NEWSLETTER
INSURANCE AND FINANCE

THE GENEVA ASSOCIATION

No. 13, February 2014

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.

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

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[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".

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 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.