

Insurance Banana Skins 2009

Identifying the risks insurers face

The Centre for the Study of Financial Innovation (CSFI) earlier this year completed the *Insurance Banana Skins* survey of leading members of the insurance industry to find out their concerns about the risks facing the insurance industry.

The survey, sponsored by PricewaterhouseCoopers (PwC), identifies potential sources of risks to the insurance industry and ranks them by severity. This year's survey is based on 400 responses from 39 countries.

The survey shows financial market concerns, including investment performance, equity markets and capital management, topping the ranking of risks facing the industry in many parts of the world. This is in sharp contrast to the previous survey in 2007 when too much regulation and natural catastrophes were top of mind, and market risks barely featured in the top ten. Other high-level risks identified by the survey include regulation, risk management techniques and reinsurance securities.

Following is the summary of this year's survey. The full report can be obtained from your PwC insurance contact (please see details on the back of this publication) or downloaded from www.pwc.com/bananaskins.

Summary

The top three risks identified by respondents to the survey are all connected with the fall-out from the credit crunch, and its impact on the strength and profitability of the insurance industry.

The ability of insurance companies to get through the crisis depends above all on their investment performance (placed No 1), i.e. achieving sufficient returns to protect capital, remain profitable and meet commitments to customers. Key here are the equity markets (No 2) on which the industry will depend heavily for income if, as expected, the crisis produces a fall-off in insurance business and a surge in claims.

The resulting squeeze on profitability could affect the industry's solvency, making capital availability (No 3) a key consideration in the period ahead. The scale of financial market disruption will depend on macro-economic trends (No 4) about which the majority of respondents to the survey were gloomy, particularly those in North America.



Top 10 Insurance Banana Skins 2009

(2007 ranking in brackets)

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|-------------------------------|-----------------------------------|
| 1 Investment performance (11) | 6 Risk management techniques (14) |
| 2 Equity markets (13) | 7 Reinsurance security (27) |
| 3 Capital availability (26) | 8 Complex instruments (19) |
| 4 Macro-economic trends (-) | 9 Actuarial assumptions (8) |
| 5 Too much regulation (1) | 10 Long tail liabilities (7) |

The risk of too much regulation (No 5) has fallen from the top position it occupied in the last survey. But it has not disappeared, only been overtaken by more urgent issues. There is now widespread concern that the crisis will trigger a regulatory crackdown on the financial sector which will put pressure on the insurance industry to increase capital and take on more compliance costs at a time when resources are stretched. The insurance sector feels that it may be unjustly penalized for the sins of the banking sector.

The next set of risks is linked to the industry's ability to manage its way through the crisis and avoid unnecessary losses. Concern about the strength of the industry's risk management techniques (No 6) has risen sharply in the wake of the crisis at AIG and revelations about insurance companies' exposure to complex instruments (No 8), especially those in the credit insurance market. The security of reinsurance arrangements (No 7) is a fast-growing concern with worries about the capacity of the reinsurance sector to meet a surge in claims on risks that have been laid off by primary insurers.

Profitability on the non-life side of the industry will depend heavily on the pricing cycle (No 12). Insurers are hoping that a capacity shake-out will enable them to push up rates, but the contrary view holds that insurance business will fall away as clients seek to cut costs.

A growing concern is potential damage to the insurance industry's reputation (No 15) caused by insurers' attempts to push up premiums and take a tougher line on insurance claims, as well as disappointing returns on savings products. The industry expects to see an increase in fraud (No 23), a common reaction to hard times. Corporate governance risks (No 17) are also expected to grow as companies come under greater pressure to deliver results.

The survey showed a striking fall in concern about environmental issues. Natural catastrophes fell from No 2 last time to No 22, possibly because of fewer major recent events. Climate change also dropped sharply, from No 4 to No 28, reflecting a sense of declining urgency about the issue. Pollution risks eased noticeably, from No 21 to No 34.

Concerns about structural change to the insurance industry were also less prominent. The threat of new competitors fell from No 10 to No 32 because respondents felt the insurance market had become less attractive. Similarly, the prospect of mergers remained low at No 31.

The survey also reveals a dramatic fall in insurers feeling well-prepared to address the risks identified a drop from 21% down to 4%. But, there is a reassuring increase in the risk sensitivity level reflecting a shift in interest, with risk moving up the board agenda. Overall, the survey showed that the level of risk sensitivity in the insurance industry has risen since the last survey in 2007.

If you would like to discuss the issues raised in greater detail, please contact any of the PwC representatives located at the end of this publication.

www.pwc.com/ca/insurance