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EDITORIAL

Stability, Sustainability, Markets and Regulation in Insurance

By Etti Baranoff[+]

Stability and sustainability are two concepts that could be regarded as complementing each other. Both are related to markets trends, natural disasters, economic cycles, industrial development and man-made catastrophes. These topics along with regulatory risks are discussed in this issue of the Insurance and Finance (IF) newsletter through a series of eight articles. In this Editorial I provide the links for the articles leading to the conclusion stated in Goto's article:

> "Some risks are beyond an individual firm's ERM: Market-wide problems require market-wide solutions..... Sustainability of affordable insurance coverage is ultimately what an insurer's ERM should achieve. It sometimes requires a collective effort."

This 13th issue of the IF newsletter begins with the feature insurer, IAG (Insurance Australia Group)—the largest general insurer in Australia which represents the future regarding both financial stability and efforts in sustainability. The interview with Mike Wilkins, Managing Director and CEO, IAG took place in November 2013. While financially stable and a successful company, IAG is an innovative insurer in the area of risk mitigation and involvement in the communities. They convened the inaugural IAG Risk Matters Summit at which community stakeholders gathered to agree on the activities to achieve the greatest reduction of risk in their communities. These actions lead to sustainable, disaster-resilient communities, with solutions for the management of risks. The efforts contribute to insurance affordability and deliver tangible benefits to the insurer.

IAG is a leader among the founding signatories to the United Nations Principles for Sustainable Insurance (PSI) in June 2012.

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

Their Chief Strategy Officer was appointed co-chair of the UN PSI Board. The readers are invited to read the complete interview with Mike Wilkins following this Editorial.[1]

To illuminate the great needs in Australia for sustainability, risk mitigation and awareness, is the next article, "The Australian insurance market: key changes since 2011" was written by Rob Whelan, Executive Director & CEO, Insurance Council of Australia (ICA). It describes the challenges posed by the Australian natural environment since 2011—the worst year in memory with eight natural disasters in the continent including cyclone, floods, bushfires and storms. The Australian insurance industry provided a significant response with *"initiatives to adopt a more pro-active approach to disaster mitigation and affordability".* The ICA devised a 10-point plan to help make communities more resilient to extreme events. They focused on a range of measures to be taken by the government and the insurance industry, with the objective to overcome the negative results experienced in 2011. The efforts in Australia to provide affordability and solution to extreme disasters are worth exploring further. Following is an example of innovation for stability and sustainability by IAG for earthquake damage in New Zealand.

House lifts get off the ground

A high-lift hydraulic jack, developed by local firm Smith Cranes and Construction, provides an innovative solution to repairing earthquake damage to customers' homes in New Zealand. IAG was the first insurer to use this system. The home pictured was lifted and held at 2.7 metres for three weeks while the damaged concrete foundation pad was broken up, removed and replaced with a new foundation.

Source: IAG "Our customers and communities".

The next article in this newsletter focuses on insurers' financial stability. Peter G. Gallanis, President, National Organization of Life and Health Insurance Guaranty Associations (NOLHGA), U.S. provides a narrative of his speech delivered on the topic of "Consumer Protection Frameworks and Guarantee Funds" at the 20th Annual Conference of the International Association of Insurance Supervisors in Taipei on 18 October 2013. The remarks about "The "Resolvability of a Major Insurer" lead to the conclusion that insurers' failures do not lead to systemic interruption of economies and financial markets. Peter provides convincing insights into the stability of the U.S. life insurance industry: "… throughout a financial crisis that rivaled in severity the Great Depression of the early 1930s, the failures of traditional insurance companies did not contribute to (let alone cause) the crisis, and neither were traditional insurers drastically affected by it". Gallanis regards the recent crisis as a "real-world, live-fire stress test". "A strong case may be made that the insurance sector was an anchor that kept the crisis from getting worse than it did….There were no 'runs on the bank' at major insurers. There was no 'contagion' among major insurers. There were no fire sales of assets. Insurers quietly held to their course, as did insurance consumers." The real world experiment of the crisis that began in 2008 illuminated the strength and stability of insurers to sustain themselves while providing sustainability to the rest of the economy.

While the traditional insurance products provided stability and sustainability, alternative capital markets products such as catastrophe bonds continued their growth in recent years. These have added capacity to the insurance industry from the capital markets. William Dubinsky, Managing Director and Head of Insurance Linked-Securities at Willis Capital Markets & Advisory (WCMA) provides his private view on the catastrophe bonds markets "Spreading the Load—The Past, Present & Future of Catastrophe Bonds". Dubinsky explains that "Cat bonds fulfil a growing need of insurers and reinsurers looking to trade their peak coverages, which require a lot of capital to sustain. … This has led to a steady stream of capital—and therefore capacity—flowing into the reinsurance space. … In 2000 the amount of capacity for insurance-linked securities (ILS) and related solutions was USD3 billion; at the end of

[1] For more reading about IAG strategy see "A Focus on the Future". Also, to learn more about the UN efforts in the area of sustainability, see "What is Sustainability?" section on United Nations' website. See also UN news such as "Value Driver Model Helps Companies Communicate Financial Impact of Sustainable Business Strategies".

2013, estimates are of an equivalent number of approximately USD50 billion. … This influx has been especially pronounced in the last two years". The cat bonds article is educational as well as adding a layer showing how innovations that enhance the capacity for the reinsurance and insurance industries are aiding in fostering stability and sustainability.

While innovative arrangements and products act to add stability and sustainability with greater capacity from the capital markets, financial markets conditions have presented major difficulties to insurers. Most challenging is the lingering low interest rates environment. Two contributions are included in this newsletter: (1) Mike Earley and Lloyd Ayer, Insurance Strategists, Client Solutions Group, Deutsche Asset & Wealth Management write "Asset Allocation Strategies for a (still) Low Interest-Rate World," and (2) Age Lindenbergh, Partner, KPMG provides a discussion on "Managing Interest Rate Risk in a Changing Regulatory Environment". The emphasis in the first article is on insurers' response to the low interest rates.

> "The traditional responses to a compression of yield in the fixed income market are a move down in credit quality or out in duration. Since the turmoil in the bond markets at the end of June, portfolio managers have been reducing their duration in fear that the low interest rate environment might be ending in the foreseeable future. ... Another approach taken by some more sophisticated insurance companies is the use of derivatives to assemble a synthetic asset allocation that improves yields and reduces duration. … Although it requires the insurance company to invest in strong internal risk management, and even so, regulators will set practical limits".

The second interest rates article by Lindenbergh focuses on "significant capital consumption due to higher provisions and low profitability". He discusses employing hedge programmes and a shift out of interest rate-based towards fee-based products. Also "The move from a Solvency I to a Solvency II world coupled with regulatory change in other fields, such as IFRS and EMIR, creates further complexity both where it relates to hedging and investment strategies".

Closing the newsletter are the articles by Shigeyuki Goto, Head of Group ERM, MS&AD Insurance Holdings "Insurance ERM for New Generations" and that by Kathrin Hoppe and Kunihisa Kawasaki "ComFrame—Quo Vadis?" These articles continue Lindenbergh's reference to the regulation risks which are intertwined with market conditions risks and are challenging the stability of insurers. Goto begins with "Insurers face a daunting task of coping with new and enhanced regulatory requirements … specific to systemically important insurers and internationally active insurers". He regards the challenges as changing the insurers' game and in *"particularly in the field of ERM"*. ERM is essential to sustainability and stability. Goto connects expanded, multi playered ERM to achieving the successes of IAG in that *"Market-wide problems require market-wide solutions. … Sustainability of affordable insurance coverage is ultimately what an insurer's ERM should achieve. It just sometimes requires a collective effort."*

More specific to the regulatory challenges for Internationally Active Insurance Groups (IAIGs) is the article by Kathrin Hoppe and Kunihisa Kawasaki who have been working with the International Association of Insurance Supervisors (IAIS) on the various phases of the ComFrame initiatives.

> "…IAIS announced in October 2013 that it would develop a global insurance capital standard by 2016 to be applied to IAIGs from 2019. Combined with a separate yet closely related announcement that the IAIS would also develop in 2014 a basic capital requirement (previously called a back-stop capital requirement) for G-SIIs (global systemically important insurers), the industry is now faced with two workstreams: The first is a short-term (and perhaps even a temporary) initiative, the basic capital requirement, which is expected to be a non risk-based (i.e. a factor-based) requirement applicable to G-SIIs; the second is what was originally the ComFrame solvency requirement – now called the global insurance capital standard – a mid-term initiative, which was originally expected to come in the form of a risk-based and economic value based requirement (perhaps as a scenario-based requirement based on sensitivity/stress tests)".

These regulatory reforms underway by the IAIS are in part a response to the mandate by the G20, through the Financial Stability Board (the IAIS) to ensure financial stability in all global financial sectors. This is anticipated to grow and mobilise sustainability for future generations.

FEATURE INSURER

Geneva Association Interview with Mike Wilkins, Managing Director and CEO, Insurance Australia Group (IAG)

By Etti Baranoff[+]

The most striking statement by Mike Wilkins during our phone interview in November 2013, was "I believe in the future." Mike Wilkins is a dynamic forward-looking CEO who is able to uncover opportunities and take them as far as possible while advancing IAG success for all its stakeholders. *Realising Opportunities* is the title of IAG annual review[2] for 2013 and it states: "This year, we continued to develop services and products to meet our customers' needs and remained committed to making our communities safer and more resilient, by promoting a deeper understanding and awareness of risk".

Overview: IAG today

IAG is the parent company of a general insurance group with controlled operations in Australia, New Zealand, Thailand and Vietnam, employing over 13,500 people (8,759 are in Australia). IAG has more than 762,000 shareholders. IAG's share register is the fourth largest in Australia. IAG is a top 30 ASX-listed company.

IAG's current businesses underwrite approaching AUD10 billion of gross written premium (GWP) per annum, selling insurance under many leading brands including NRMA Insurance, CGU, SGIO, SGIC and Swann (Australia); NZI, State and AMI (New Zealand); Safety and NZI (Thailand); and AAA Assurance (Vietnam). IAG also has interests in general insurance joint ventures in Malaysia, India and China. Standard & Poor's has assigned a 'Very Strong' Insurer Financial Strength Rating of 'AA-' to the Group's core operating subsidiaries. Across IAG's portfolio of brands IAG insurs 8.4 million cars, 2.9 million homes, 103,000 farms, 123,000 employers and 408,900 businesses. IAG had more than 16.1 million policies in force in financial year 2013.

IAG's ambition is to be the world's most respected group of general insurance companies. IAG's strategy is to manage a portfolio of high performing, customer-focused and diverse operations that provide general insurance in a way that delivers superior experiences for customers and creates value for shareholders.

The Group's strategic priorities are to:

- Accelerate profitable growth in Australia
- Sustain a leading position in New Zealand
- Realise the potential of the Asian platform
- Provide customer-focused delivery and execution
- Leverage cultural strengths

Following is a series of questions with Mike Wilkins' answers:

Q: What are the specialties of IAG? What is its size in terms of premiums, number of employees, geographical diversification, etc.?

The Group has a portfolio of end-to-end businesses aligned around customers, brands and markets. Through this devolved model, accountability and responsibility are close to the end customer.

Australian operations

IAG's Australian operations distribute a range of personal and commercial insurance products, both directly to the customer and indirectly through a network of intermediaries.

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

[2] IAG (2013). *Realising Opportunities*, 2013 Annual Review.

There are two businesses in IAG's Australian operations:

- *Australia Direct* is the Group's largest business. It distributes products through a network of branches, franchises and country service centres throughout metropolitan, regional and rural Australia, as well as through call centres and online. Australia Direct generated GWP of approximately AUD4.6 billion for the year ended 30 June 2013, representing approximately 48 percent of Group GWP.
- *Australia Intermediated*, known as CGU, sells products nationally, through intermediary channels, including a network of more than 1,000 insurance brokers and authorised representatives, as well as through motor dealerships and financial institutions. Australia Intermediated generated GWP of approximately AUD3 billion for the year ended 30 June 2013, representing approximately 32 percent of Group GWP.

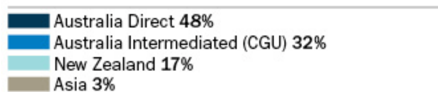
New Zealand operations

IAG is the leading general insurance provider in New Zealand across both the direct and intermediated channels. Insurance products are sold directly to customers predominantly under the State and AMI brands, and through intermediaries (insurance brokers and authorised representatives) predominantly under the NZI brand. Personal lines and commercial products are also distributed under third party brands by IAG's corporate partners, including large financial institutions. New Zealand generated GWP of approximately NZD2 billion for the year ended 30 June 2013 representing approximately 17 percent of Group GWP in that period.

Asia operations

At 30 June 2013, the carrying value of IAG's investment in Asia was approximately AUD820 million. The Group has established a presence in five markets Thailand, Malaysia, India, China and Vietnam.

PORTFOLIO MIX BY BUSINESS – % OF GWP BY BUSINESS FOR THE YEAR ENDED 30 JUNE 2013



PORTFOLIO MIX BY PRODUCT – % OF GWP BY PRODUCT FOR THE YEAR ENDED 30 JUNE 2013

Notes: [1]RACV is via a distribution relationship and underwriting joint venture with RACV Limited. [2]98.6 percent beneficial interest in Safety Insurance. [3]49 percent ownership of the general insurance arm of AmBank Group, AmGeneral Holdings Berhad, whose wholly owned subsidiary trades under the AmAssurance and Kurnia brands. [4]26 percent ownership of SBI General Insurance Company, a joint venture with the State Bank of India. [5]63.17 percent ownership of AAA Assurance Corporation. [6]20 percent ownership of Bohai Property Insurance Company Ltd. For more information please go to http://iag.com.au/about/index.shtml.

Q: What special highlights would you like to share with the readers regarding the financial results in the past 3-5 years?

IAG has performed strongly across the 2013 financial year. The Group's businesses in Australia and New Zealand have recorded further improvement in underlying profitability, along with strong GWP growth. The Asia division has posted a modest profit and is on track to achieve its longer-term financial goals.

Over the past few years we have created a solid platform for growth and have addressed the underperforming areas of our business. Part of this process was the sale of our U.K. business, which was completed in April 2013.

We expect the Group's performance will continue to improve in the 2014 financial year as the momentum evident in 2013 continues. We anticipate sound GWP growth of between 5–7 percent and an insurance margin in the range of 12.5–14.5 percent.

Q: What are the main highlights in the history of IAG that you would like to share with our readers?

From its beginnings as a motor vehicle insurer in New South Wales (NSW), Australia, IAG has grown to become a general insurance group diversified by product, distribution channel and geography. The Group's heritage dates back to 1921, when the National Roads and Motorists' Association (NRMA) was established and subsequently offered motor insurance to its members. In 2000, the insurance arm of NRMA demutualised and was listed on the Australian Securities Exchange. The company was subsequently renamed Insurance Australia Group Limited in 2002 (ASX:IAG).

While IAG's direct heritage dates back to 1925 when the NRMA started providing insurance to its members in NSW and the ACT, through our CGU business, we have been providing insurance services in Australia for almost 160 years.

In New Zealand, NZI is one of New Zealand's largest and most well-known insurance brands, having been established in 1859.

Q: How would you describe your management philosophy?

I try to hire and promote people who I believe have integrity and are authentic people. From an organisational point of view, integrity is about being true to your purpose. For us, that's helping people manage risk and recover from the hardship of unexpected loss. When an organisation has integrity as its foundation, then it's about achieving success in the right way. That is, delivering on the promises or "social contract" we make to our people, customers, shareholders and community, and living up to the standards we set for ourselves.

Attracting and retaining the right people in the right roles and developing capability and a pipeline of leaders are fundamental to our ability to address the challenges of the future. We must harness and build diversity of thought, make our workplaces safer and develop a strong performance culture.

Leaders make decisions based on what they believe is the right thing to do—and sometimes this can be unpopular. They don't feel compromised, because authentic leaders approach life and business in the same way—and treat their customers and people fairly and with respect, and their personal values align with the organisation's values.

Q: How the corporate structure and corporate governance evolved throughout the 20th century and in the first decade of the new millennium?

From an Australian general insurance sector and corporate governance point of view there is a common misconception that the HIH Insurance Group collapse in March 2001 and its aftershocks prompted a reshaping of the Australian general insurance prudential and regulatory framework. In fact, significant legislative change to modify the legislative framework was already underway before the HIH collapse.

However the collapse accelerated reform and change, escalated its perceived importance and public profile, and caused an expansion of the focus on the various aspects of the legal and regulatory framework which were considered to be in need of attention.

A noticeable trend has been the drive to harmonise more and more regulatory requirements across the various sectors within financial services. There are some aspects, such as business continuity and fit and proper where harmonisation makes absolute sense. However, in other areas there are fundamental differences in the types of risks faced by life insurers, general insurers and banks.

We remain concerned about the tendency to transfer regulatory concepts from one sector of the financial services industry to another without differentiating between them. While endorsing harmonisation of prudential regulation across financial sectors, the Australian general insurance industry believes that regulators should take account of sectoral differences:

- General insurance has different risk profile to banking
- General insurance failures can generally be managed over time. Bank failures occur much faster and have the scope to be more disorderly than insurance failures (there can't be a "run" on an insurance company)
- The failure of a general insurer has less severe and more delayed consequences for the wider economy than of a bank so the need to guard against failure is lower

Q: What are the unique attributes that symbolizes the nature of IAG?

To be the world's most respected group of general insurers, IAG not only needs to outcompete in its chosen markets through effective customer value propositions, we also need to be the leaders in the proactive management of risk. To this end we continued to invest in improving the understanding of risk, its prevention, reduction, protection and recovery, ultimately leading to improving resilience.

For many years, IAG has proactively promoted better understanding and reduction of risks on the road, at home, in business and in the natural environment. We believe we have a responsibility to share our knowledge about risk to make communities more resilient and help people live safer lives.[3]

In May 2012, we convened the inaugural *IAG Risk Matters Summit* at which community stakeholders gathered to agree the activities we should lead to achieve the greatest reduction of risk in our communities. Since then, we have made progress against the commitments set. These actions will create more sustainable communities, contribute to insurance affordability and deliver tangible benefits to our business. We will continue to focus our risk reduction efforts on these four areas in the coming years.

In New Zealand, IAG continues to work through the complex issues following the devastating Canterbury earthquakes of 2010 and 2011. We launched a national public education campaign, "need2know", to support homeowners making the change from "open ended" to "specified sum insured" home insurance policies, triggered by the need to provide reinsurers with greater certainty around their natural peril exposure. The scale and depth of this public education campaign were market-leading.

Q: What additional features reflect IAG's management of cultural differences?

Diversity is a key part of IAG's strategy. IAG's diversity ambition is to respect and value the different experiences of IAG's people, and harness the opportunity and business benefits that diverse ideas and perspectives bring to IAG and its stakeholders. Diverse thinking is key to creating a culture of inclusion and ultimately increasing innovation, IAG's ability to service its customers and improve business performance. This approach is supported by an ongoing focus on diversity demographics such as age, ethnicity and, gender.

Q: How does IAG contribute to the communities, social responsibility activities/actions?

To achieve our ambition, of being the world's most respected group of general insurance companies, we need to manage our businesses in a way that out-competes in our core markets and we need to be the leaders in the proactive management of risk. Helping our customers and broader society have a deeper understanding of risk, how to prevent it, reduce it or more effectively insure it—this underpins our business sustainability strategy and is delivered through a focus on the pillars of our people, our customers, our environment and the community.

IAG reports annually on its social, economic and environmental performance against a series of indicators. The quantitative results of IAG's business sustainability performance are incorporated into the company's annual review. This approach to the reporting of IAG's business sustainability performance demonstrates the ongoing commitment to ensuring business sustainability issues are considered as part of IAG's overall performance.

In December 2012, IAG convened the Australian Business Roundtable on Disaster Resilience & Safer Communities, comprising the CEOs of IAG, Australian Red Cross, Investa Property Group, Munich Re, Optus and Westpac Group.

[3] Details about "Risk on the Road;" "Risk at Home;" "Risk in the Environment;" and "Risk In Business" can be obtained from the interviewer.

The Roundtable is working collaboratively with governments to bring about change in public policy and increase investment in building safer and more resilient communities with an aim to improve the capacity of people and businesses to better withstand natural disasters. A White Paper released by the Roundtable in June 2013 contains recommendations for action.

Consistent with this and IAG's purpose, IAG became a founding signatory to the United Nations Principles for Sustainable Insurance (PSI) in June 2012, and in February 2013, IAG's Chief Strategy Officer, Leona Murphy, was appointed Co-Chair of the UN PSI Board. We are the only general insurer across Australia and New Zealand to do so.

The Principles are a framework for the global insurance industry to address environmental, social and governance (ESG) risks and opportunities and seek to strengthen the insurance industry's resilience and its contribution to building sustainable communities and economies.

Signatories to the UN Principles commit to integrating environmental, social and governance issues within their businesses. They are also committed to collaborative action to promote sustainable and disaster-resilient communities, while actively proposing solutions to the management of risks—so there is a very close alignment to our goals.

Insurance industry signatories are working together, as well as engaging governments, regulators, non-government organisations and other stakeholders to work on common environmental, social and governance challenges, to achieve sustainable development outcomes. I am proud to say that we are leading the way in this area in Australia.

The value of having sustainability principles embedded in our normal every day way of doing business has been recognised globally. We have been ranked in the Asia Pacific and Australian Dow Jones Sustainability Indices (DJSI) for eight consecutive years, where we are the insurance industry leader for sustainable business practices.

For a similar length of time, IAG has been included in the Carbon Disclosure Project Leadership Index, for reporting on our carbon emissions and our approach to managing risk and building resilience to extreme weather events and climate change.

IAG has been included in the FTSE4Good Index for nine years now, and we are also one of the only nine Australian companies included in the Global 100 Most Sustainable Corporations in the World. And on the award front, we recently won the Best Insurance Company in Socially Responsible Performance award at the recently held AB&F Insurance awards.

Q: Do you have a special Enterprise Risk Management (ERM) system in place? What are the internal controls and philosophy?

Managing risk is central to the sustainability and resilience of IAG's business and delivery of value to shareholders. Risk is part of business and IAG's risk management framework is based on the interaction of the governance structure, internal policies, key management processes and culture. Some of the key underlying principles that influence IAG's approach to risk management are:

- accepting risk management is not trying to avoid all risks, rather risks need to be identified, understood and assessed against the levels of risk IAG is willing to take and those risks are appropriately managed and monitored
- considering the reasonable expectations of all external stakeholders including customers, shareholders, the community and regulators in considering factors which bear upon IAG's continued good standing
- taking into account IAG's legal and statutory obligations and
- a proactive risk management culture at all staff levels within IAG, providing the foundation for appropriate and sustainable risk management.

While having ERM system capability is critically important, it is just one piece of what is needed rather than a silver bullet. The challenge for all insurers, even those with the most sophisticated systems in place, is in understanding the strengths, weaknesses and key assumptions in the systems and then overlaying the qualitative observations, expertise and experience.

Q: What are the new risks that are included in IAG's risk map?

Since the global financial crisis we have broadened the types of external risks that are considered. However, I think the most significant shift has not been what risks are included, but a move from considering each risk in isolation to consider how the major risks can interconnect to each other. This is being done in a similar way to that used by the World Economic Forum. This "interconnectedness" approach can shift the focus from "how do we manage that specific risk" to "how do we manage this cluster of risks". This approach is an acknowledgement that we now live in a highly connected and dynamic world.

The worldwide liberalisation of trade and capital markets has resulted in Australian businesses being increasingly exposed to international opportunities and competition in our home markets. As such, it is vital that Australia has a regulatory framework which allows business to respond to challenges and developments in the international marketplace.

For international companies to continue to operate globally it will be important to ensure that any changes to international regulation of groups lead to reduction or elimination of regulatory overlaps and more efficient and fair operation of the global marketplace.

Q: What were the impacts of the natural disasters in the past two decades?

In Australia there has been an upward trend in natural disaster costs, particularly since 2000. Importantly, there are a number of factors contributing to the increased economic and community impact of natural perils. We are seeing marked increases in population density generally and especially in areas that are prone to natural disasters (particularly around coastal areas), leading to more damage. In addition to the growing number of properties, the increasing value of building and contents and inappropriate construction play a role. A number of factors make Australia particularly vulnerable to the increased threat posed by climate change. For example, more than 80 percent of Australia's population resides within 50 kilometres of the coast and about one quarter of Australia's population growth occurs within 3 kilometres of the coastline. These communities are particularly exposed to some of the most damaging extreme weather events, such as tropical cyclones, storm surges, windstorms, hailstorms and coastal river flooding.

As will be described in the next article about the Australian general insurance market, 2011 was the worst year on record for natural disasters in this country. Insured losses from catastrophes were around AUD5 billion. Across the Tasman where IAG is New Zealand's largest insurer, the damage bill from the Christchurch earthquakes has now topped AUD30 billion alone.

Q: In conclusion, which special "accolades" would you like to share with the readers about your company?

For more than 10 years, IAG has focused on building a culture where driving sustainable outcomes is ingrained in the way we think and do business. We recognise the essential role insurance plays in society and the economy—we are entrusted to help people, businesses and broader communities manage risks and recover from the hardship of unexpected loss. This responsibility motivates our daily decisions and shapes our actions to ensure the proactive management of risk is an outcome of everything we do, ultimately creating more resilient and sustainable communities.

Q: And finally, as the largest insurer in Australia, how do the top executives of IAG manage to sleep well at night (if they are)? How does the governance structure help?

IAG executives not only sleep well at night, they get up in the morning because they are passionate about helping people manage risk and recovery from loss.

The general insurance industry in Australia is considered a competitive and dynamic sector with ever increasing transparency of pricing and policy features. The Australian insurance sector is serviced by a large number of insurers, providing a wide range of offerings to customers. In this market there is intensive price, service and product competition. Customers have access to a healthy range of products from which to choose. They are able to take advantage of special features such as loyalty and multi-policy discounts. This market is considered to be a stable market, being a consolidated market that is quite disciplined in risk-based pricing of its products.

The Australian Insurance Market: Key Changes Since 2011

By Rob Whelan[+]

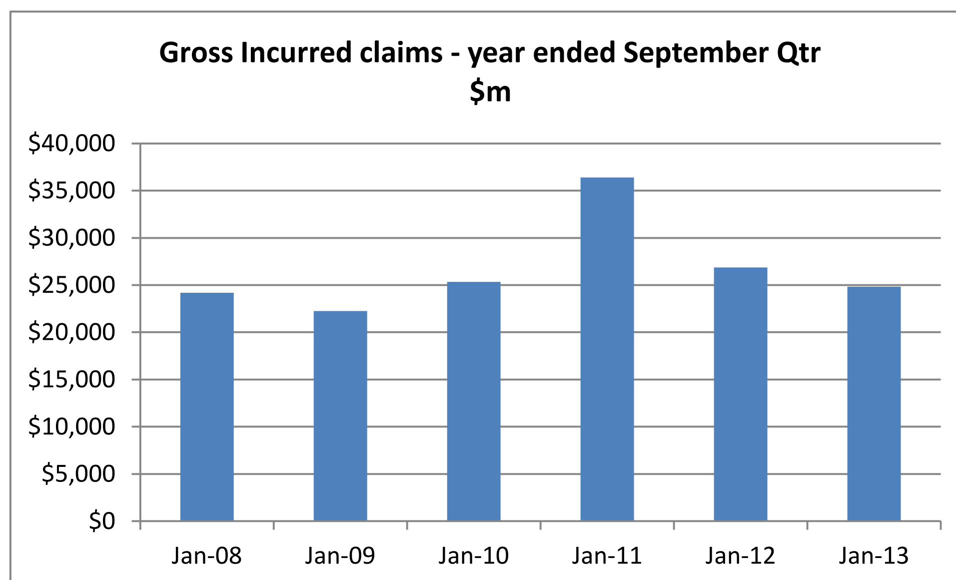
The Australian insurance market: key changes since 2011

Australia, a vast continent, is beset by a range of disasters including floods, cyclones, storms, bushfires and earthquakes. Though Australia has experienced many insurance catastrophes over recent decades—most notably Cyclone Tracy, the Newcastle earthquake and the 1974 floods—2011 was the worst year in memory for multiple natural disasters.

The Insurance Council of Australia (ICA) declared eight catastrophes in 2011, including cyclone, floods, bushfires and storms. These disasters triggered a significant response from the insurance industry and substantial reforms and industry initiatives to adopt a more proactive approach to disaster mitigation and affordability.

The numbers

The private-sector general insurance industry in Australia generates gross premium revenue of AUD39.9 billion a year, has assets of AUD118.1 billion and pays out AUD92.5 million in claims, on average, to policyholders each working day. Following is the chart showing the Gross Incurred Claims in Australia from 2008 to September 2013. As shown, 2011 was the hardest hit year as is discussed later.



Market share and level of competition

The general insurance market in Australia is highly competitive and rigorously regulated, with 122 licensed insurers operating. Four general insurers are listed on the Australian Stock Exchange—Calliden, IAG, QBE and Suncorp.

Newer entrants such as Hollard, AIG, Real Insurance, Youi and Coles are becoming as well known as the traditional dominant players in motor and home insurance. Research commissioned by Accenture Australia found three of the most recognised 12 home insurance providers and five of the top 12 motor insurance providers were challenger brands, with these providers gaining awareness and effective cut through in their market messaging to consumers.

Australia: managing disasters

Over the course of 2011, general insurers stepped up their physical and policy response to an unprecedented number and scope of natural disasters—massive floods and a cyclone in Queensland, two storms and floods in

[+] Executive Director & CEO, Insurance Council of Australia.

Victoria and two large bushfires in Western Australia—leading to total catastrophe-related claims of AUD5.4 billion for the year.

Even as the flood waters receded from two disasters in January 2011, the ICA devised a 10-point plan to help make communities more resilient to extreme events. This focused on a range of measures to be taken by government and the insurance industry, with the aim of preventing future catastrophic weather events having the same impact as those experienced in 2011 including:

- investment in permanent mitigation infrastructure to protect at-risk communities
- introducing a standard definition of flood
- provision of adequate flood data and mapping to regularly inundated areas
- policy and industry initiatives to develop an effective and sustainable response to disasters, inviting government and the industry to engage in a dialogue on how to mitigate the damage caused by future flood events.

According to the Financial Ombudsman Service (FOS), one of the biggest outcomes from the Queensland floods of 2011 and more catastrophic floods in January 2013 was the rapid rollout of flood cover by insurers, and a dramatic reduction in the number of disputes between insurers and customers.

Standard definition of flood

Following the devastation of the 2011 catastrophes, the scope of reforms introduced nationally and in several state jurisdictions is benefiting the wider community and insurers.

The most significant of these reforms was the introduction of a standard definition of flood following 18 months of discussions with the Federal Government. This was an outcome the industry had first tried to achieve in 2008. Today, consumers and insurers have greater peace of mind about flood cover and insurance companies have rolled out flood-based products. More than 90 per cent of residential policies purchased in Australia have flood cover, compared with only 3 per cent of policies in 2006.

Despite the introduction of flood cover, a key issue remains—many of the towns and cities flooded over the past four years will be flooded again unless governments urgently invest in permanent, well-designed and maintained physical mitigation infrastructure.

Self-regulation

The ICA's General Insurance Code of Practice (Code) raises services standards, improves the way that claims and complaints are handled and helps people better understand how general insurance works.

Continuing its commitment to the relationship between consumers and insurers, the ICA Board agreed to changes to the Code in February 2012 to provide clearer timeframes for claims handling, including during declared catastrophes. These came into effect on 1 July 2012.

The ICA also brought forward its triennial review of the Code by 12 months and commissioned a thorough review. A new Code is slated for introduction from July 2014.

The insurance industry worked with Australia's Federal Treasury on the introduction of a one page Key Facts Statement (KFS) to complement plain-English Product Disclosure Statements for home building and contents insurance, with the industry having a two-year transition period until November 2014.

Flood data

Access to affordable insurance is a significant issue for communities that are exposed to extreme weather events such as floods and cyclones, and the ICA is working closely with governments and customers to help them understand insurance risks and work towards practical solutions.

Part of this work involves improving access to flood data around Australia so that insurers can develop more accurate pricing for policies. In most jurisdictions, flood data is collated and managed by local governments and the

ICA is contacting local governments to request flood data for inclusion in its National Flood Information Database, which is used by insurers to determine the flood risk to individual properties.

A Memorandum of Understanding (MoU) between the Queensland Government and the ICA signed in October 2013, shows the collaboration between industry and government. This provides the insurance industry with full access to flood data and sets out a programme of work to help address the issue of insurance affordability in Queensland. It represents a significant step in helping reduce the uncertainty in assessing risk and calculating insurance premiums for Queensland households and businesses.

Community infrastructure

Flood mitigation infrastructure can reduce the impact of flooding and the ICA believes that disaster mitigation is a key area that needs to be urgently addressed; otherwise damage will continue for those in exposed areas, which will be reflected in the price of insurance policies.

Governments in Australia are increasingly focusing on this issue and the construction of permanent mitigation is already leading to the reduction in premiums in flood-prone areas. For example, one Australian insurer slashed the cost of new home and contents policies by an average of AUD400 in Charleville, Queensland, following the completion of flood mitigation works in the town. In Roma, another Queensland town which has experienced consecutive years of floods, an average 30 per cent reduction in insurance premiums is expected following the construction of Stage 1 of the Roma levee.

Land-use planning

Better land-use planning along with physical mitigation are the best ways to help protect at-risk properties. Though this complex area requires effective coordination between federal, state and local governments, the ICA has long encouraged greater communication on this issue. The Queensland Flood Commission identified in its 2012 report that land-use planning which prevents development in inappropriate areas, such as flood plains, will help reduce the impact of natural disasters on new and expanding communities.

Building standards

The ICA believes new properties should be built to withstand natural disasters by revising building standards to improve resilience. The ICA has several resilience programmes in place including the Australian Resilience Taskforce, the Property Resilience Exposure Program and the Building Resilience Rating tool.

An independent study in 2013 into strata-title properties in Tropical Queensland by James Cook University, commissioned by the ICA, recommended these types of properties undergo regular engineering inspections to ensure these properties are resistant to future extreme weather events and to improve understanding of the buildings' potential performance during these events.

Education and financial literacy campaign

Listening and responding to the concerns of policyholders, governments and consumer advocates following the disaster-filled years of 2010-2011, the insurance industry committed to develop its Understand Insurance financial literacy initiative. Launched in late 2013, this is a consumer-friendly and information-rich website supported by social media aimed at empowering consumers and businesses to make better, more informed decisions about their insurance.

Understand Insurance research, conducted by Quantum for the launch of the initiative, revealed a high level of underinsurance in the Australian community.

Tax reform

On tax reform, the ICA believes abolition of all state levies and stamp duties is achievable by 2015 if state and federal governments work together on tax reform.

The Victorian State Government's reform of funding fire services—where it has abolished the Fire Services Levy (FSL) from 1 July 2013—was one of the key recommendations of the Bushfires Royal Commission into the devastating 2009 bushfires in Victoria that killed 173 people. Now funding for fire services is shared across the

community via a property-based charge and not unfairly and inequitably carried by insured policyholders. This reform has resulted in almost universal falls in premiums, with the Fire Services Levy Monitor reporting: "Most brands have averaged a total premium reduction of between 11 and 18 per cent in the Metropolitan Fire Brigade region and between 21 and 35 per cent in the Country Fire Authority region, largely due to the FSL coming out of the total premium".

The New South Wales Government is considering its own steps towards reforming its emergency funding model, issuing a discussion paper in 2012 and embarking on a consultation process in 2013.

In the Australian Capital Territory, the Government announced it would phase out insurance stamp duties over a five-year period, an initiative the ICA would like to see adopted by all states by 2015.

However, in 2012 the Tasmanian Government announced a 2 percentage point increase in the general insurance stamp duty rate to 10 per cent and in 2013, the Queensland Government also increased it stamp duties to 9 per cent effective from 1 August 2013 (up 1.5 percentage points for household policies and 4 percentage points on motor vehicle policies).

It is clear that insurance affordability will be an ongoing issue and governments control many of the fiscal levers that could reduce the costs to consumers.

Insurance Council of Australia

The Insurance Council of Australia (ICA) is the representative body of the general insurance industry in Australia and its members represent more than 90 per cent of total premium income written by private sector general insurers. ICA members, both insurers and reinsurers, are a significant part of the Australian financial services system.

The "Resolvability" of a Major Insurer

By Peter G. Gallanis[+]

The following is an edited version of remarks delivered on the topic of "Consumer Protection Frameworks and Guarantee Funds" at the 20th Annual Conference of the International Association of Insurance Supervisors in Taipei on 18 October 2013. The opinions expressed are solely those of the author and do not necessarily represent the views of NOLHGA or its membership.

When I was an undergraduate, I had the good fortune of meeting and talking with the economist Milton Friedman, who was a longstanding member of our faculty.

A famous classroom teaching practice of his was to respond to a student's observation about how some pattern or practice appeared in the real world by saying, "That's all very well in practice, but how does it work in *theory*?"

Like the Oracle at Delphi in ancient Greece, Professor Friedman sometimes offered cryptic statements that were susceptible of misunderstanding, and this question was like that.

It was interpreted by students in one of two ways:

Some students took it as an assertion that the study of economics—and perhaps even the development of economic policy—was properly concerned more with pure theory than with the empirical lessons presented by transactions and experiences in the real world.

They misunderstood Friedman. What he really meant was that one couldn't properly analyse empirical data—and certainly couldn't predict future performance or develop normative economic standards—without a properly functioning organising hypothesis. Such a hypothesis should explain the available empirical data, and certainly should not be *contradicted* by that data.

+ President, National Organization of Life and Health Insurance Guaranty Associations (NOLHGA), U.S.

As I look at some important recent deliberations about insurance regulatory policy, I wonder which way various policymakers would have interpreted Professor Friedman's statement—"That's all very well in practice, but how does it work in *theory*?"

Would they take it as an assertion that pure theory, untethered to reality, is the key driver in policy decisions; or would they take it to mean that our actionable theories should be drawn from and consistent with real-world evidence?

One of the key issues now before makers of insurance regulatory policy is the "resolvability" of large insurance groups under current laws and processes. It is thought that, if such groups are NOT resolvable under current laws and processes, they must be subjected to significantly different regulatory measures and resolution processes.

And indeed, policymakers—internationally and within some key jurisdictions—appear well on their way to concluding that large insurance groups (most of them writers of traditional insurance products) would *not* be resolvable under current systems.

What do we see in the various explanatory documents and findings relating to policymakers' thinking to date on this key issue? What I read and see are conclusions based almost entirely on theories that themselves rest on supposition, speculation, and assumptions about what would happen if a large insurance entity were to fail.

These theories are sometimes elegantly stated and, for the most part, internally consistent. But what I do NOT see is any convincing effort to relate the theories and their corollary assumptions with relevant real-world experience.

One very proper regulatory initiative since the inception of the financial crisis has been to require large financial entities to conduct "stress tests"—tabletop modeling exercises analysing projected outcomes in hypothetical adverse economic scenarios.

One can learn a lot from such exercises, even though they are only models and only as good as their assumptions.

But it is not widely appreciated that we have just come through a financial crisis—the worst in generations—that was, among other things, the most illuminating and probative "live-fire" stress test that we hope ever to see in our lifetimes.

This real-world stress test showed us much about the regulatory and resolution regimes in place at the start of the crisis.

In the U.S., during the four-year period from the start of 2008 to the end of 2011, we saw over 400 banks and thrifts fail; the largest investment banks *all* failed, were acquired, or reorganised into bank holding companies; Fannie Mae and Freddie Mac went into receivership; a leading money market fund "broke the buck"; two of the top three auto-makers entered bankruptcy; and hundreds of pension plans, hedge funds, and finance companies failed.

And what of the traditional insurance sector? (I speak primarily about the U.S. life insurance market, but the outcomes were substantially similar for general insurance in the U.S. and for both life and general insurance in other countries.)

In the U.S., during that same period (from the start of 2008 until the end of 2011), a grand total of about a half dozen writers of life and annuity business failed. They were all *tiny* companies by the standards of the current regulatory debates. Few of the distinguished insurance experts at this conference would have heard of *any* of them. Their total face amount of liabilities to policyholders amounted to about USD950 *million*—with an "M." Compare that to Lehman Brothers alone, which, when it entered bankruptcy, owed creditors over six hundred *billion*—with a "B". And of that USD950 million owed to consumers, consumers received all but a few million dollars of what they were originally promised.

Stated differently, throughout a financial crisis that rivaled in severity the Great Depression of the early 1930s, the failures of traditional insurance companies did not contribute to (let alone cause) the crisis, and neither were traditional insurers drastically affected by it.[4]

[4] This point is considered generally and at some length in a recent study by the U.S. Government Accountability Office. GAO (2013). *Insurance Markets: Impacts of and Regulatory Response to the 2007-2009 Financial Crisis*. Washington: U.S. Government Accountability Office, June 2013.

This real-world, live-fire stress test revealed no significant causative connection extending from traditional insurance businesses to the financial economy. If there were systemic issues that manifested themselves in the financial economy in the recent crisis, companies writing conventional insurance products did not cause them. Indeed, a strong case may be made that the insurance sector was an anchor that kept the crisis from getting worse than it did.

There were no “runs on the bank” at major insurers. There was no “contagion” among major insurers. There were no fire sales of assets. Insurers quietly held to their course, as did insurance consumers—in this trying recent period, and indeed, before that, even during the Great Depression, as my friend Terri Vaughan has recently written for The Geneva Association.[5]

I make the following observations about why it is no accident that the traditional insurance sector performed as well as it did in the recent financial crisis.

Harking back to Professor Friedman’s challenge—“That’s all very well in practice, but how does it work in *theory?*”—these thoughts are offered as an alternative organising hypothesis that not only explains the available empirical evidence, but that is more consistent with that evidence than some other theories recently articulated.

The hypothesis offered here has everything to do with the focus of today’s discussion: insurance consumer protection frameworks. The thesis is this:

That well-developed insurance policyholder protection schemes—of which our U.S. guaranty system, I submit, is one—that are well integrated with an effective, broad system of protecting consumers against insurer insolvency—not only can and do work to protect consumers and promote financial stability, but can be expected to do so under any reasonably foreseeable real-world “stress” scenarios.

Policyholder protection schemes must meet certain necessary conditions to function well: those conditions involve, among others, articulation of who and what is covered and the extent of coverage; reliable financing sources; statutory tools for crafting an appropriate resolution plan for a given company’s failure; solid processes for developing and implementing a plan; and the human resources needed to do the job.

In one sense, a policyholder protection scheme can be evaluated on the basis of how well it satisfies those necessary conditions. I believe the U.S. guaranty system satisfies them all. The relevant details of the U.S. life and health guaranty system are available at our website, www.nolhga.com.

But beyond those necessary conditions, I submit further that a policyholder protection mechanism can be judged meaningfully only in the context of the *overall* system of insurance consumer protection in its jurisdiction.

U.S. consumers have been well protected over the years not only because we have developed—through trial and error and a lot of challenging experience—an effective policyholder protection scheme—but because several interdependent parts of a *complex* of consumer protection elements combine well to serve the interests of insurance consumers.

Those elements, in brief, are the following:

First, we have a set of established and generally followed business norms for insurer operations that render it highly unlikely that an insurer will fail, even in periods of economic stress. U.S. insurers are not “high fliers”—they are by industry custom and consumer expectation a financially conservative sector that takes seriously the long-term nature of commitments to consumers and the need to underwrite, price, manage, and invest so as to permit performance of the promises the companies make.

Second, we have strong financial regulation that has only gotten better over the years, and that in general does a very good job of requiring the maintenance of appropriately high levels of capital and of spotting and intercepting solvency problems early enough to permit the development of regulatory and resolution plans that minimize and usually eliminate losses to consumers.

[5] Vaughan, T. (2012). *Life Insurance: Providing Long-Term Stability in a Volatile World*, discussion paper prepared for The Geneva Association General Assembly, 7 June 2012.

Third, we have a well-designed and generally effective framework for administering the resolutions of the few insurers that do fail—a receivership framework that effectively prioritizes the protection of consumers by requiring the application of assets of a failed company to the satisfaction of consumer contracts before assets can be used for any other purpose.

Finally, to the extent that, in those rare cases when companies fail and assets are *insufficient* to satisfy contractual obligations, the guaranty system has, over four decades, and in a number of cases (including companies both large and small) always delivered a guaranteed "floor level" of consumer recoveries that is usually augmented—above that floor level—by substantial recoveries from assets of the failed insurer.

The indisputable factual lesson of the financial crisis regarding traditional U.S. insurance markets is that consumers were well served by the interdependent functioning of those four elements: a conservative industry, strong regulation, effective receivership processes, and a capable, well-designed guaranty system "safety net".

My humble prediction is that consumers can likewise expect to be protected under any reasonably foreseeable future circumstances.

Spreading the Load—The Past, Present and Future of Catastrophe Bonds

By William Dubinsky[+]

Those who've walked across a frozen lake know the best way to avoid a dip in the icy water below is to spread your weight across the ice. The same theory applies to risk management.

A policyholder shares a risk with an insurer, who can then share a proportion of the collective risk of some or all of its policyholders with a reinsurer.

A storm brewing…

When Hurricane Andrew hit south Florida in 1992, however, reinsurers were shocked at the pure scale of insured—and ultimately reinsured—losses, which were significantly larger than anticipated.

This led people to look for a way to spread their risk more widely. This occurred against the backdrop of a growing securitisation market, especially in the U.S., principally focused on mortgages and consumer loans.

Pioneers in the market worked to combine securitisation technology with the need of the insurance industry for a wider pool of capital, resulting in the first catastrophe bond (cat bond) transactions.

Cat bonds are insurance-linked securities, i.e. tradable insurance-related financial transactions. In the beginning these deals covered insurers and reinsurers who had the most extreme exposure to peak events, i.e. those that were likely to result in the largest insured losses, such as Florida hurricane and Japanese earthquake.

The earliest pioneers included companies such as Tokio Marine, USAA and St Paul Re, which is now Platinum Re. The transactions themselves would be fairly familiar to practitioners today, in terms of format.

For example, the first deal for St Paul Re, Georgetown Re, was essentially the same as a "sidecar", and the initial deals for Tokio Marine, USAA, and also the California Earthquake Authority were basically indemnity trigger and index trigger cat bonds.

This means that while the community transacting these structures has evolved, the actual transactions themselves have not changed dramatically. Rather the last 15 years has seen incremental tinkering to improve them.

+ Managing Director and Head of Insurance-Linked Securities for Willis Capital Markets & Advisory (WCMA). Dubinsky has authored this article in his individual capacity and its does not necessarily represent the views and opinions of WCMA.

Feeding a need

Cat bonds fulfil a growing need of insurers and reinsurers looking to trade their peak coverages, which require a lot of capital to sustain, to a third party who needs less capital to sustain them. This has led to a steady stream of capital—and therefore capacity—flowing into the reinsurance space.

The influx of capital has been significant. In 2000 the amount of capacity for insurance-linked securities (ILS) and related solutions was USD3 billion; at the end of 2013 we think an equivalent number is approximately USD50 billion.

If you can't beat 'em, join 'em

This influx has been especially pronounced in the last two years, and has begun to have a significant effect on parts of the catastrophe reinsurance market. Capacity flowing in from the capital markets is now resulting in price reductions across various lines of business, being particularly pronounced on lines unaffected by catastrophe losses.[6] The sheer volume of capacity currently in the market has now, however, got to an extent where it is resulting in price stabilisation on many loss-affected lines as well as, as some traditional reinsurers try to retain business.

Others have evolved into hybrid third party capital managers, setting up sidecars to take investor's capital and use their underwriting expertise to deploy the capital profitably and taking a fee for their trouble.

So why is there so much interest from investors in insurance risk? Primarily many investors are seeking investments where default risk is largely uncorrelated to the rest of the investment market. Insurance risk, unlike equity in actual insurance companies, is largely uncorrelated to the rest of the stock market. If the U.S. stock markets drop 20 percent in a quarter, the drop will not cause a natural catastrophe. Similarly, even though natural catastrophes can cause devastating losses to people and property, they tend to have little if any impact on the broader financial markets.

So where are we now?

With approximately USD17 billion of cat bond capacity producing an equivalent amount of collateralised capacity, the cat bond market has grown significantly from its mid-1990s origins. The market is largely driven by U.S. primary insurers; with 11 of the top 15 U.S. insurers by premium volume having accessed the cat bond market.

European reinsurers including Swiss Re, Munich Re and SCOR also make up a sizeable component of outstanding capacity, issuing for their own account as well as fronting for their clients. Bermudian reinsurers, Japanese insurers, government affiliated insurers, as well as corporates, also utilize cat bonds.

Given the potential for very large losses from U.S. natural catastrophes, it is no surprise that over 86 percent of outstanding cat bond capacity is exposed to U.S. perils and 73 percent is exposed to U.S. hurricane.

So who invests in cat bonds?

While generalist institutional investors (and reinsurers) still participate, specialised funds dedicated to insurance risk investments provide nearly two-thirds of total capacity. These dedicated ILS funds, either independent or affiliated with a reinsurer or other financial institution, provide an efficient way for generalist institutional investors to access this alternative asset class. As the asset class continues to gain scale, the pendulum may swing back towards the generalist investors who may see value in developing in-house expertise, especially for cat bonds.

In recent years, sidecars and reinsurance-sponsored collateralized funds have expanded to offer the generalist additional ways to invest in reinsurance risk. In contrast to cat bonds, which are excess of loss or nonproportional reinsurance, sidecars are quota share or proportional reinsurance.

Although more than 150 investors actively monitor and invest in cat bonds, the market remains quite concentrated with between 15 to 20 core investors that drive the market. Capacity remains concentrated with approximately two-thirds of overall direct investor capacity located in North America, a third in Europe and a limited amount in Asia.

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6 Willis Re (2014). *1ST View.* London: Willis Re.

So where do we go from here?

In regards to the future, it is my opinion that we will see cat bonds, and other capital markets reinsurance solutions (such as sidecars, collateralized reinsurance, contingent capital, etc.) becoming more "main stream", as opposed to sitting at the side lines of the traditional reinsurance market.

It is becoming an ever more central part of the conversations that brokers, reinsurers and large insurers are having about the role that capital and contingent capital should be playing. I think that this will continue, because the more mainstream that cat bonds become, the more people will look to use them.

Cat bonds have many benefits: for insurers and reinsurers as they offer the opportunity for carriers to make better use of their capital and increasing returns. They also offer multi-year collateralized protection. Cat bonds traditionally provide a single limit over a two to four year term at a fixed rate on line. The cat bond proceeds are invested in AAA securities such as U.S. Treasury money market funds that can be liquidated readily to fund recoveries.

In particularly extreme events the collateral provides certainty in ability to pay vs. the mere promise to pay from an assuming company. From a public policy perspective they also offer the chance—because of their lower associated costs—to make insurance more widely available and affordable for policyholders (i.e., more people buying insurance). This increased demand can expand the take up rate of insurance and close the gap between economic losses and insured losses.[7]

I also believe that ILS in general will spread into areas outside of property catastrophe, such as pandemic business interruption coverage or casualty coverages of different types. As insurance needs begin to develop and expand worldwide, I think we'll see ILS expand into a lot of different areas as a complement to the product offerings of insurers and reinsurers.

Asset Allocation Strategies for a (still) Low Interest-Rate World[*]

By Mike Earley and Lloyd Ayer[+]

Insurance companies have struggled to remain profitable in the declining interest rate environment of the past several years. Central banks' accommodative monetary policies since the 2008 financial crisis have pushed rates on government debt to near historic lows; in some instances, real interest rates in developed economies have turned negative.

Insurers have changed their pricing on new policies to reflect this environment, but legacy products with prices based on higher interest rate assumptions will take time to expire. These costlier liabilities are difficult to fund profitably in the current low-rate environment, making asset-liability management a challenge.

In turn, this erodes the market value of insurance companies and makes it more expensive for them to raise capital. Investors recognise the earnings pressure that low interest rates cause, and mark down the value of insurance assets as rates fall. As Figure 1 illustrates, the average price-to-book ratio of a sample of large European and American insurance companies fell by over two-thirds between 2000 and 2011, as interest rates fell by about 50 percent.

Insurers cannot look overseas to obtain the returns they need. The secular decline in government yields has been a global phenomenon, across all the major developed economies, and one that pre-dates the financial crisis. The U.S.

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[7] BNY Mellon (2013). *The Disaster Gap.* New York: The Bank of New York Mellon Corporation.

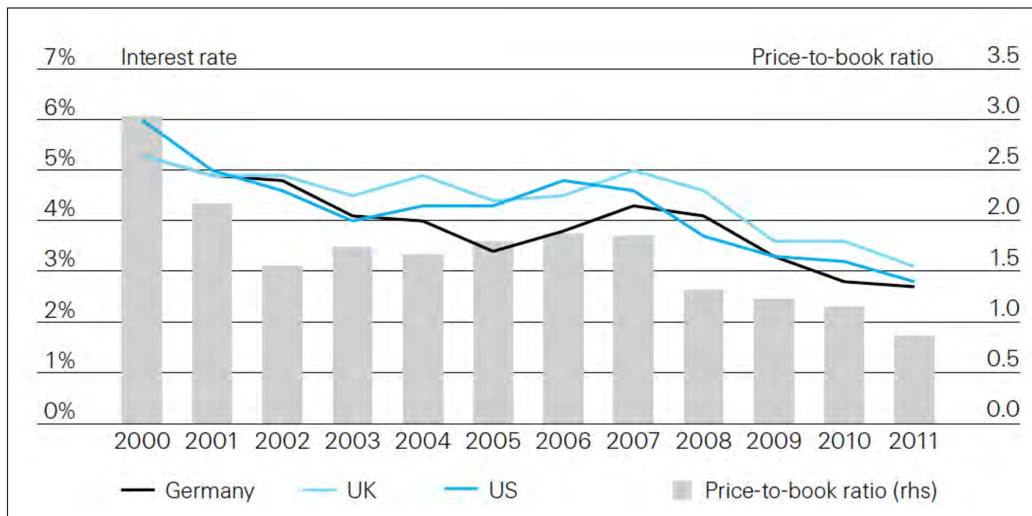
[*] This article is republished with the agreement of the authors. The article was originally published by Deutsche Asset & Wealth Management (2013) *Asset allocation strategies for a (still) low interest-rate world,* September 2013.

[+] Insurance Strategists, Client Solutions Group, Deutsche Asset & Wealth Management.

10-year Treasury yielded about 8 percent in early 1995; it has been on a downward trajectory ever since. Ten-year bonds from other high-quality sovereign issuers have declined in a similar fashion, as Figure 2 illustrates.

Other types of bonds, apart from Treasuries and agencies, have seen a similar compression of spreads and yields. In the investment-grade credit market, this has been driven in part by low net issuance in recent years, which has reduced supply to the point where investors are bidding up prices (and thereby compressing yields) on the remaining bonds.

Figure 1: Insurer price-to-book values and long-term interest rates

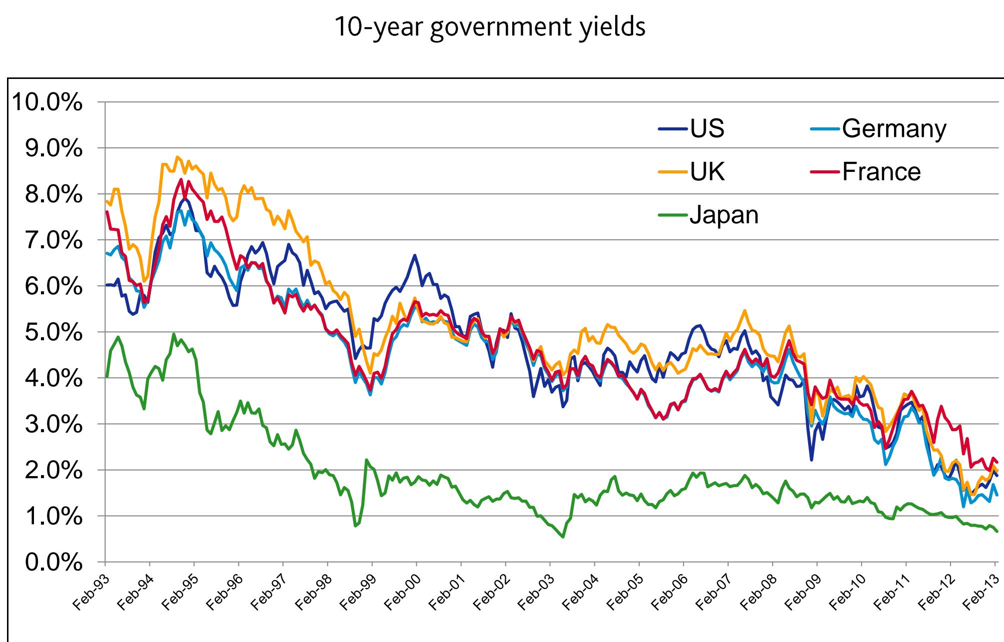


Source: Bloomberg, Swiss Re, Economic Research & Consulting. Data through year-end 2011.

Note: The company sample includes Generali, Prudential PLC, Great-West Life, Aflac, Lincoln, Protective Life, Torchmark, Legal & General, Swiss Life, Allianz, AXA, CNP, Helvetia, Hartford, Met Life, Sun Life.

Figure 2: Global government yields near historic lows

10-year government yields



Source: Bloomberg as of 28 February 2013. For illustrative purposes only.

Insurers are also limited in their ability to seek return in other asset classes. Regulators since the 2008 financial crisis have highly prioritized solvency from a run-off perspective in the new rules they have written. So while market conditions have caused insurance companies to look beyond bonds, regulators have made other alternatives less palatable. While insurance regulators are aware of the difficulties this is causing insurance companies, systemic risk and solvency concerns have taken precedence in their rulemakings.

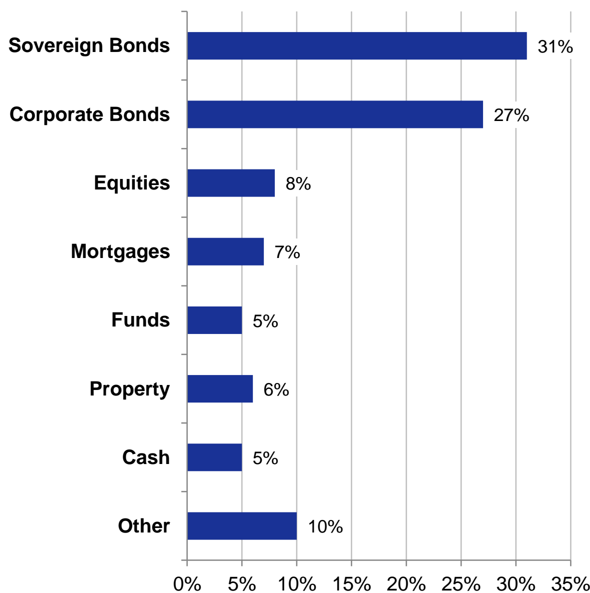
Portfolio responses

The traditional responses to a compression of yield in the fixed-income market are a move down in credit quality or out in duration. Since the turmoil in the bond markets at the end of June, portfolio managers have been reducing their duration in fear that the low interest rate environment might be ending in the foreseeable future. Insurance portfolio managers are likewise looking to position themselves for future interest rate increases by keeping their durations short.

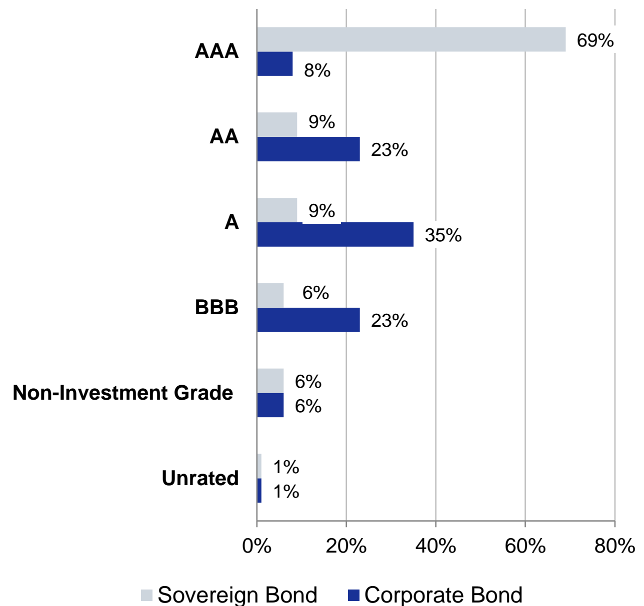
There is a risk trade-off. Going down in credit could be a more attractive move for many insurance companies, and such a reallocation is supported by the economic cycle. Corporate balance sheets are in good shape and credit fundamentals are supportive. Insurance company fixed-income investments remain overwhelmingly conservative; three quarters of all corporate bonds in their portfolios are rated single-A or better. (See Figure 3.)

Figure 3: Insurers' asset allocations

Global Life and Non-Life Insurers' Asset Allocation



Global Insurers Sovereign and Corporate Bond Allocations by Rating

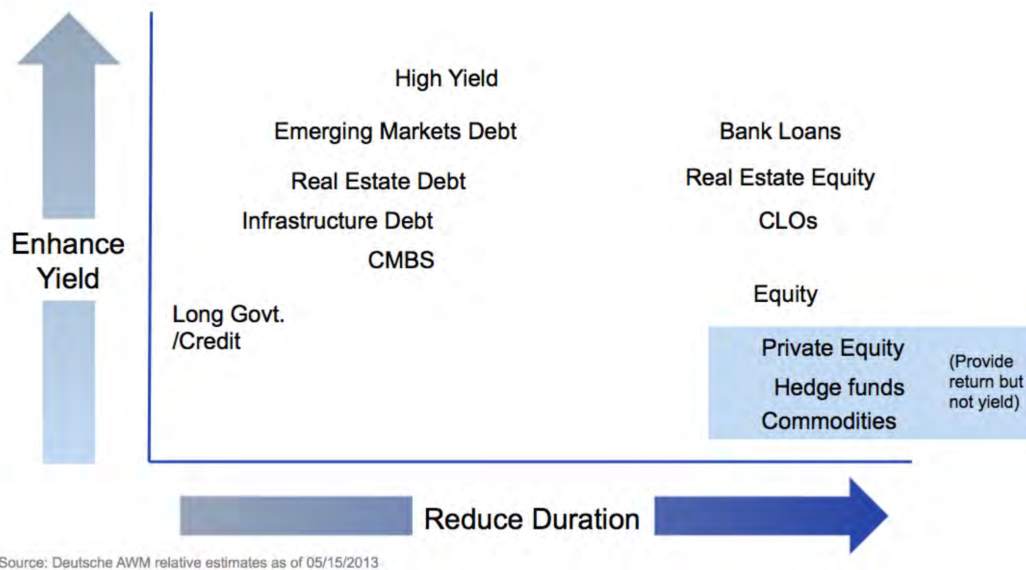


Notes: As at December 2012.

Source: Insurance Collateral Survey, BNY Mellon/Insurance Risk/Ernst & Young.

Insurers can travel down the credit spectrum via a number of different types of products that are close analogues to their core holdings, such as high-yield bonds, bank loans, commercial mortgage-backed security (CMBS) and collaterized loan obligations (CLOs). Along with the possibility of gaining more yield, these structures can reduce duration, and they have their own specific risks and benefits. (See Figure 4.)

Figure 4: Duration risk versus yield enhancement



CMBS, for example, provides exposure to the revival of the commercial real estate market, and the highest tranches of the instruments can be appropriate for insurance companies. Bank loans are another example. They provide the opportunity for a higher yield but are also floating rate, so they have no duration risk.

CLOs are also floating rate. They gained a bad reputation during the financial crisis as repositories for toxic loans banks did not want to hold. However, the new crop of CLOs are less risky, being designed with a high degree of asset visibility so investors know what is in their portfolios. Critical to success in this bond category is using that transparency wisely in assessing opportunities.

Other close analogs to core include private real estate debt, emerging market debt and infrastructure.[8] These can provide yield enhancement and diversification while giving insurers exposure to potentially attractive sectors.

Even among these assets, yields have fallen recently. There has been a significant reallocation to these assets by insurers and other investors, which has compressed yields, making some of them less attractive from a risk-adjusted return perspective. However, depending on market levels, they remain worth investigating.

Another approach taken by some more sophisticated insurance companies is the use of derivatives to assemble a synthetic asset allocation that improves yields and reduces duration. This can be accomplished using total return swaps or a combination of futures and options, although it requires the insurance company to invest in strong internal risk management, and even so, regulators will set practical limits.

Alternatives to core

Assets that do not have fixed income's iron clad relationship with interest rates can be attractive in some circumstances. Regulators' tolerance for assets that bear no resemblance to traditional core components, such as equities, commodities, private equity and hedge funds, varies from state to state and country to country. From a solvency perspective, these assets typically attract a higher capital charge.

While the higher capital charges make these investments more expensive from a return on surplus point of view, depending on their structure and the returns they offer, however, the math can work under certain circumstances. Apart from yield enhancement, these assets also have some ancillary advantages. For example, insurance companies can invest their surplus assets and excess capital in these assets to take advantage of diversification

[8] Real estate and infrastructure are relatively illiquid and require an understanding of specific asset characteristics.

benefits resulting from their lower correlation to core fixed income holdings in their portfolios, and achieve some degree of offset to declines in bond market values if rates rise.

Insurance companies also have an advantage over other regulated institutions, such as banks, when investing in some of these asset classes. Unlike banks, where depositor money is more mobile, insurance policyholders cannot accelerate the timing of their claims, so when investing, they can take on more liquidity risk in return for improved terms. For example, an insurance company could invest in private equity which generally has low liquidity but expects higher returns.

As Figure 5 shows, a significant number of insurance companies plan to hire alternative or asset managers with a particular investment expertise. One-in-five expect to outsource private debt management, double the amount that currently do so. Private equity fund-of-funds are growing in popularity also, with 14 percent of insurers reporting that they will likely issue new mandates for that asset class.

Figure 5: Likely new alternatives mandates

Percent of US Insurance Companies currently outsourcing and likely outsourcing new alternatives mandates

Alternative Investments and Real Estate

Base: Current/likely users	Current use	Likely new mandates
Private debt	11%	**20%**
Private equity fund of funds	6%	**14%**
Private equity (single funds)	9%	**12%**
REITs	7%	**11%**
Mezzanine debt	4%	**10%**
Infrastructure	4%	**10%**
Hedge fund of funds	4%	**9%**
Hedge funds (single manager)	5%	6%
Commodities	1%	6%

High future outsourcing activity likely

Source: Eager Davis & Holmes 2012 Survey of Insurance Companies, October 2012.

Conclusion

Despite a possible perception and focusing on asset allocation, there are five ways to increase yield in a fixed-income portfolio: the use of duration, leverage, volatility, liquidity and credit. Given the need to be conservatively invested, insurance companies will typically avoid volatility and leverage. They can use their tolerance for illiquidity to invest in asset classes that some other institutions must avoid, such as private debt and private equity.

Like most investors, insurers are reducing duration in anticipation of rising rates. To do this, while increasing returns, they can go down the credit spectrum using instruments that also shorten duration, like bank loans, or have other advantages, like CMBS.

These types of instruments often have more attractive return/duration trade-offs than straight investment grade bonds. They can be supplemented by alternative assets, carefully chosen and with the right investment structure so their return is still attractive when the capital charge is factored in. With current returns low, and rates possibly on the rise, these are options from which insurers could benefit.

Managing Interest Rate Risk in a Changing Regulatory Environment

By Age Lindenbergh[+]

Introduction

The Western world is experiencing a prolonged period of low interest rates and the jury is still out on whether this situation will come to an end when Europe and the U.S. emerge from the economic crisis. In November 2013, the OECD saw the global economy as a whole strengthening in 2014 and 2015 which suggests the pressure to keep interest rates low may subside. What this means to an insurance sector that is aiming to become less sensitive to market risks is discussed below.

Low interest rates: two sides of the same coin

In 2007, when the financial crisis really started to bite, central banks and governments took hitherto unseen measures to stabilize the banking sector, including offering banks almost unlimited access to liquidity at low interest rates. This strategy enabled banks to overcome the funding constraints resulting from the shut down of the interbank financing markets. In 2012, these measures were followed by the much-lauded move by Mr. Draghi to facilitate European states to finance themselves, as he indicated that he would defend the Euro at all costs. Both moves, coupled with Western economies that are still operating below capacity levels, as they adapt to the new, post-crisis, reality, are underpinning, for now, a historically low interest rate environment.

At the same time, the low interest rate environment has taught insurers some hard lessons on interest rate risks, as return guarantees embedded in products sold in the past got "in-the-money", leading to significant capital consumption due to higher provisions and low profitability. As a consequence, various insurers have chosen to enter into significant hedge programmes to reduce their interest rate exposure. Moreover, a large number of players have even shifted their strategy from interest rate-based towards fee-based products.

Whereas the initial decline in interest rates led to substantial mark-to-market results on investments available-for-sale, those positive accounting gains reduced when the financial crisis continued. At that time the uncertainty around the severity of the financial crisis made insurers hesitant to re-risk their assets. The resulting pressure on profitability has forced many insurers to reshape their business models.

With the recovery comes more uncertainty on future interest rates

The recovery of the American economy appears to be well underway, although every mention of the start of "tapering" is greeted with considerable anxiety from the capital markets.

Whereas the crisis appeared to bring one certainty, a low interest rate environment, the economic recovery looks to bring at least some uncertainty, as a number of thought leaders are not questioning whether but when interest rates will start to rise. In their view it is only a matter of time before inflation starts to rise due to the abundant supply of liquidity and the decreased necessity to support banks with low interest rates as they start to become appropriately capitalised and return to profitability. Exactly how fast or slow such an increase in interest rates may unfold is subject to much debate. The English regulator has already commissioned research to assess the vulnerability of the financial sector to a sudden interest rate hike.

On the other hand, various commentators believe that the Western world should prepare itself for a scenario such as that seen in Japan, with a prolonged period of low interest rates. As most Western states are highly indebted and run budgetary deficits, there also continues to be a strong case for low interest rates.

The sheer diversity of the potential outcomes of future interest rate developments poses a challenge to risk and capital managers, in particular of life insurance companies. Insurers need to determine to what extent they intend to run interest rate risk and ensure this is reflected in the hedge strategy they put in place.

Inconsistencies in accounting and regulatory concepts affect hedging strategies

The inconsistency in the treatment of changes in assets and liabilities for regulatory and accounting purposes leads to a fundamental conceptual challenge: insurers are being forced to choose between either developing their

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hedging strategy to reduce capital volatility from a regulatory perspective or reduce volatility of earnings. On the one hand, under current international accounting rules, liabilities are considered applying a cost-type convention, with only a limited number of insurers opting for a "market value" accounting approach. On the other hand, solvency regulations demand a calculation of provisions based on observable market-based assumptions.

In particular, under the Solvency II rules that are now envisaged to be implemented by 2016, a market prices-based calculation of the provisions is required. Therefore, reducing the exposure to interest rate-based products may be the only way to reduce both regulatory and accounting volatility.

The increased uncertainty around interest rates comes at a time when most large European insurance companies have put the crisis behind them, as they have replenished their capital positions and are generating considerable free cash flows. This in turn means that those insurers are reconsidering their preference of regulatory over accounting volatility, which also affects their hedging strategies.

Regulatory change adds additional complexity

In particular for long-term liabilities this is not the end of the story. The heated debate around the parameterisation of the calculation of provisions for long-term liabilities has eventually led to definitions of the last liquid point (LLP) and the ultimate forward rate (UFR) that are clearly the outcome of a political process.

This outcome leaves insurers to decide how to go about hedging their interest rate risk beyond the LLP: should a company focus on economic capital models or should it hedge the risk that is run based on regulatory capital calculations?

In addition, fairly strict eligibility criteria will come into effect under Solvency II for insurers that use the Matching Adjustment for assets that can be used to match the insurance liabilities. This may force insurers to reassess their investment strategy and may increase the costs of creating and maintaining a suitable investment portfolio.

Recent regulatory changes in the market infrastructure (EMIR) create additional challenges as long-duration hedges (swaps) are forced to be entered into through instruments that are cleared with central counterparties. As set out by Simon Hotchin of HSBC, this leaves an insurer to either keep hedging through the use of swaps, which now leads to potential liquidity risk as a result of collateral calls, or hedge through entering into long-dated bonds. The latter hedging strategy forces insurers to take on the credit spread risk of a potential widening of the difference between the yield on the bond and the swap rate.

Conclusions and recommendations

Conclusions

The green shoots of recovery also bring increased uncertainty regarding the future development in interest rates. This comes at a time in which the relative importance to management of accounting versus regulatory volatility resulting from interest rate developments may also change. Shareholders are likely to attach value to greater visibility on future earnings and, as regulatory requirements are met, investors' requirements are likely to play a more important role going forward.

Undoubtedly a move towards offering more fee-based products would help in providing more stable earnings, but such a decision clearly has to be aligned with the broader product strategy and profile the insurer intends to maintain.

The move from a Solvency I to a Solvency II world coupled with regulatory change in other fields, such as IFRS and EMIR, creates further complexity where it relates to both hedging and investment strategies.

Recommendations

The recommendations for insurance companies operating under such conditions would appear to be as follows:

- Develop a clear understanding of the expectations of the various stakeholders regarding capital and earnings volatility
- Based on the above, develop a well-articulated, concise risk appetite statement that drives the decision-making on the overall product strategy as well as the related risks
- Conduct a clear assessment of the implications of new regulatory requirements on both the hedging and investment strategies
- Implement a hedging and investment strategy that reflects the profile of the insurer and is based on the risk appetite statement.

Insurance ERM for New Generations

By Shigeyuki Goto+

Insurers face a daunting task of coping with new and enhanced regulatory requirements. The financial crisis in 2008-2009 and the so-called black-swan events of 2011 led to a major overhaul and/or refinement of regulatory requirements around the world. And now that there are new sets of requirements specific to systemically important insurers and internationally active insurers, we are seeing a further change in the rules of the game, particularly in the field of ERM. New times call for new thinking. New generations in insurance firms should follow three rules when adapting their ERM systems and processes to such ever-evolving times.

Rule 1: It's all relative

Insurers should favour scenario-based capital requirements. Such scenario-based assessments should be backed with stress tests, and also complemented with emerging risk identification and monitoring processes. For cases where setting out a factor based requirement is a must, the calibration at least should be based on scenarios.

Do away with purely stochastic-assumption based requirements that are not linked to scenarios (e.g. VaR assessments simply run on a spreadsheet). That is becoming a thing of the past. Instead of trying to guess in vain what our capital requirement is in absolute terms (i.e. what our 99.5 percent value at risk is), we should focus on understanding it in relative terms (i.e. look at how an outcome under one specific scenario compares to another in the overall context of things). Having to understand multiple outcomes based on scenarios and stresses and make a decision on them leads to substantive discussions on whether/why one outcome is more meaningful than another (if at all). It is essentially a built-in thinking process.

As for models, they should be seen as mere tools to generate and run scenarios. They are perhaps advanced tools at that, but nothing more. The best models are marginalised ones.

Rule 2: What you think you know could hurt you

This then needs to be backed by a process that addresses fallacies, biases and cognitive traps in our decision making process.

All too often, insurers base their risk management on past experience and fail to account for risks they can not (or will not) perceive. As the moral of the story of the blind men and the elephant teaches us, what we (think we) know often is at best a very small part of a much bigger picture and at worst totally off the mark.

Secondly, individual heuristics (instinctive thinking based on rule of thumb) will always be inherent in decision making. Any firm's risk management is only as effective as the least effective individual involved in running the process.

Recognising these two features, there needs to be a qualitative process that forces us to go beyond our perception(s) and/or rule of thumb thinking and consider what lies outside the bounds. In terms of scenario-assessments, stress tests, and emerging risks, there has to be a step that systematically asks us whether we have missed anything or whether we got something wrong.

Rule 3: Some risks are beyond individual firms ERM

Market-wide problems require market-wide solutions. There are just some things that are beyond the control of individual risk management and hence require wider, collective risk management. Recognising insurance may not be commercially viable for certain risks, markets—led by individual firms with high awareness of ERM—must consider putting in place special systems such as pre-event cat reserves, firm-specific counter-cyclical capital buffers, mandatory pooling schemes, state co-insurance (or government support phase-in schemes), or a combination thereof. Examples could include extreme risks with unknown return-periods and/or highly public lines of business. This rule applies regardless of how advanced the market is or not. Non-competition areas can exist in

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highly competitive markets. Sustainability of affordable insurance coverage is ultimately what an insurer's ERM should achieve. It just sometimes requires a collective effort.

The underlying common feature of the three rules is the differentiation of risk and uncertainty. Having a seemingly sophisticated risk measurement and management structure in place can lead people to believe they have taken the "uncertainty" factor out of risk assessment. History has shown us that is not possible and nothing could be a more dangerous perception. In fact, it is better to have uncertainty constantly hanging over our risk assessment. Only then can we take account of and deal with uncertainty in ways mentioned above, thereby creating a more resilient and accountable system.

ComFrame—Quo Vadis?

By Kathrin Hoppe[+] and Kunihisa Kawasaki[++]

It all started in 2009/2010 with an International Association of Insurance Supervisors (IAIS) task force at the time chaired by Monica Mächler. The objective of ComFrame, as was envisioned by the task force back then, was to make cross-border group-wide supervision more consistent and effective. The recommended means to achieve this objective came in the form of a set of categorically-grouped approaches aimed to better monitor group solvency, group structures, group business mix and intra-group transactions[9] of Internationally Active Insurance Groups (IAIGs). The task force successfully completed its initial task and the recommendations therein were approved by the IAIS Executive Committee who then further mandated the task force to continue working on shaping ComFrame. Already at the time it was clear that ComFrame would set specific quantitative and qualitative requirements, but nobody knew how detailed and prescriptive they would be. Target dates were also set: there would be a comprehensive concept paper in 2011, a first draft in 2012 and a final version at the end of 2013 followed by impact assessments—today better known as ComFrame field tests.

The target dates were met and the insurance industry had an opportunity to comment on the concept paper in summer 2011. The industry at the time was still unsure about the objectives of ComFrame, worried about an additional layer of regulation and feared that overly prescriptive standards[10] would be introduced. They continuously engaged with the IAIS in discussions on the development of ComFrame modules. In the course of the discussion the majority of industry representatives embraced the necessity of better supervisory coordination and cooperation. Discussions not only at industry level, but also at supervisory level were primarily ignited when what is now Module Two was discussed. Module Two addresses a whole range of requirements on the part of the IAIG, but most importantly capital adequacy—the most sensitive issue. Whoever followed the discussions could easily understand where the difficulty lay: different solvency regulation under way in different countries and regions of the world and there was no common valuation basis. Not surprisingly, many wished to see a standard which interferes as little as possible with the existing national one whilst only a few welcomed the idea of a global group-solvency measurement. The IAIS made significant progress in all areas of ComFrame, but Module Two remained the biggest challenge—not least because the IAIS Executive Committee wished to consider as many options as possible to identify the best way forward.

After endless rounds of discussions on the solvency requirement piece, the industry was ready to focus on considering whether one or two selected ideas of the IAIS could work for ComFrame going forward. Plans were underway to sort out and test the pending technical issues in the field test phase when the IAIS announced in October 2013 that it would develop a global insurance capital standard by 2016 to be applied to IAIGs from 2019. Combined with a separate yet closely related announcement that the IAIS would also develop in 2014 a basic

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9 IAIS (2010). *IAIS approves development of a Common Framework for the Supervision of Internationally Active Insurance Groups*, press release, 19 January 2010.

10 The Geneva Association (2011). *Geneva Association Intervention at IAIS ComFrame dialogue in Seoul*, 27 September 2011. Geneva: The Geneva Association.

capital requirement (previously called a back-stop capital requirement) for G-SIIs (global systemically important insurers), the industry is now faced with two workstreams: The first is a short-term (and perhaps even a temporary) initiative, the basic capital requirement, which is expected to be a non risk-based (i.e. a factor-based) requirement applicable to G-SIIs; the second is what was originally the ComFrame solvency requirement—now called the global insurance capital standard—a mid-term initiative, which was originally expected to come in the form of a risk-based and economic value based requirement (perhaps as a scenario-based requirement based on sensitivity/stress tests). How and in what way the IAIS advanced its ideas on the latter still remain unclear. While the ComFrame project was always rightly kept separate from G-SII regulation, the new developments are now linked (at least in terms of the underlying valuation method), since the ComFrame field tests will also be used to test the basic capital requirement. The results will among others form the basis for developing a global insurance capital standard. Many recognise the need for the IAIS to rapidly sort out the increasing cluster of issues and similar-yet-different projects and streamline its deliverables. Nevertheless, the recent developments brought industry experts and supervisors together to consider and determine milestones to meet the very challenging timeline.

It is unclear today, for instance, whether the basic capital requirement is going to continue to exist once the global insurance capital standard is in place. The overall interplay between the different global capital standards and even more so its interplay with national capital requirements are questions the industry is seeking answers to. Supervisors, on the one hand, are struggling to find the adequate granularity as they need to appropriately reflect all risks in order to secure comparability, while, on the other hand, contain to keep the framework. Supervisors are moving step by step relying heavily on the ComFrame field tests to answer some of the outstanding questions.

Apart from the capital discussions, also the ComFrame Module Three is undergoing further work with regard to recovery and resolution planning. The Financial Stability Board, which had established Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions, published a consultation paper with a suggested Annex to its original paper for Insurance. The Geneva Association answered to the FSB consultation[11] as did many other stakeholders. As the reconciliation of the insurance annex with the comments was still pending, the IAIS excluded the relevant parts of ComFrame from the consultation.

Even though the consultation phase on the 2013 ComFrame draft has closed, further additions have now been moved into the ComFrame field testing phase.

The ComFrame project has therefore reached a different level from when it started and has caught significant interest of the Financial Stability Board and the banking community. We can expect Central Bankers to very closely monitor the future developments on capital adequacy and recovery and resolution planning—hopefully with the intention to clearly differentiate the different business models of insurers and banks.

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[11] The Geneva Association (2013). *The Geneva Association Response to the FSB Consultation, 12 August 2013*. Geneva: The Geneva Association.

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For further information on this special issue, please contact Etti Baranoff at etti_baranoff@genevaassociation.org

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2014

February

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

March

24	Geneva	**The Geneva Association/IAIS Executive Committee High-Level Meeting**, hosted by The Geneva Association (Board members only)
24-25	Geneva	**30th Regulation and Supervision (PROGRES) Seminar on "Growing Complexity and Sophistication of the Multiple Regulatory and Supervisory Regimes in Insurance Around the Globe: Are We Safer?"**
28	Berlin	**Conference on Collateral Risk: Counter-Cyclical Measures**, co-sponsored by The Geneva Association, HypZert GmbH and the AEI international Center on Housing Risk, hosted by Alllianz SE

May

14-17	Toronto	**41st General Assembly of The Geneva Association** (members only)

June

4	Zurich	**8th Meeting of Chief Investment Officers in Insurance**, hosted by Swiss Re (CIO members only)
5-6	Paris	**12th Annual Round Table of Chief Risk Officers**, organised jointly by The Geneva Association and SCOR, sponsored by SCOR
22-25	London	**The Geneva Association/IIS Research Award Partnership**

September

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

October

23-24	New York	**6th CR+I Seminar on "Extreme climate and weather events in the USA and globally"**, organised in collaboration with XL Group

November

18-19	Munich	**10th CRO Assembly**, hosted by Munich Re