, specialty insurers need to keep an eye on the future, especially the disruptive potential that changes in the communications and data environment bring to their business model.

This article looks at current capabilities and priorities at specialty lines insurers. It is adapted from several recent Novarica reports, including *Business & Technology Trends: Specialty Lines Insurers* (April 2013) and *Top Five Disruptors in the Next Five Years for Insurers* (January 2013), and focuses on three primary areas: business intelligence, front-end broker and customer communication, and core systems.

Business intelligence

Despite all of the hype around big data and the increasing use of third-party data to support underwriting, business intelligence is still a secondary priority for many specialty carriers. Given the heterogeneity of the average specialty carrier's book of business, extracting meaningful intelligence can prove challenging, so specialty lines insurers are beginning to focus on data stewardship and enterprise relationship views. Business users are participating in data definition committees and carriers are using external data models, with large carriers particularly drawn towards IBM's Insurance Application Architecture. Some vendors have indicated more interest in tools embedded in claims or policy administration systems, possibly because they are easier for business users. While carriers are interested in predictive analytics, it's a much lower priority than simply getting the data in order. This may change in light of issues with cat modelling and the need to price business profitability in a competitive market.

Recent business intelligence initiatives for specialty insurers include XL Insurance Group's implementation of SAS Visual Analytics as the basis for collaboration between analytics team and underwriters, which the insurer sees as a source of competitive advantage.[14] RLI Corp. undertook an event data mining project, pulling data from its various business solutions and correlating that information to present it to the various stakeholders using business terms and measurements to improve operational insight, problem and performance management.[15]

Front-end systems

Agent/broker portals play an important role for specialty carriers. Carriers that use wholesalers or large brokers are generally more focused on creating real-time upload/download capabilities. As one carrier put it, "Saving work for the general agents (GAs) is important. In terms of revenue, if you are easier to do business with and can save that GA effort, you are the more likely partner." But while some distributors welcome a carrier that has a full rate/quote/issue solution, others prefer to use their own rating and issuing capability. They just need carriers' rates

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[14] O'Donnell, A. (2012) "XL Adopts SAS Visual Analytics to Get a Jump on Big Data's Potential", *Insurance & Technology*, 09/12.

[15] Josefowicz, M. (2013) *Best Practices Case Study Compendium 2013*, n.p.: Novarica.

and prefer to pass data back and forth. The challenge is working with a number of different distributors without creating a number of proprietary one-off interfaces.

Some examples of recent investments in these areas include ACE Commercial Services' introduction of its International Advantage portal, which enabled more efficient online policy placement of small commercial international package policies,[16] and Starr Companies' launch of the Starrlink aviation broker portal, providing brokers with access to policy information, the ability to issue new certificates and to view accounts receivable and loss reports.[17]

Specialty insurers are also improving their agent/broker on-boarding capabilities by managing licensing and commissions more effectively. Carriers implement new distribution systems to generally streamline processes, reduce duplication and eliminate paper. Many carriers are using older or customised solutions. In particular, specialty lines insurers are looking to eliminate paper and streamline processing in agency licensing and contract management; modernise the technology to align with a generally more modern architecture; and, often, to use home-grown systems to manage highly complex commission programmes.

An example of a recent initiative in this area is Torus Specialty Insurance Company's creation of a single, comprehensive database of Torus brokers and a complimentary compliance management system to assure that those brokers were properly licensed and appointed to write business in their respective venues. Broker data can now be leveraged across multiple functions such as underwriting, finance, compliance and operations.[18]

Customer portals are tertiary concerns at best for specialty insurers. The very nature of the business makes it less likely that carriers would provide consumer portals. If the bulk of a carrier's business is written on a non-admitted basis or through wholesaler agents, there are limitations on the level of customer interaction the carrier can provide. Those carriers that are providing these capabilities are typically extending self-service capabilities that have been in place for agents for a while.

Core systems

As for many property/casualty insurers, policy administration system upgrades or full replacements are the most common number one priority for specialty carriers. The top concerns for specialty lines insurers are:

- Ensuring that policy administration systems are flexible enough to deal with very complex, tailored policies typical for specialty insurance. This includes an ability to deal with both primary insurance and reinsurance as well as support for product configuration.
- Acquisition and storage of detailed, structured and unstructured, risk data in core systems is a key priority to enable better risk selection and pricing.
- Business process flexibility for elements such as underwriting outside the system or manual endorsements, which means strong BPM or workflow capabilities.
- Support for remote underwriters, which means browser-based solutions are preferred.

Specialty lines insurers are also moving forward with claims enhancements for the same reasons that other property/casualty carriers are doing the same thing: reducing paper, streamlining operations and standardising processes while providing improved customer service are typical reasons cited by carriers for a claims administration project. Manuscript endorsements are more common, providing unique coverages; a variety of deductible types may apply, and special handling may have been sold as part of a programme. In particular, specialty lines insurers are looking for core claims administration systems that increase operational efficiencies and improve data; flexibility to permit handling of multiple lines of business, complex claims and unique coverages; and the ability to track and manage special handling instructions.

16 Business Wire (2012), "ACE Launches International Advantage Web-Based Portal; Offers Streamlined Online Policy Placement for Small Commercial International Package Policies", 13 November.

17 Business Wire (2012), "Starr Companies Launch Aviation Broker Portal", 29 October.

18 Josefowicz, *op. cit*.

Macro-challenges for specialty lines insurers

While most specialty insurers are focusing their short-term IT strategies on addressing shortcomings in their existing capabilties, they are also keeping an eye on three macro-trends: regulation, changing weather patterns and the evolution of big data.

Governments around the world are certainly not shy about imposing new regulations on the insurance industry. More than any specific development, insurers are concerned about the uncertainty of how various regulations will be implemented. Will regulators look to extend the minimums on medical loss ratio (MLR) to other types of loss ratios? What impact will this have on distribution models? How will state privacy regulations affect insurers' abilities to use big data in underwriting and claims? Given all of the uncertainty, insurer IT leaders are focusing on the agility of their systems environment to ensure that products and practices can be brought quickly into line with whatever new requirements are imposed by regulators.

The old saw says insurance is an industry that loses money when the wind blows, and makes money when the wind does not blow. But as the wind blows more and more, insurers are re-evaluating their catastrophe modeling and making sure that they refresh and understand their risk exposures—which requires additional investment in data infrastructure.

Improving the ability to manage risk in a world of shifting weather patterns is only one of the upcoming data-related challenges facing insurers. Dealing with massive volumes of structured and unstructured data is a considerable technology challenge for which most insurers' IT infrastructures were not designed. But beyond the technical challenges, the emergence of big data has the potential to help reshape the industry by shifting the locus of competition among insurers from the ability to gather better information than their peers to the ability to process information better than their peers. While there is widespread concern about this issue, there is limited action by specialty insurers today.

A world of ubiquitous data means that underwriting and loss adjusting could be completely transformed—what does it mean to insurers' operating models when it becomes possible to know everything you need to know about an applicant or claimant from third-party data sources without connecting with their counterparty directly?

In addition, insurers will have a greater ability to pre-select good risks at the top of the underwriting funnel (through more analytics-driven marketing) rather than weeding out bad risks once they are already in the funnel. This could imply significant organisational changes as underwriting needs fewer resources and marketing needs more.

Conclusion

As Yogi Berra famously said, "It's hard to make predictions, especially about the future." But for insurers, a highly probable future has more regulations, more demanding consumers, more challenging investment markets, more catastrophe losses, and much more data to be consumed, managed and analysed effectively.

To meet these challenges, specialty insurers need to invest in data and analytics capabilities to make sure that they remain competitive in the core function of insurers: understanding and pricing risk—however that may evolve. They also need to build agility into their systems and organisations, so they can help their firms "skate to where the puck will be, not where it is"—whether this involves changes in product, internal process, or channels.

THE RESEARCH PROGRAMME ON INSURANCE AND FINANCE

The research programme on insurance and finance comprises academic and professional research activities in the fields of finance where they are relevant to the insurance and risk management sector.

The programme is dedicated to making an original contribution to the progress of insurance through different initiatives in the field of insurance and finance. It engages in: highlighting issues of key importance, promoting studies of the function of finance in insurance, discussing the relevance of financial concepts and instruments to the industry, detecting new and promising theoretical developments and diffusing knowledge and the results of research worldwide.

The Geneva Association

The Geneva Association is the leading international insurance think tank for strategically important insurance and risk management issues.

The Geneva Association identifies fundamental trends and strategic issues where insurance plays a substantial role or which influence the insurance sector. Through the development of research programmes, regular publications and the organisation of international meetings, The Geneva Association serves as a catalyst for progress in the understanding of risk and insurance matters and acts as an information creator and disseminator. It is the leading voice of the largest insurance groups worldwide in the dialogue with international institutions. In parallel, it advances—in economic and cultural terms—the development and application of risk management and the understanding of uncertainty in the modern economy.

The Geneva Association membership comprises a statutory maximum of 90 Chief Executive Officers (CEOs) from the world's top insurance and reinsurance companies. It organises international expert networks and manages discussion platforms for senior insurance executives and specialists as well as policymakers, regulators and multilateral organisations. The Geneva Association's annual General Assembly is the most prestigious gathering of leading insurance CEOs worldwide.

Established in 1973, The Geneva Association, officially the "International Association for the Study of Insurance Economics," has offices in Geneva and Basel, Switzerland and is a non-profit organisation funded by its Members.

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FORTHCOMING CONFERENCES OF THE GENEVA ASSOCIATION

2013

October

28-29	Sendai, Japan	5th CR+I Seminar of The Geneva Association on "Lessons Learned from the Events of 11 March—the Earthquake and Tsunami and its Impact on Human Life, Terrestrial Infrastructure and Consequential Losses", jointly organised with Tokio Marine & Nichido Fire Insurance Co. Ltd.

November

4-5	London	10th Annual Liability Regimes Conference on "Taming the Liability Hydra: Opportunities from Innovations and Expansions of Social Theory", hosted by Lloyd's
5-7	Zurich	9th CRO Assembly, jointly organised with Swiss Re and CRO Forum
18-19	Zurich	10th Health & Ageing Conference of The Geneva Association on "Insuring the Health of an Ageing Population", co-organised with Swiss Re

December

5	New York	Four Pillars Roundtable on "The Retirement Crisis: The Fierce Urgency of Now"

2014

January

14	New York	Joint Industry Forum for P&C Insurance Industry, co-sponsored by The Geneva Association

February

27	Munich	16th Meeting of the Annual Circle of Chief Economists (ACCE), hosted by Munich Re (ACCE members only)

March

24-25	Geneva	30th PROGRES International Seminar on "Growing Complexity and Sophistication of the Multiple Regulatory and Supervisory Regimes in Insurance around the Globe: Are We Safer?"

September

15-17	St. Gallen	41st Seminar of the European Group of Risk and Insurance Economists (EGRIE)
17-18	Washington DC	2nd International Conference on Collateral Risk, co-hosted by the American Enterprise Institute and The Geneva Association