Insurance Banana Skins 2011

The CSFI survey of the risks facing insurers

In association with

pwc

CSFI

Centre for the Study of Financial Innovation

The Centre for the Study of Financial Innovation is a non-profit think-tank, established in 1993 to look at future developments in the international financial field – particularly from the point of view of practitioners. Its goals include identifying new areas of business, flagging areas of danger and provoking a debate about key financial issues. The Centre has no ideological brief, beyond a belief in open markets.

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Preface

To me (and, I guess, to anyone who reads the report), the most striking finding in this, our third *Insurance Banana Skins* survey, is the virtually unanimous conclusion that regulation is the biggest threat that the industry faces.

My initial reaction was that this reflected dissatisfaction with Solvency II – which, as another CSFI report has pointed out[1], seems to have been written with the life insurance industry in mind, no matter what the collateral damage to the general insurance industry. But, in fact, the unease about regulation is more widely spread; it tops the list of concerns for virtually everyone, except (of course) regulators themselves. Certainly, Solvency II is top of the pile; but concerns include the UK's Retail Distribution Review, the MiFID review, new capital requirements, IFRS etc. The cost and complexity of these regulations is almost universally felt to be the industry's biggest challenge.

Other than that, I was intrigued to see the shortage of 'talent' in the industry appear at No 6. Given the complaints by British university graduates about the difficulty of finding well-paying, interesting entry-level jobs in the City, that should be self-correcting – though insurance's reputation (unfair, I am sure) as the 'idiot cousin' of investment banking may be hard to shake. More substantial, perhaps, is the increase in perceived political risk.

On the other hand, I was impressed by the sharp drop in the perceived riskiness of complex financial instruments. Are we really better at managing them? Or is this yet another example of just how short the financial sector's memory is?

Whatever, this is (as always) a fascinating trawl through the concerns of one of the most important parts of the global financial services industry. I cannot vouch for its *predictive* power, but it is certainly a very persuasive picture of what concerns the insurance industry right now.

Thanks, as usual, to my colleague David Lascelles for pulling it all together. An awful lot more goes into this than meets the eye. Thanks, too to PwC for its generous support, which is much appreciated – and for its help in ensuring that we get a strong response from a wide diversity of individuals, firms and geographies.

Andrew Hilton
Director, CSFI

[1] Shirley Beglinger: June, 2010. *"Struggling up the learning curve: Solvency II and the insurance industry"*

This report was written by **David Lascelles**
Cover by **Joe Cummings**

Sponsor's foreword

Welcome to Insurance Banana Skins 2011, a unique survey of the risks facing the industry, which has been produced by the CFSI in association with PwC.

We're pleased to be continuing our support for this initiative. The Banana Skins series (a banking edition is also available) provides valuable insights into the risk concerns at the top of the boardroom agenda and how these perceptions change over time.

Even though most insurers came through the financial crisis largely unscathed, dealing with regulation (the number one risk in the Banana Skins survey) is clearly going to be a massive challenge over the next few years. Most of all, insurers will need to make sure that the current wave of regulatory change does not distract them from the opportunities ahead. An ageing population and a changing pattern of risk (the recent spate of catastrophes is an unfortunate but telling example of this) give insurers a reason to be optimistic about future profitable growth. The insurance leaders in our latest survey of global CEOs were the most confident about their growth prospects of any of the financial services sectors. Companies that move the regulatory burden away from a box-ticking exercise to something that is embedded into their business and used to manage their changing risk profile more effectively will be in the best position to capitalise on the openings ahead. You might think of the challenges as like finals exams – a tough ask now, but the gateway to a more prosperous future.

More effective communication will be crucial in conveying the true value and potential of insurance businesses to a sceptical market – a challenge that few companies have so far been able to crack. The key priority is a clearer explanation of the income being generated, the risks being run and the sustainability of the resulting earnings. Insurers also need to demonstrate the strength and differentiation of their brand and their resulting ability to attract new business. With attracting talent finally being recognised as a key priority (number six on the list of risks, having not featured before), more effective communication will also be crucial in highlighting the increasingly varied and rewarding professional opportunities within a rapidly evolving sector.

I would like to thank the CFSI and their colleagues on the editorial panel for producing such a timely and interesting survey. The results amply highlight the challenges ahead at this critical juncture for the insurance industry. However, I believe that the opportunities for nimble and farsighted firms outweigh the challenges – the way that insurers deal with the risks set out in this report will be a crucial competitive differentiator.

I hope that you find the results thought provoking. If you have any feedback or would like to discuss any of the issues raised in more detail, please do not hesitate to contact me.

David Law
Global Insurance Leader
PwC

About this survey

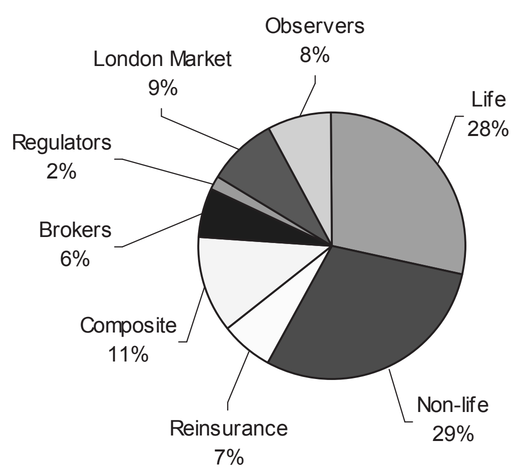
Insurance Banana Skins 2011 surveys the risks facing the insurance industry at a time of considerable market turbulence, and identifies those that appear most urgent to insurance practitioners and close observers of the insurance scene around the world.

The report, which updates previous surveys in 2008 and 2009, was conducted in March and April 2011, and is based on 490 responses from 40 countries.

The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the insurance sector over the next 2-3 years. In the second, they were asked to rate a list of potential "Banana Skins", both by severity and whether they were rising, steady or falling. In the third, they were asked to rate the preparedness of insurance institutions to handle the risks they saw. This report ranks and analyses each Banana Skin individually.

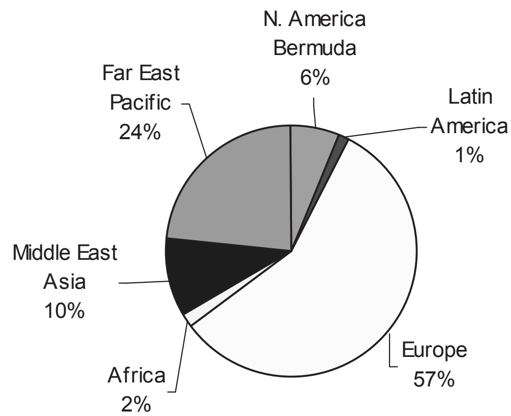
Replies were confidential, but respondents could choose to be identified.

The breakdown of responses by type of respondent was



About two thirds of the respondents were from the primary insurance industry, six per cent from reinsurance, and nine per cent from the London Market. The remainder consisted of brokers, regulators and observers. The observer category includes analysts, professionals, academics and respondents who are not insurance practitioners but close to the business.

The breakdown of responses by region was



The breakdown of responses by country was

Australia	21	Hong Kong	4	Norway	2
Bahrain	2	India	21	Poland	4
Belgium	6	Indonesia	6	Qatar	4
Bermuda	10	Ireland	8	Singapore	22
Brazil	6	Isle of Man	2	Slovakia	8
Canada	8	Japan	1	South Africa	4
China	1	Kenya	1	Switzerland	17
Cyprus	7	Latvia	19	Taiwan	3
Czech Rep.	9	Lebanon	2	Turkey	26
Dubai	1	Malawi	1	UAE	6
Finland	7	Malaysia	14	UK	190
Germany	1	Malta	6	US	6
Greece	8	Netherlands	10	Venezuela	1
		New Zealand	15		

The geographic spread overweighs Europe and underweighs North America. This reflects the fact that much of the international insurance business is concentrated in London.

Summary

Regulation is now seen as the top risk

This survey identifies the risks facing the global insurance industry in early 2011, as seen by a global sample of nearly 500 practitioners and close observers of the scene. It comes at a time when the industry is recovering from the effects of the financial crisis, but is going through a cyclical downturn of its own, made worse by an unprecedented set of natural catastrophes.

Insurance Banana Skins 2011 (2009 ranking in brackets)	
1	Regulation (5)
2	Capital (3)
3	Macro-economic trends (4)
4	Investment performance (1)
5	Natural catastrophes (22)
6	Talent (-)
7	Long tail liabilities (10)
8	Corporate governance (17)
9	Distribution channels (16)
10	Interest rates (11)
11	Political risk (18)
12	Actuarial assumptions (9)
13	Managing costs (14)
14	Management quality (13)
15	Risk management (6)
16	Reputation (15)
17	Back office (24)
18	Retail sales practices (25)
19	Complex instruments (8)
20	Climate change (28)
21	Reinsurance (20)
22	Fraud (23)
23	Terrorism (26)
24	Product development (29)
25	Pollution (34)
26	Managing mergers (31)

However, the top risk identified by the survey is the **burden of regulation** that is being placed on the industry by a wave of regulatory reform at international and local levels, in particular the EU's Solvency II Directive. The fear is that these initiatives will load the industry with heavy costs, and distract management from the task of running profitable businesses.

The central thrust of these initiatives is to improve the capital strength of insurance companies. But the **scale of the new capital requirements** (No. 2) is such that the industry could end up being hindered by them rather than helped.

The initiatives come against a background of highly **uncertain macro-economic trends** (No. 3)**,** rife with risks such as resurgent inflation and a return to recession. Closely related is the risk of poor **investment performance** (No. 4) by insurance companies, many of which depend on strong revenues from financial markets to fund their products and compensate for weak sales revenues. But with low **interest rates** (No. 10) and uncertain markets, these cannot be guaranteed.

The big newcomer to the Top Ten is **natural catastrophes** (up from No. 22 to No. 5), a change which is to be expected after the recent disasters in Australia, New Zealand and Japan whose full impact on the industry cannot yet be measured, but is certain to be far-reaching.

Another newcomer is **talent** (No. 6), reflecting concern about the industry's persistent difficulty in attracting – and retaining – high quality staff, a problem that affects the industry the world over, and may be an aspect of the mixed **reputation** (No. 16) it has in many markets. There are also concerns about the strength of **corporate governance** in insurance companies (up from No. 17 to No. 8), a perennial issue but one which has been sharpened by the threat of closer regulatory scrutiny. **Management quality** (No. 14) remains an issue for some, though this risk has eased from the high position it occupied a few years ago.

A strong riser is **political risk** (up from No. 18 to No. 11), again to be expected in light of recent events, particularly the uprisings in the Middle East and the threat of sovereign default in the eurozone.

Big movers

This year's survey has produced dramatic changes in the ranking of Banana Skins, reflecting shifting perceptions of risk in a volatile market. Here are some of the big movers.

UP
Regulation: too many big and costly initiatives coming at once
Natural catastrophes: to be expected after New Zealand and Japan
Corporate governance: still weak in parts and subject to closer scrutiny
Political risk: turbulence in North Africa, sovereign risk in the eurozone
Distribution channels: proliferation of choices creating a strategic minefield

DOWN
Risk management: insurers managed the financial crisis better than banks
Complex instruments: now shunned by insurers after earlier disasters.

Retailing and distribution risks are growing

The means by which insurance companies market their products is an area of rising risk. **Distribution channels** (up from No. 16 to No. 9) are the object of growing concern because of the proliferation of channels, digital and otherwise, and the high cost to insurance companies of getting them wrong. Associated with this are the risks in **retail sales practices** (up from No. 25 to No. 18), long a difficult area, but now the target of much tougher regulation.

Among the risks that have fallen in this survey, the most notable are **risk management** (down from No. 6 to No. 15) and **complex instruments** (down from No. 8 to No. 19). The insurance industry benefits from a perception that its members managed their way through the crisis better than the banks. They have also reduced dependence on the structured products through which they gained exposure to the more toxic parts of the financial markets in the crisis, with disastrous results in a few cases.

The low-ranking Banana Skins contain three risks which would come higher if the only measure was the newspaper headlines: **climate change** (No. 20), **terrorism** (No. 23) and **pollution** (No. 25). Despite a high incidence of floods, bombings and oil spills over the last couple of years, these continue to be seen as manageable underwriting risks, and much less threatening to the insurance business than regulatory change.

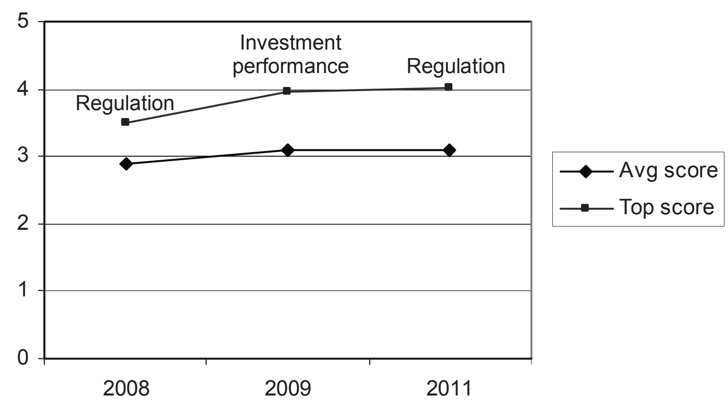
Types of respondent. The survey shows a close similarity between the concerns of the life, non-life and reinsurance sectors. All of them put regulatory risk at the top of the list. Even the type we have labelled Observers (i.e. non-practitioners, but close to the industry) rank it No. 1, suggesting that concern about the burden of regulation exists more objectively as well. The only exception to this ranking are the regulators themselves who put it No. 8.

Geography. A breakdown of responses by region also shows a strong consensus about the regulatory threat. This risk comes top in all the regions covered by the survey. Other risks that rank high across the world include worries about the global economy and the performance of the investment markets. The availability of capital for the insurance industry is more of an issue in Europe and Eastern markets than in North America.

Preparedness. Respondents were asked how well prepared they thought the insurance industry was to handle the risks they had identified. The results were slightly more positive than in the last survey. Five per cent said "well", up from 4 per cent. Eight per cent said "poorly", down from 11 per cent. The remainder gave a "mixed" reply. Capital strength and an ability to manage regulatory risk were among the key determinants of good preparedness.

'Anxiety levels' are still high

The Insurance Banana Skins Index provides a picture of changing "anxiety levels" in the insurance business. The top line shows the average score given to the top risk over the last three surveys, and the bottom line the average of all the risks. Although the lines have levelled out since the last survey, they suggest that the level of concern in the industry is still as high as it was at the peak of the financial crisis.



Who said what

A breakdown of the results by respondent type and region shows a strong common concern with the negative impact of new regulations on the insurance business, against a background of difficult market conditions. However there are also striking sectoral and geographical differences.

Regulation is a top concern across the industry

Life insurance

1. Regulation
2. Capital
3. Macro-economic trends
4. Distribution channels
5. Investment performance
6. Managing costs
7. Interest rates
8. Talent
9. Retail sales practices
10. Reputation

The life insurance industry faces big regulatory changes: a tougher solvency regime, and new regulations on the sale and distribution of life and savings products. There are concerns about its ability to handle this huge agenda. At the same time, investment markets are difficult because of low interest rates and economic uncertainty. There are also longer term questions about the viability of the traditional life insurance savings model. The sector's reputation could do with a polish.

Non-life

1. Regulation
2. Macro-economic trends
3. Natural catastrophes
4. Capital
5. Investment performance
6. Corporate governance
7. Actuarial assumptions
8. Talent
9. Management quality
10. Interest rates

The big story on the non-life front is the exceptional incidence of natural catastrophes over the past year, and the surge in claims: earthquakes, floods and storms. The insurance cycle is also at a low point, with little sign of recovery in a soft market. These concerns come on top of heavy regulatory demands on capital and solvency, as well as continuing uncertainty about the global macro-economic outlook. Management quality and staffing remain high level concerns.

Composite

1. Regulation
2. Capital
3. Macro-economic trends
4. Talent
5. Investment performance
6. Distribution channels
7. Natural catastrophes
8. Risk management
9. Corporate governance
10. Reputation

Composite insurers have more diversified portfolios than pure life and non-life companies, but they are exposed to the same risks: global economic uncertainty, volatile investment markets, growing catastrophe claims and soft pricing. Improved risk management is high on their agenda. Their exposure to regulatory risk is among the highest in the industry because of the breadth of their activities.

Finding good talent is a strong concern

Reinsurance

1. Regulation
2. Natural catastrophes
3. Capital
4. Long tail liabilities
5. Investment performance
6. Macro-economic trends
7. Political risks
8. Talent
9. Interest rates
10. Risk management

The reinsurance market is bearing the brunt of the surge in catastrophe claims at a time when market conditions are difficult and regulatory pressures are growing. Conditions are intensely competitive: capacity is ample and pricing is soft. The sector's capital and reserves are also coming under closer scrutiny by the regulators and the primary insurers. The sector is exposed to long tail liabilities and to the political uncertainties currently facing many countries. Its ability to manage risk is always on test.

The London Market

1. Regulation
2. Natural catastrophes
3. Macro-economic trends
4. Talent
5. Investment performance
6. Capital
7. Corporate governance
8. Managing costs
9. Long tail liabilities
10. Management quality

The London Market, the hub of the international insurance business, feels hard pressed by the wave of new regulation and rising catastrophe claims. Its deeper concerns are with the squeeze on profitability from rising costs and excess capacity which is keeping premiums down. The competitive position of London itself is also an issue in light of new rules and taxes. This sector is among the most concerned about the difficulty of attracting good people into the insurance business.

Regulators

1. Retail sales practices
2. Capital
3. Investment performance
4. Actuarial assumptions
5. Long tail liabilities
6. Corporate governance
7. Macro-economic trends
8. Regulation
9. Managing mergers
10. Natural catastrophes

The regulators have a very different view of risk from the industry. Unsurprisingly, they are the only group that does not see regulation as the No. 1 risk (though it still made No. 8). Instead they focus on the big regulatory agendas in the areas of retail sales practices and capital/solvency, and on the quality of the industry's assessment of risk. They clearly expect some consolidation in the industry since they are concerned about the management of mergers.

Observers

1. Regulation
2. Capital
3. Investment performance
4. Natural catastrophes
5. Long tail liabilities
6. Actuarial assumptions
7. Risk management
8. Complex instruments
9. Macro-economic trends
10. Distribution channels

Observers (respondents to the survey who are not insurance practitioners but close to the industry) also have regulatory risk as their top concern. This is an important finding since it says that this risk is not just an industry concern. Where observers differ from the industry is in their stronger focus on risk management capability, and the continuing use of complex instruments of the kind that got insurers into trouble during the financial crisis.

North America and Bermuda

1. Regulation
2. Interest rates
3. Investment performance
4. Natural catastrophes
5. Macro-economic trends
6. Political risks
7. Talent
8. Long tail liabilities
9. Corporate governance
10. Distribution channels

Regulation topped the list of risks for all geographic areas covered by the survey, making this a truly global issue. The North American and Bermudan markets differed from the rest in their strong concern about the path of interest rates, where there is great uncertainty in the US, and the related performance of their investment portfolios. They also had fewer concerns about pressures on capital compared to other regions (like Europe) where new solvency regulations are on the way.

Capital adequacy is a big issue for Europe

Europe

1. Regulation
2. Capital
3. Macro-economic trends
4. Investment performance
5. Natural catastrophes
6. Long tail liabilities
7. Political risks
8. Actuarial assumptions
9. Interest rates
10. Talent

Europe dominated the responses numerically, though many of the London-based respondents were from different parts of the world. This ranking, therefore, reflects the broadest consensus about the risks facing the global insurance industry: burgeoning regulation, particular so far as it affects capital adequacy, uncertainty about the economic and investment environments, and the sharp rise in catastrophe claims. The shortage of talent is also a worldwide concern for the industry.

Middle East/Asia

1 Regulation
2 Talent
3 Corporate governance
4 Capital
5 Distribution channels
6 Managing costs
7 Management quality
8 Actuarial assumptions
9 Reputation
10 Retail sales practices

Although Middle East/Asia share other regions' concern about regulatory risk, the response is notable for the strong ranking of institutional issues such as staffing and corporate governance. Talent is in short supply in this market. Respondents also show a concern for marketing issues (distribution, retail sales and reputation) and are the most conscious of all the regions of the need to contain costs. Concern about fraud is highest in this region but macro-economic risks are less of an issue.

Catastrophes dominate in the Pacific region

Far East/Pacific

1 Regulation
2 Capital
3 Talent
4 Macro-economic trends
5 Natural catastrophes
6 Investment performance
7 Interest rates
8 Distribution channels
9 Reputation
10 Managing costs

This is the region which has been hardest hit by recent catastrophes, and where the pressure on human and capital resources is currently strongest. The industry sees its reputation very much on the line in the quality of its response to the disasters. But overriding all these concerns is the scale of regulatory reform being imposed in many countries, and the industry's ability to manage it while market and claims pressures are so intense. There are questions, too, about the rating of Japanese insurance companies.

The Banana Skins

1. Regulation (5)

The fast-rising tide of regulation emerges as the greatest risk seen to be facing the global insurance industry today – and global is the word since this risk ranked high in all the major markets responding to this survey. Even the class of respondent we have labelled Observers (i.e. non-practitioners, but close to the industry) placed regulatory risk No. 1. The only class that did not were the regulators themselves who placed it No. 8.

This result repeats the finding of the first *Insurance Banana Skins* survey in 2008. In the subsequent survey (2009) regulatory risk fell to fifth place, but this was only because of more urgent concerns about the impact of the financial crisis. The latest result also repeats persistent findings in the parallel *Banana Skins* survey of the banking sector where regulatory risk has been a front-runner for many years.

Regulation is a huge cost and distraction

Regulatory risk is seen by our respondents to take many forms.

Cost. The sheer volume and complexity of new regulations – now flowing at three levels, international, regional and local – imposes a heavy cost and distraction on insurance companies at a time when capital and management are already tightly stretched. The chief risk officer of a leading UK insurer said: "The regulatory challenge is the most significant risk faced by the insurance industry in 2011, particularly within Europe and especially the UK. This comes at a time when market conditions continue to soften against the backdrop of increased incidence of catastrophe losses and deteriorating economic conditions. As a result there has been a diversion of talent to managing the regulatory risk, potentially to the detriment of oversight of the commercial challenges". This view was widely echoed by other respondents. There was even concern in insurance-friendly Bermuda where one respondent listed "regulatory cost and accuracy" among his chief concerns.

Volume. Many major initiatives are coming at once, among them the EU's Solvency II Directive, the new IFRS reporting standards and the UK's Retail Distribution Review. This is adding to the cost and the confusion.

Capital. New regulations are likely to lead to substantially higher capital requirements, with attendant costs. (See No. 2).

Banking spillover. The insurance industry feels it is being tarred with the same brush as the banks in the aftermath of the crisis, and will, as a result, end up with unnecessarily onerous and inappropriate regulation. David Keefe, joint editor of *Global Risk Regulator*, said insurers "could be hit with higher than necessary capital charges in regulators' post-financial crisis enthusiasm for lumping all financial institutions together".

Uncertainty. The amount of new regulation plus structural changes to the regulatory system in the EU and the UK are creating uncertainty and complicating business planning. The timing of major regulatory initiatives has also to be settled, adding to the difficulties. A senior executive at one of the big German insurers said

> **'A ridiculous burden'**
> [The biggest risk] is the sheer level of regulatory change that is converging at the same time – RDR, Test-Achats, Solvency II, IFRS 4 Phase 2 – all scheduled within a few weeks of each other. Whilst I don't agree with every part of every initiative, I am far more concerned that this is placing a ridiculous burden on key technical areas and creating a change programme no sane company director would ever take on in that period through choice…
> **Steve Groves**
> Chief executive officer
> Partnership, UK

that the biggest risks were "uncertainty over the Solvency II final implementing measures, and other legal and regulatory uncertainty, and increased scrutiny."

Change. Many respondents expect the scale of the regulatory upheaval to lead to big structural changes in the industry: mergers, new business strategies, sudden exits, all of which will heighten risk. Pekka Luukkanen, chief executive officer of Nordea Life in Finland, said that the new regulatory environment "could lead insurance companies to shift their strategies too quickly to ensure their ability to deliver an acceptable level of return on equity".

Competitiveness could be badly affected

Unlevel playing field. One of the major risks seen in Europe is that the weight of EU regulation will put the region at a disadvantage vis-à-vis the US and Far Eastern markets, and drive business away. This concern is particularly strong in London where the Financial Services Authority has a reputation for "gold plating" the rules and adding to their cost. The head actuary at one of the life companies said that "a combination of increased capital requirements and regulations, preventing the use of risk factors, will push up costs and drive business offshore".

This was not just an EU problem. The vice-chairman of a large Swiss life company said that regulatory pressures were creating "an uneven playing field" there too and several other respondents wondered how Solvency II would play out in the global marketplace in competitive terms. There was also concern in emerging markets. An insurer in India said the regulator there was becoming "a supercop", and a respondent from the Gulf said regulators were using new regulation as a pretext to build protective barriers round the local market.

But a minority of respondents saw regulatory risk in a different light: in the reluctance of the insurance industry to accept the need for improved regulation, and adapt to it accordingly. A Solvency II consultant said that the new measures "represent an enhancement of good practice, so well-run entities will be able to embrace [them]. Those entities which do not hold high quality capital and have poor risk management tend to be overly critical of Solvency II. The risk is that there will be setbacks in implementation due to industry lobbying which is not necessarily in the best interests of the industry as a whole".

2. Capital (3)

The availability of capital to meet tougher regulatory requirements and mounting claims is a high level concern throughout the industry. In particular, the EU's forthcoming Solvency II Directive laying down new rules for capital and liquidity is expected to put heavy pressure on insurance companies: compliance, resource management, pricing and ultimately on profitability. One senior regulatory expert said that Solvency II "remains a dark cloud hanging over so many business issues".

Solvency II is proving highly controversial

The debate over the merits of Solvency II is complex, but the balance of sentiment among our respondents was strongly negative. The great majority of them expected it to be excessive, adding cost and distraction, and, by reducing profitability, triggering widespread and potentially disruptive restructuring in the industry. A London insurance consultant said that "the path to Solvency II is proving rather extended and it is beginning to undermine its credibility. The cost to the industry has probably already passed the value of any benefits".

Much of the concern focuses on the constraints that Solvency II will put on insurance companies' choice of investments. Andrew W. Sharpe, financial risk director at the Prudential in the UK, said that "despite many signals that Solvency II should be developed in a manner that enables companies to develop bespoke, company specific approaches based upon their risk profile and proportionality, there is a significant risk that the industry will migrate towards solutions that are way in excess of this as we seek to platinum plate our models".

Sir Adam Ridley, chairman of Equitas Trust, warned that Solvency II could hit the Lloyd's insurance market especially hard because its underwriters were efficient and worked with lower levels of capital. Solvency II, he said, "offers the opportunity to jealous competitors and anxious regulators to discriminate against Lloyd's by raising solvency and capital requirements disproportionately – which would have extremely bad consequences not just for Lloyd's' businesses and their clients but for London generally". One Lloyd's underwriter described it as "largely pointless".

Some respondents warned that smaller insurance companies might not be able to meet the new requirements and would be taken over, or that less profitable lines of business would be dropped. Product innovation could also be held back. Martin Rueegg, chief operating officer at AXA Insurance in Singapore, said that while Solvency II had some good elements, "it will also be translated into a re-focussing; i.e. some niche lines of business will suffer due to missing capital".

Although the focus of capital availability is the EU, it is troubling other parts of the world as well. Respondents from the US, Bermuda, the Far East and South Africa expressed similar concerns. In the Asia Pacific region, recent earthquakes in Japan and New Zealand have put heavy pressure on insurance company resources and could strain capital availability there too.

But some respondents pointed out that the problem is the exact opposite: there is too much capital in the industry, creating a soft market and weak prices. The finance director of a UK insurer said that "too much capital is causing prices to continue to slide". A Lloyd's underwriter saw "a soft market driven by excess capital, despite a number of significant natural catastrophe losses which ought to focus improved pricing".

3. Macro-economic trends (4)

A highly uncertain economic outlook in many regions

The difficult economic and financial climate remains a top level concern for the industry, with several dangers in view: a weak recovery, resurgent inflation and instability in many regions. These concerns are widespread, coming from all major markets.

Concerns are strongest in Europe where the chief risk officer of a large UK composite said that “recent and ongoing unrest in North Africa and Middle East has the potential to spill over into major oil producers (Saudi, Iran) with knock-on oil price increases and a detrimental impact on fragile economic recovery in the western economies”. The EU’s sluggish performance compared to other regions was widely noted.

In the US, concerns focus on the budget and trading imbalances, and the uncertain outlook for monetary policy in the wake of quantitative easing. A senior insurance company auditor said he was concerned about “continuing low interest rates, currency dilution by the Fed as it monetizes government debt and the impact on the purchasing power of US citizens as less discretionary income may mean fewer investable funds”.

In the Far East, the prospects for both China and Japan remain hard to judge. A senior insurer in Hong Kong saw the industry exposed to “a return to slow/negative GDP growth in major markets”, and several respondents from the populous Indian market said conditions there were “soft and difficult”.

The specific Banana Skins are several.

Inflation. Rising prices are becoming a global problem, with a potentially heavy impact on insurance portfolios, particularly on the life side. The chairman of a large UK pension fund said: “The future course of inflation is unknown and dangerous territory”.

Inflation trends are ominous

Growth. Persistently weak economic conditions would be bad news for the insurance sector as it struggles out of one of its cyclical downturns. Worries about the level of demand and the “soft market” are strong. Steve Corfield, head of group actuarial developments at Aviva, foresaw “reduced customer demand and persistency driven by austerity measures”. Patrick Kelly, internal audit director at ACE Insurance in Singapore, was concerned about “the impact of global financial crises on personal credit, which impacts insurance purchase at a retail level”.

Instability. The stresses in the eurozone, the Middle East and the Far East could still spring nasty surprises: defaults, major market disruption, and long-term structural change. Also, the banking system is not out of the woods. Christopher O'Brien, director of the Centre for Risk and Insurance Studies at the University of Nottingham, said that the financial climate “will remain fragile, and we will continue to have concerns about banks, which will lead to hesitancy about the prospects for a firm financial future”.

4. Investment performance (1)

The ability of insurers to earn sufficient investment income to remain profitable and meet their liabilities remains a pressing issue, though it has been pushed out of its previous top position by more urgent concerns about the regulatory onslaught.

A combination of economic recession, historically low interest rates and new sovereign debt fears has cut investment returns at a time when insurance sales are also depressed. With the return of inflation now a growing issue, concern about profitability is growing. The head of investment at a UK life insurer said: “This is where much of the risk management takes place”.

Shocks and swings in the markets

It is not only the volatility of markets but the shocks and swings. “There are big risks in asset values, and in yields. In these economic conditions, variations can be exceptionally large and sudden, offering no opportunity, or insufficient opportunity, for counteracting action”, according to a pension sector respondent.

There is also a regulatory question: whether new solvency rules on so-called “admissibility” will limit the range of investments that insurance companies can make, forcing them into an expensive portfolio rebalancing exercise.

The concerns are particularly strong on the life side which relies on investment income to fund its products: savings, pensions, annuities. An actuary with a large Japanese life insurer said: “The current low interest rate environment and the shortage of long term bonds will pose challenges to asset/liability management. Furthermore, life insurers will struggle to come out with attractive products as in the past, such as endowment, whole life and annuity plans”.

> **‘Risks beyond the industry’s control’**
> The demise of our industry will not come from the collapse of one or two re-insurers but from another financial cataclysm of the kind that culminated in the financial meltdown of September 2008. These are risks beyond the control of our industry unless – and this is probably a vain hope – the collective investment arms of the insurance industry can lay down rules to the capital markets regarding what they can and cannot do with our money.
> **Insurance company CEO**
> Middle East

Especially at risk are products which guarantee long-term returns. One respondent commented: “Problems remain dire. I don't know how anyone can offer many of the long-term investment products still on sale with a decent conscience”. In Singapore, the CEO of a life company agreed: “Long-term capital guarantees are certainly creating the biggest risk and have led to the failure of companies in the past. Many people see natural disasters or events like SARS as a key risk, but the financial risks companies take on the investment side are significantly larger”.

The investment squeeze could also hurt the non-life side. A director of a large international brokerage observed: “In the medium term, it is difficult to see how a capacity-driven soft market can sustain rising claims costs without the prop of high investment returns”.

5. Natural catastrophes (22)

The reasons for the sharp rise in this risk are sadly too familiar. After a string of ultra-severe events, the catastrophe insurance business is suffering from the after-shocks. A director at a leading international broking firm said: "We seem to be experiencing another 'one in a hundred year event' every six months".

Has catastrophe risk been underpriced?

Whether or not recent disasters signal a new phase of global seismic activity, the damage costs are rising because of the places they are striking. A leading P&C insurer in New Zealand said that catastrophe events "have greater impact due to increased population density and increased values at risk".

Geographically, concerns about these risks were highest in the Far East/Pacific and North America, and, within the industry, among the non-life, reinsurance and London markets, as might be expected. Several respondents thought another major event in the US was due.

As to the impact on the industry, some observed that catastrophe risk had been heavily underpriced due to the intensity of competition in the sector. This was enlarging the impact of claims and reducing the availability of reinsurance cover. Companies' reserving policies were also questioned. The head of reinsurance at a large European insurer saw the risk of "insufficient reserving due to the low rates, and thus an inadequacy of funds among property insurers".

The indirect impact could also be severe. If the Japanese 'quake and the nuclear fall-out hit economic confidence more widely, the insurance sector would certainly be affected. The CEO of a Japanese insurance subsidiary said that "confidence in Japanese insurers has been shaken by an earlier downgrade and another potential downgrade brought on by the recent earthquake and tsunami".

However, there was also a group of respondents who felt that the spontaneous response to natural disasters should be checked. As one of them pointed out, "We shouldn't get over-worried by recent events which – while they remind us that major disasters can and do cost money – also suggest that much of the strain inevitably falls on governments". John Smith, company actuary at Fidelity Life in New Zealand, a country with its share of catastrophes, said that "although rates may increase, 90 per cent of business is yearly renewable term (YRT) so the cost can be passed onto policyholders". At Lloyd's, one underwriter took a very hard-nosed view: "There seems to be an increased incidence [of catastrophes], creating uncertainty, so beneficial".

6. Talent (-)

Human capital is included in the *Insurance Banana Skins* survey for the first time this year since it is emerging as an issue for the sector. The fact that it came in the Top Ten shows it has some urgency.

The reason is scarcity. Talent is in short supply through much of the industry, both as to type and geography. Respondents from markets as varied as Canada, Switzerland, the Gulf, India, Singapore, South Africa and Australia complained of the difficulty of finding – and retaining – good staff. A respondent from the Far East put it bluntly: “There is an insufficient talent pool in Asia”.

Some of the strongest concerns were voiced in London, the centre of the international insurance industry. A main board director of one of the large brokers spoke of “a war for talent”. David Thomson, director of policy and public affairs at the Chartered Insurance Institute (CII), the professional body, said there was “a long-term danger of key skills shortages in areas of UK comparative advantage, e.g. the London market; specialist areas of underwriting etc”.

Talented staff are hard to find – and retain

The scarcity is made worse by the flood of new regulation which has spawned new branches of the business in areas like regulatory policy and compliance. Many respondents said that the demands of Solvency II were drawing their best people away from managing the business, creating shortages on that side as well. The chief risk officer of a large UK insurer said that there had been “a diversion of talent to managing the regulatory risk, potentially to the detriment of oversight of the commercial challenges”.

A further problem flagged by some respondents was poor training. A Lloyd’s manager said there was “decreasing quality coming out of education, a reduction in on-job training and apprenticeships. Also, insurance is not seen as an attractive career”. Some respondents blamed talent shortages on the fact that insurance had a poor reputation. Jean-Louis Reynaert, risk manager at AG Insurance in Belgium, said the industry was “often viewed as boring and non-innovative”.

7. Long tail liabilities (10)

Long tail liabilities (very unlikely losses, or ones which take a long time to materialise), are seen to be a growing risk, partly because of recent events such as natural disasters and the financial crisis, but also because the regulatory climate is becoming more exacting about the way insurance companies manage the reserves they hold against them.

Michele Hengen, chief risk officer at The Co-operators in Canada, said that “events that used to be considered as tail events (e.g. major storm loss, economic crisis) are occurring with greater frequency. There may be increased awareness of the risk, but it was present from the beginning”. Thomas Weist, vice-president of Tokio Millennium Re in Bermuda, said that the traditional way to deal with extreme risks was to diversify into different lines and geographies. “But since these ‘rare and independent’ events continue to occur more frequently than expected, this strategy is not working well.”

Respondents noted a number of areas where long tail risk seems to be growing: the fall-out from the financial crisis where claims are still going through the courts, growing litigiousness of society at large, longevity, and a revival of concern about radiation following the Japanese nuclear meltdown.

The essential question is how insurance companies reserve against long tail liabilities: have they understood the risks and set enough aside to cover them? This area will soon come under the requirements of Solvency II which are likely to be more rigorous and therefore more costly.

8. Corporate governance (17)

Although the risks in corporate governance are seen to have risen quite sharply since the last survey, the tone of the responses suggested that much work is being done to strengthen this once notoriously weak area. In a comment that reflected many of them, a non-executive director of a large UK insurance company said there had recently been “a major improvement in the understanding of the need for good governance”.

Much of this has been achieved under pressure from regulators in many parts of the world. Polys Michaelides, general manager of Laiki Cyprialife in Cyprus, said that “increased cross-border regulation, especially in the eurozone, has helped to improve accountability and uniformity amongst different jurisdictions”.

Governance is becoming a regulatory risk

However the rising risk is now regulatory: the cost of implementing new rules, and the penalties for non-compliance. The risk manager of a Lloyd’s agency said that while overall governance risk was falling “due to improving structures and procedures within the organisation, the likelihood of regulatory demands is rising”. A similar view was expressed in other jurisdictions.

A minority of respondents felt that governance still had a long way to go. The head of group risk at a UK underwriting group saw “a lack of sufficient oversight and governance from non-executives – or insufficient high quality NEDs with knowledge of the industry and an ability to challenge, impacting [insurers’] credibility in the markets”. Geographically, this risk scored high in the Middle East and Asia region. James Portelli, executive vice-president of strategy and planning at Oman Insurance in the UAE, said that companies in the area “have yet to start down this road despite the rhetoric stating otherwise”.

9. Distribution channels (16)

The management of distribution channels – an issue mainly for the life industry which ranked it No. 4 – is a fast-rising concern due to its cost and complexity.

There is also the prospect of major regulatory upheaval in many countries, led by initiatives such as the UK’s Retail Distribution Review (RDR). This will make distribution strategies subject to heightened regulatory scrutiny, which could be costly to manage. Michael Wainwright, partner at City law firm Eversheds, said there were “major changes in store for retail distribution in the UK”. (See No. 18 Retail sales practices.)

There are also technology issues: the choice and management of successful channels in today’s competitive internet world where the shopper has become more powerful. Some respondents felt that the industry was failing to take full advantage of the new possibilities. According to an insurance consultant, the life industry “persists with expectations that it can continue to sell structured products through traditional IFA channels”, Stuart Cliffe, chief executive of the UK’s National Association of Bank and Insurance Customers (NABIC), said that “more innovative use and development of sales channels will be required”.

The rising cost of distribution is another concern. In many markets, competition for distribution capacity is intensifying, driving up brokers' commissions and cutting into manufacturers' returns. Respondents reported examples of poaching, of brokers' "cartels" and other questionable practices. An actuary in Singapore said that "life insurers are aggressively recruiting insurance advisers from competitors with lucrative buy-outs and offering generous retention packages. Though this is a free economy, this 'unhealthy' competition may eventually drive up costs and affect customers…" In India, K.G. Krishnamoorthy Rao, managing director of Future Generali India Insurance, said there was "a lack of development of distribution channels in rural areas, making penetration of insurance a bigger challenge".

10. Interest rates (11)

The low interest rate regime in major markets continues to be a source of concern, particularly on the life side of the business, though the real risk lies in what happens next: change, or no change.

Huge uncertainty about rate trends

With interest rates at historically low levels for four years now, investment returns are under severe pressure, which is hurting income and complicating the management of guaranteed return products in the savings field. A respondent from Bermuda said: "From an investment perspective, we are concerned about the low interest environment which will hurt overall investment returns".

But looking ahead, eyes are on the risk that rising inflation and the aftermath of quantitative easing will force central banks in the major markets to increase interest rates. This was described by several respondents as an area of huge uncertainty, itself a risk. The main worry is the potential impact of higher rates on bond prices against a background of weak economic growth and sovereign debt problems. Life companies are particularly at risk.

However a small number of respondents were more relaxed about the rate outlook. Some thought we were "over the worst", and another said that higher rates would increase the cost of capital and drive surplus capacity out of the market, opening the way to firmer prices.

11. Political risk (18)

The sharp rise in this risk reflects dramatic recent events in North Africa and growing concerns about sovereign risk in Europe, but also longer running trends in the always uneasy relationship between the worlds of government and insurance.

Political risks are increasing

The real concern is about the effectiveness of government, and therefore about political stability. One respondent said: "Almost everywhere there is little plausible political leadership; and a relapse into a double dip recession plus regional pressures could bring down a number of governments, or, as with the Democrats in the US, render them unable to do very much at all". The Middle East is a key focus. One respondent commented: "It was already high risk. After the Libyan civil war, this will increase and will impact on the future cover for Middle East and Arab countries". But there are also the travails of the eurozone with doubts about the ability of governments to manage their affairs. Although the leading question is financial – will Greece and Co be able to pay their debts? – the essential question is political: if they have to be bailed out, how will the cost be spread?

Many respondents also saw political risk in the relationship between the insurance industry and government, always an area of tension. Some issues here are general, for example the sense that the industry has been caught in the slipstream of the crackdown on banks. A senior insurance executive in Hong Kong said: “Political risks are rising as attention moves from banking to other financial services”. The group tax director of a US insurer said that “punitive tax regimes initiated by banking issues will impact insurers/reinsurers, reducing ROEs”.

Some countries have specific concerns about political intervention, such as the medical insurance industry in Australia where new public health policies have created a serious rift between insurers and the government, or India where much of the industry is subject to government *diktat,* and Latvia where the insurance industry lives with a continuously uncertain tax policy. In Europe and North America, there was concern that cost-cutting governments would try to force the insurance industry to take on a greater share of social service provision, though this could also be a business opportunity.

Managing the cycle

This report coincides with a cyclical downturn in the insurance industry which has been made worse by global economic uncertainty. Excess capacity on a grand scale, cut-throat pricing and the entry of new suppliers are all adding to the intensity of competition. The head of risk and capital at a global insurer saw “continuing soft market conditions, low investment returns and rising inflation culminating in the ‘perfect storm’ to lose money and erode balance sheets”.

For non-life insurers, the biggest risk is that these pressures will prevent them raising prices to sustainable levels. The director of risk management at a large US non-life insurer warned that “the insurance industry is competing to such an extent that it is writing at a loss and will suffer something like the turbulence it experienced at the end of 2001\beginning of 2002”.

Although the industry has been able to keep its nose above water by drawing on reserves, this has also put those reserves under closer regulatory and investor scrutiny. Meanwhile profitability has been squeezed by rising claims, driven by the economic downturn and the recent spate of natural disasters. Niche markets are also suffering with a cargo insurer in Latvia observing that new entrants were driving rates down to “ridiculous” levels.

In Europe, the requirements of Solvency II will oblige many insurers to raise capital at precisely the point in the cycle where they need to be as capital efficient as possible to sustain their income and profitability.

12. Managing costs (14)

Cost management remains a strong concern in an industry which is exposed to rising prices and claims in many markets.

At the macro level, the accelerating pace of inflation worldwide is making itself felt. "It's getting more and more difficult to manage costs", said a senior insurance executive in Malaysia. The gradual economic recovery is also having an impact, leading to tighter markets in areas like staffing. In Australia, a senior actuary said that "costs may increase due to competition for talent and the improving macro-economic environment".

Cost pressures are growing

In specific sectors like health and motor insurance, costs are rising well above inflation. Anthony Connon, chief financial officer of Australian Unity Limited, pointed to "the inexorable increase in costs as further advances in medical science enable people to stay alive longer for yet another procedure". Another specialist area where costs are rising is reinsurance as a consequence of the recent wave of disasters. The cost of distribution is also rising in many markets.

But the big cost pressure comes from a quarter which is more difficult to control: regulation. Many respondents said that regulatory compliance had now become their biggest cost problem, with soaring staffing, systems and capital resource budgets. The corporate strategist at a large UK composite group wondered: "Given the costs of regulation and the increasing levels of backing capital, can the industry provide customers with savings products they want to buy at a price that gives backers a return high enough for them to want to invest in our industry?"

13. Actuarial assumptions (9)

The quality of the assumptions used by actuaries to model and measure risk are a constant source of debate, and this risk always throws up sharply conflicting comment in *Banana Skins* surveys. This year was no exception. The president of a life company in Indonesia observed: "I'm not sure why this is a risk" while an insurance consultant asked: "Are actuarial models…becoming the main operational risk?" This risk was No. 4 on the regulators' list.

In general, the responses we received were sceptical about actuarial assumptions, seeing them as increasingly remote from developments in the "real world". The chief operating officer of a leading New Zealand life company said that "generally, the world is moving increasingly quickly, and so the validity of assumptions is falling".

Elements of the changing world include increased longevity and – for the EU at least – the potentially huge implications of the Test-Achats ruling on gender. In this landmark case, the European Court of Justice ruled that insurers can no longer take gender into account when pricing insurance policies. The main products affected are motor insurance, life insurance and annuities – which will require major adjustments in pricing.

Many respondents condemned the ruling. One actuary warned that there would be greater legal uncertainty, even market turmoil, and wondered whether the next step would be to outlaw discrimination based on age: "low likelihood but potentially horrendous".

Actuarial assumptions will also be an area affected by the rules of Solvency II on reserving, making them potentially more controversial. John Pollock, executive director of protection and annuities at Legal & General Group, said that "externally imposed requirements [are] uncertain and less stable than internal capability".

14. Management quality (13)

In the first *Insurance Banana Skins* survey in 2008, the poor quality of insurance management emerged as the No. 3 risk facing the industry, a rather shocking finding. One respondent described it as "a mixed bag which may need invigorating".

In the second survey in 2009, however, this concern slipped to No. 13, though the comments were still unflattering: "Generally poor", and "On the whole, less than required".

Insurance companies are doing better than banks

This time, the ranking of this risk is little changed, and some of the comments were even flattering, on the basis that insurance companies had, with some exceptions, come through the financial crisis a lot better than the banks. "Surprisingly good, given the challenges" said an insurance company finance director.

Some respondents also attributed the better performance to more disciplined regulation and training. One Lloyd's risk manager said he had seen an improvement "due to increased governance and regulatory requirements on firms". A senior executive with a Swiss life company said there had also been a shift "away from short term profit to long term focus".

But the increasing demands of regulation may also be having a damaging effect on management quality, by bogging it down with uninspiring issues like Solvency II, and sapping its energy on non-productive tasks. An actuary with one of the large UK non-life companies saw management issues becoming more problematic "as top managers may be put off by rising regulatory intervention". In the regional markets, securing good quality management remains particularly problematic.

15. Risk management (6)

The striking fall in the ranking of this Banana Skin reflects the fact, as one respondent said, that "risk management is improving fast". The industry's capability in this field has certainly been severely tested in the last 2-3 years, and has, arguably, come out better than the banks'.

Is risk management improving?

But the story is not over. New regulatory initiatives, particularly Solvency II, will raise the bar considerably for insurance risk management, a point noted by a large number of respondents. One of them said: "Solvency II is driving a step improvement change within the industry", though Solvency II could itself bring about unwelcome changes, such as an over-mechanistic approach in an industry with a strong "seat of the pants" tradition.

Typical here would be an over-reliance on models and "quant" mathematics. George Tyrakis, an analyst at Aon, said that "as the push for internal models under Solvency II intensifies, risk managers and underwriters may start to place more reliance on the model and less on judgement". The head of the life business at an international reinsurance group was concerned that regulation would create "pressures to 'avoid risk' rather than 'manage risk', where the latter should be fundamental for this industry".

16. Reputation (15)

Reputation risk has been more of an issue for the banks than the insurance companies in the last couple of years. But now that normality is returning to the financial markets, more deep-seated reputational issues for the insurance industry are beginning to appear as well.

The industry image is still tarnished

One is "brand contamination", the risk that the insurance sector will end up being tarred with the same brush as the banks, and will suffer the same political and regulatory comeback. For many respondents, this is already happening. "Punitive taxes" were being extended to insurers, and regulators were "seeking their revenge", they said.

'The lack of desire to pay claims…'
Reputational risk is without doubt the key area that will threaten the insurance industry in the foreseeable future. The lack of clarity about exclusionary language, the lack of desire by insurers to pay claims as a result of flood/water damage, and general procrastination in policy wordings, plus the complete lack of an Industry Body that has real power, will all result in policyholders continuing to view this industry as an unprofessional group without *gravitas*. Confidence will continue to slide and the number of those who choose to self-insure will increase.
General manager
Australian reinsurance company

Whether or not they deserve this fate, insurers are sensitive about their public image after the many controversies of recent decades, particularly on the life side. In the Netherlands, Mark Vlaminckx, manager of value management at Eureko, said that "winning back the trust of consumers" was key. In Singapore, the CEO of a large composite insurer said that the industry "continues to suffer from a lack of trust and insufficient transparency. There must be a concerted drive to put the customer first". In South Africa, Izak Smit, managing executive of Absa Life, said that "churning of life policies due to upfront commission is leading to reputational damage and further regulation".

On the non-life side, the management of claims is also a controversial issue. Respondents from Australia and New Zealand said that the industry's poor response to recent catastrophes "is causing great problems in the relationship with policyholders and government etc.", according to an insurance company director. In Latvia, the CEO of one of the country's leading brokers said there was "a lack of will to pay claims". Many respondents brought up the problem of underinsurance, blaming it on the consumer's mistrust of insurance companies.

Although new regulatory initiatives are designed to deal with many of these problems, there is also a fear in some quarters that they will merely add to insurers' costs which will be passed on to the consumer, tarnishing the industry still further.

17. Back office (24)

This Banana Skin is rising because of the burdens placed on back offices and systems – already creaking – by the weight of increased regulation.

Insurance back offices have long been problem areas: overstretched, underfunded, and seen as low priority by senior management. A German insurer said: "Operational risk has in the recent years not been in the focus of insurers, although it ultimately might be one of the most significant and challenging risks". From Hong Kong, another respondent observed that this was "an enduring problem being addressed only slowly".

Operational risk is returning to the fore

The risks identified by respondents included waste, errors, poor data management, fraud, exposure to cyber attack and reputation damage. In emerging markets many of these problems are particularly acute. An insurer in Malawi reported that "most systems are yet to be automated, such that claims information is still being kept manually".

But it was particularly the task of adapting systems to the more stringent reporting requirements imposed by new regulation that attracted comment. Would these force through much-needed improvement, or merely trigger chaos? Some respondents saw this becoming "a drain on resources" and a challenge that some firms would fail. But others felt it would be positive, though with plenty of difficulties on the way. "Better systems are gradually being introduced", said a London-based insurer, and several respondents said that improvements were already visible.

18. Retail sales practices (25)

The risks in retail sales practices are seen to have risen even though this is an area where insurers have had plenty of time to correct the practices that gave them a bad name in past years. The reason is that the regulators are now hot on the tail of insurance salesmen, and big regulatory changes are on the way. For regulators, this was the No. 1 risk.

Regulatory crackdown on poor sales practices

The subject is dominated by initiatives like the UK's Retail Distribution Review (RDR), a mammoth six-year exercise conducted by the Financial Services Authority to bring transparency to a notoriously opaque area of the market. Measures to improve product description, eliminate conflicts in the sales function and set professional standards are being introduced with a final deadline in 2012. Similar moves are afoot in other markets, for example the EU's proposed legislation for packaged retail investment products (PRIPS). The finance director of a UK insurer said that "RDR could have a big impact on our business as the whole landscape of the IFA market changes".

This raises big issues as to the ability of insurance companies to meet the new demands, to handle the costs, to be ready on time. On many of these scores, respondents felt that insurance companies lacked clear strategies and would not be compliant – with expensive consequences. A regulatory adviser said: “In the UK I am still unconvinced that enough firms have robust strategies going into RDR reforms”.

Some respondents saw this risk stemming from a culture where the customer came second to profit. One saw “a persistence of product-push sales processes and management”. Another said that the industry needed to adopt strategies of “needs-based selling”. It is also a growing problem in China where the president of a large life company listed mis-selling among the main risks facing the industry there. These attitudes would have to be rooted out if the industry was ever to eliminate a self-inflicted risk.

19. Complex instruments (8)

Concern about the use of complex instruments by insurance companies has dropped sharply for the simple reason that they have become less used following the disastrous experiences of the credit crisis. It was through structured and derivative-based products that insurance companies found themselves directly exposed to collapsing financial markets.

Simon Groves, head of internal audit at Hyperion Insurance Group, said they had “had their day (hopefully)”. Another insurance company manager said that “after the sub-prime disaster, insurance companies have become more conservative in their choice of alternative investments”. A number of respondents from the non-life side pointed out that these instruments were not appropriate to their line of business anyway, and may well become more difficult to access under the new regulatory regime.

But they are still around. The chief financial officer of a Czech insurance company said that structured products “are still valued by the people who caused the crisis”. Some also saw the upcoming solvency requirements potentially opening up a new market in instruments to mitigate the effects of tougher capital adequacy rules, which some insurance companies might find tempting.

20. Climate change (28)

The industry is relaxed about global warming

Climate change is seen as a low order risk by financial services providers. In more than ten years of Banana Skins surveys of the banking sector, it has never come higher than No.15 in the rankings. Four years ago, it made it to No. 4 in the *Insurance Banana Skins* survey when Hurricane Katrina was still fresh in people’s minds. But after that it plunged, and even the recent floods in Queensland have not restored its position.

The responses to this survey reflected a sceptical attitude towards climate change among a large segment of the insurance industry. “A red herring” said one respondent bluntly. The chief actuary of a Lloyd’s underwriter said that “climate change exists, but all it does is change risk levels. It is not fundamental to the P&C

Industry as not much happens on a one-year basis, which is the term of most non-life policies".

Nonetheless, many respondents listed climate change among their leading concerns, including a senior Japanese insurance executive who ranked it alongside earthquakes as the most pressing issue facing the industry. A senior financial regulator warned that it would "lead to more natural disasters and higher flood risk". Among types of insurer, this risk ranked highest with reinsurers (No. 12) who ultimately bear the brunt of the losses.

Alice Chapple, director of sustainable financial markets at Forum for the Future, the green business group, said that the insurance industry "will need to rethink its approach to these long-term systemic risks and evolve new business models to take them into account".

21. Reinsurance (20)

There was little change in the position of reinsurance risk despite the massive events which have rocked the industry over the past year.

Reinsurers bear the brunt

The risks here are a matter of perspective. From the reinsurance buyers' point of view, market conditions remain favourable: capacity is broad and competitively priced. The risk is that this will change because of the catastrophe losses. Edward Eadie, chief financial officer of Fidelity Life Assurance Company in New Zealand, one of the countries in question, said that rates "will definitely increase following the Canterbury earthquake and other global events (e.g. Japan)". Paul Barnicoat, chief financial officer of insurance at Westpac in Australia, where floods have caused large losses, said that "reinsurance costs will obviously be an issue in this part of the world".

The availability of reinsurance could also be affected, particularly if the sector suffers reinsurer failure, as some respondents thought possible. Linked to this was the issue of credit risk: how secure are the counterparties to reinsurance transactions?

The view is different from the reinsurance seller's point of view. Here, the concern is about the intensity of competition and cut-throat pricing. A senior underwriter with one of the large European reinsurers saw prices continuing to fall. He said that "along with regulatory changes, margins are narrowing to a point where profitability over a cycle seems more challenging than ever". Reinsurers are also bothered by persistent questions over their financial strength, and the "power" of the credit rating agencies which assess them. The chief risk officer of a Bermuda-based reinsurer listed "rating agency accuracy" as one of his top concerns.

22. Fraud (23)

The slight rise in concern about fraud and other types of financial crime reflects the well-known phenomenon that application and claims fraud tends to jump in a recession. This was widely remarked, though with varying levels of intensity. "Fraud has become an industry" according to an actuary in Finland, but a UK respondent commented: “Obviously up, but given economic circumstances this is not surprising and not that worrying”. The region with the highest level of concern on this risk was Middle East/Asia.

Insurance fraud always rises in a recession

If anything, concern is stronger about new types of crime because they are less well understood, particularly those facilitated by modern technology: organised communication-based crime, cyber attacks, hacking, both as they affect insurance companies directly and the risks they insure. One respondent pointed out that the proliferation of distribution channels is another factor behind the rise in fraud.

23. Terrorism (26)

Very mixed views about this risk, which has always been lower on the Banana Skins scale than the newspaper headlines suggest it should be.

The London Market had the highest concerns about it. The risk manager of a Lloyd’s agency saw the risk rising because of “increased instability in the Arab world, and change in regimes to the unknown and likely extremist”, and other respondents pointed to the large, even growing, number of unresolved conflicts around the world. In Malta, an insurance company chairman felt particularly exposed: “Internationally, the main concern is the rising risks of terrorism and natural catastrophes”.

But others were more sanguine. “Insurers have a much better handle on terrorism exposures than some years ago” said the director of risk management at a US underwriter. Others said it was “limited to certain geographic areas” and “on the wane” or “excluded from the majority of contracts”.

But one London underwriter felt that insurers were dangerously underestimating the risk. “The market tends to see this as 'free' profit; when an event occurs, the fallout will be interesting”.

24. Product development (29)

Although the insurance industry’s record on product development attracts frequent criticism, this is not seen as a high risk area. In fact, the message coming through responses is that the flow of new products is likely to get worse rather than better.

This is because of the impact of tougher regulation and higher capital costs. One respondent said that “the industry is so hamstrung that it is unable to react innovatively or flexibly”. Andreas Bachofner, director of the Shires Partnership, said that “modelling for new products is difficult, and the impact on Solvency II requirements is hard to assess. This could lead to even fewer new product developments”.

Even so, the risks of poor innovation are recognised. One insurance consultant said that the industry “is not addressing business/operating models radically enough to meet future customer product and [distribution] channel requirements”. Other respondents were concerned that products had become “too commoditised”, and were failing to offer sufficient choice or value. One said that “competitors are quick to copy, so there is a need for continual innovation to stay ahead of the pack". The chief financial officer of a large Belgian insurer saw the industry threatened by products from banks on the savings side.

In New Zealand, the managing director of a leading composite insurer said the task of the industry there was "to develop products that are meaningful and affordable in a world where the consumer is facing inflation and recovery from personal hardship through major insurance events". Others pointed to the need for more products to suit an ageing population and a world where governments are cutting back on social services.

25. Pollution (34)

Pollution risks are seen to be manageable

Surprisingly, perhaps, after the Gulf of Mexico oil spill and other recent disasters, this risk comes way down the list. But this is in line with earlier surveys where pollution risk was described as "important but containable".

A broader point that emerges from this survey is that underwriting risks (eg weather events, pollution etc.) are seen as lower order risks by insurance companies than operating risks (regulation, management, systems etc). But that is as it should be: underwriting risk is their business.

Nonetheless, the number of major pollution incidents is increasing, and one respondent said there were also "unknown costs from contingent business interruption and political scapegoating, e.g. Deepwater Horizon". The segment of the industry that had the greatest concern about this risk was reinsurance.

26. Managing mergers (31)

More mergers on the way?

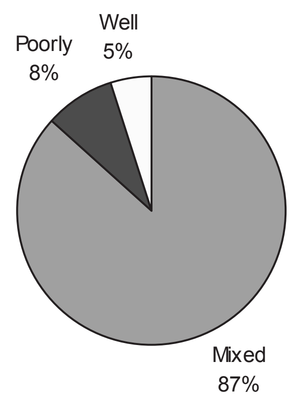
The conditions seem ripe for consolidation in the industry: a soft market, rising costs and capital requirements, and the need for efficiency gains. But will consolidation create healthy new entities, or deals that fail? This was one of the Top Ten concerns for regulators, and some respondents were sceptical.

The finance director of a European insurer said the industry's record on mergers "has never been good, but the number of mergers will increase". In Norway, a risk manager said that "regulatory changes will drive M&A activities without value creation, and create bigger entities".

But some respondents did not see a risk in their own markets. In New Zealand, a respondent said there was "a limited ability to effect mergers due to competition concerns".

Preparedness

We asked the question: "How well prepared do you think the industry is to handle the risks you have identified?" Respondents could answer: poorly, mixed or well.



Preparedness is improving – slightly

Eighty seven per cent of the respondents replied "mixed", usually because they identified strengths as well as weaknesses in the industry, and within their own organisations. Only five per cent thought the industry was well prepared, and 8 per cent thought it poorly prepared. The reasons given for good preparedness included high quality management and strategy, a strong capital position and an ability to adapt to the new regulations. The reasons for poor preparedness included weak internal controls, inadequate risk management, stretched financial resources, and exposure to regulatory risk.

But this is a more positive result than the 2009 survey when only 4 per cent answered "well", 85 per cent answered "mixed" and 11 per cent said "poorly".

APPENDIX: The questionnaire

CSFI

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Insurance Banana Skins 2011

We are asking senior insurers and close observers of the financial scene to describe their main concerns about the insurance industry as they look ahead. We'd be very grateful if you would complete this questionnaire and return it to us by March 31st 2011

Name | **Position**

Institution | **Country**

Which part of the insurance market do you represent?

Broking/intermediary | **Life** | **P&C/Non-life**

Reinsurance | **Other** (please state)

Replies are in confidence, but if you are willing to be quoted in our report, please tick

Question 1. Please describe your main concerns about the risks facing the insurance industry as you look ahead over the next two to three years.

Please turn over

Question 2. Here are some areas of risk which have been attracting attention. Looking ahead, how do you rate their severity, and how do they compare with last year? Use the right hand column to add detail. Add more risks at the bottom if you wish.

	Severity 1=low 5=high	Trend Rising Steady Falling	Comment
1. Actuarial assumptions			
2. Back office/systems quality			
3. Capital			
4. Complex instruments			
5. Corporate governance			
6. Distribution channels			
7. Fraud			
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22. Talent			
23. Climate change			
24. Natural catastrophes			
25. Pollution/contamination			
26. Terrorism			

Question 3. How well prepared do you think the industry is to handle the risks you have identified?

Poorly ☐ Mixed ☐ Well ☐

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