Insurance Governance Leadership Network
ViewPoints

3 July 2013 TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781 290 2270

Exploring the risk environment: regulatory, macroeconomic and other top risks

On 16–17 May 2013, Tapestry Networks and EY welcomed 19 non-executive directors, chief risk officers and distinguished guests to the first annual Insurance Directors' Summit in London. This was the seventh meeting of the Insurance Governance Leadership Network (IGLN).

The summit convened as the industry faces its most challenging time in recent memory. Several directors argue that the majority of insurers weathered the financial crisis reasonably well, but it remains to be seen how large insurers will navigate the multitude of economic, legal and regulatory, and strategic challenges buffeting the industry since that time.

Summit participants note that the complexity and volume of risks facing the sector is greater than ever before. New regulations and the macroeconomic climate rise to the top of the list of concerns for many directors, who engaged in a wide-ranging series of conversations related to the systemic importance of insurers, the need for supervisory coordination and the impact of persistent low interest rates over the course of the Summit. While these risks may dominate board-level discussions, insurers also stressed the need to maintain a laser focus on accurately assessing emerging risks as well.

At the summit, we were joined by key industry participants from the public and private sectors, including Yoshihiro Kawai, Secretary General, International Association of Insurance Supervisors, Patrick Montagner, Director, Insurance Supervisory Department, Autorité de Contrôle Prudential, Banque de France, Carlos Montalvo, Executive Director, European Insurance and Occupational Pensions Authority, Hugh Savill, Director of Prudential Regulation, Association of British Insurers, Paul Sharma, Deputy Head and Executive Director of Policy, Prudential Regulation Authority and Kurt Karl, Chief Economist, Swiss Re.

We are pleased to share five *ViewPoints*[1] that capture the spirit of summit conversations, as well as insights from prior meetings and ongoing dialogues with IGLN participants.

- **"Implications of 'systemically important' designation."** Since the IGLN's inception just over a year ago, the challenges presented by new modes of regulation and supervision have been a principal topic of discussion. In particular, the topic of systemic importance of insurers has come to the fore. In June two large insurers were named as domestic systemically important financial institutions (SIFIs) in the United States. By all accounts, the list of insurers considered to be global SIFIs will be made public shortly. In relatively short order, supervisors will need to clarify how new supervision, resolution and loss absorbency requirements will work.
- **"Cross-border supervision: the next big challenge."** During the summit, several directors and supervisors recognized effective cross-border supervision as a principal challenge facing the industry. Whether or not IGLN participants are designated as systemically important, all large and internationally

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics. For a complete list of summit participants, see Appendix 1. A complete list of 2013 IGLN interviewees and meeting participants can be found in Appendix 2.

active groups will face more intensive supervision in the coming years. Summit dialogue focused on the challenges to implementing a new model for cross-border supervision, which range from the need for new skills and frameworks within supervisory bodies, to the difficult work of setting supervisor and industry expectations.

- **"Improving risk identification processes."** Over the last six months, IGLN conversations have explored the ways insurers are improving risk governance. What began with discussions about the structural components of risk governance at the board and executive management levels has evolved to include a discussion of process and practice. In this meeting, participants focused on improving risk identification practices. In an environment of complex and ever-changing risks, directors hope to understand better how their companies might improve the processes for identifying emerging risks and evaluate these potential risks from new perspectives.
- **"Top and emerging risks for global insurance."** This conversation grew from the discussion of risk identification, and focused on specific risks confronting insurers. In addition to regulatory and macroeconomic concerns, participants identified and evaluated crucial and evolving risks related to: operations, information technology and outsourcing, consumer protection and company conduct, use of internal models, changes in business models and competitive threats.
- **"The extended low-rate environment: challenges for the insurance industry."** Over the past five years, rates of return have fallen to historic lows. The effects of low rates on the insurance industry are slow to develop, which may both allow insurers more time to react and tempt them to postpone necessary actions. At the summit, participants discussed why low rates of return are a concern, how insurance boards should respond, risks of a rapid rise in rates and why the industry should reach out to policymakers.

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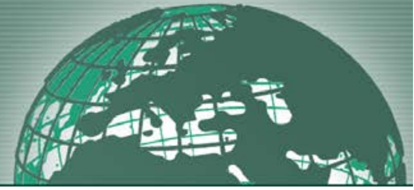
We encourage you to share these *ViewPoints* with your colleagues for discussion of the ideas they contain and the implications for your institution and the insurance sector at large. We look forward to continuing the dialogue in 2013 and beyond.

Sincerely,

Shaun Crawford	Peter Fisher
Global Insurance Sector Leader	Partner
EY	Tapestry Networks

July 2013



Implications of "systemically important" designation

> *Traditional insurance is not the thing that will combust, but within traditional insurance business is a whole lot of combustible material. You have some inherently systemic businesses within traditional insurance groups and there is a lot of interconnectedness – potential contagion. Once the market understands that the systemic activity is connected to the larger group, which is too big to fail, then it becomes consequential. It is politically and socially important. Then, the systemic business can grow on the back of the assumption that the institution is too big to fail.*
>
> – Insurance regulator[2]

The debate over the systemic importance of large financial institutions began in the banking sector during the financial crisis and spread quickly to other non-banking financial services, including insurance. Today, global and domestic regulators are moving forward with new regulatory requirements for those large financial institutions deemed too big to fail. In 2012, 28 banks were labeled global systemically important financial institutions (G-SIFIs). By the end of July 2013, the first cohort of global systemically important insurers (G-SIIs) will be named. The Financial Stability Board (FSB) recently indicated that the designation of reinsurers will not occur until July 2014.[3] National regulators are also developing lists of domestic SIFIs, and in June, US authorities designated two large insurers as domestic SIFIs.[4]

At the inaugural Insurance Directors Summit in London on 16–17 May, Insurance Governance Leadership Network (IGLN) members discussed the implications of G-SII designation. Certainly not all IGLN participants will be designated as systemically important at global or domestic levels; however, G-SII regulations are the logical extension of the enhanced supervision all internationally active insurance groups are facing. G-SII designation will have some positive and negative effects for named groups, their competitors and the broader market. New G-SII regulations, in conjunction with the wave of more intensive supervision and regulation facing all complex global insurers will disrupt the marketplace and create numerous challenges and opportunities.

By the end of the summit, participants reached the following conclusions:

- G-SII designation will hinge on non-traditional and non-insurance activities
- Impending regulations will be substantial and need to be clarified
- While the full impact will not be realized for years, G-SII designation will generate a host of potential challenges and benefits

G-SII designation will hinge on non-traditional and non-insurance activities

The insurance industry has been engaged in an effort to prevent any insurers from being designated as systemically important, particularly for activities the industry does not believe to be systemic in nature. Facts

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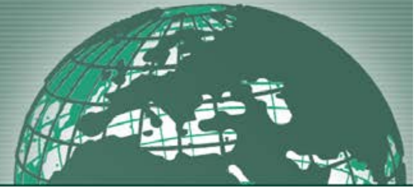
[2] In this document, "regulator" refers to any agency responsible for the development and implementation of rules-based regulatory regimes, and "supervisor" refers to any agency responsible for oversight of management and board actions within those regulatory regimes.

[3] Financial Stability Board, "Meeting of the Financial Stability Board in Basel on 24 June," news release, 25 June 2013, page 2.

[4] "The anointed: The number of too-big-to-fail institutions gets bigger," *The Economist*, 8 June 2013.



and figures have been published showing how banks are significantly more systemic, given the structure of their assets and liabilities. This industry effort appears to have been successful in encouraging regulators to be more explicit in articulating which insurance activities have the potential to create systemic risk, and it may have contributed to winnowing the eventual list of designees.

Nevertheless, it is now inevitable that some insurers will be designated as systemically important. As participants heard at the summit, many policymakers are under significant pressure to add insurers to the list of global SIFIs, especially given the challenges some insurers faced in the recent financial crisis. As one regulator noted, *"Where is the SIFI debate? There was a crisis and it triggered a bill to be paid. [Politicians] know in their hearts that if a big insurer is failing, they will not let it happen. The bill would be too big to pay, [so] they need to send a message."*

After several years of study, the International Association of Insurance Supervisors (IAIS) has completed the evaluation of approximately 50 insurers under consideration for designation as G-SIIs. The FSB, in conjunction with national supervisors and based on the work performed by IAIS, hosted a plenary session on 25–26 June 2013 to consider designation of G-SIIs. Most observers expect the FSB to issue the initial G-SII cohort in July One regulator implied there would be more than one and less than 28 G-SIIs: *"There won't be as many [insurers named] as banks."*

In the end, the decision to include an insurer on the list may turn on two key considerations related to non-traditional, non-insurance (NTNI) activities:[5] the combination of an insurer's NTNI activities and sheer size in the marketplace, and the presence of certain NTNI products regarded as particularly risky.

Combination of NTNI activities and scale in the market

The FSB first defined SIFIs as "financial institutions whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the financial system and economic activity."[6] Understanding the nature of this complexity and interconnectedness within the global insurance sector is challenging, as is measuring the degree to which insurers can generate or amplify risks within the financial system.

Over time, supervisors and regulators have clarified that traditional insurance is not inherently systemically risky; rather, sources of systemic risk lie in NTNI activities. One regulator said, *"I buy the argument that traditional insurance is not inherently systemic[ally risky]. I think the difficulty is that [some insurers] might have more expansive views of 'traditional' than I do."* Supervisors argue that the activities that are most sensitive to triggers – typically because they may be subject to higher degrees of liquidity, credit or other risks not present in traditional insurance – introduce systemic risk into an insurance group. These same activities are also typically more highly interconnected with broader markets, providing a mechanism for challenges within one insurer to propagate throughout the market.

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[5] For more information on NTNI activities, see International Association of Insurance Supervisors, *Insurance and Financial Stability* (IAIS, 2011), pp 12–13.

[6] Financial Stability Board, *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions* (Financial Stability Board, 2010), page 1.

The IAIS provide the following examples of NTNI activities:[7]

- **Non-traditional underwriting activities:** activities including alternative risk transfer, such as risk securitization through bonds; finite reinsurance, which allows insurers to reduce the risk posed by high claims by insuring a limited amount of that risk through a reinsurer and financial guarantee insurance.
- **Non-traditional investment and funding activities:** synthetic investment portfolios or significant usage of repurchase agreements and securities lending.
- **Non-insurance activities:** banking, investment banking, hedge fund activities, credit default swap or collateralized debt obligation underwriting, third-party asset management and capital market business.

However, it is the combination of NTNI activities and scale of the group – specifically, the presence of these activities within the larger group and the fear that the group may not survive if a crisis affected NTNI activities – that could put a global insurer on the G-SII list. Policymakers worry that these insurers are too big to fail, and supervisors are concerned that they could fail in the event of an adverse, perhaps idiosyncratic, incident most likely stemming from NTNI activities. One supervisor explained the case this way:

> *The premise we start with is that there are kinds of economic activities that are necessary but fragile – for example, maturity transformation … Large accumulations of fragile or systemic business within a single organization means an idiosyncratic issue can trigger a systemic event – what if [the organization] becomes insolvent? As a result, we need to worry about accumulation of risk because of idiosyncratic vulnerabilities. It is not just inherently systemic activities; it is that they become more so when collected in a single institution. So we created a set of policy measures to reduce the impact given default.*

Certain NTNI products regarded as particularly risky

For several years, insurers and policymakers have debated the systemic importance of insurance groups and products. As regulators increasingly defined systemic risk as a function of NTNI activity, attention has focused on the following types of products:

- **Variable annuities (VAs).** VA products often combine two features supervisors pinpoint as risky: guarantees and derivatives. The combination of the collapse of the equity market, poor hedging strategies and persistent low rates of return means that some insurers may not be in a position to meet long-term guarantees to policyholders. Policymakers worry that inability to meet liabilities could trigger asset sales that exacerbate distressed market conditions.

  The IAIS cautions that speculative derivatives trading creates the potential for an "insurance run" to occur because the liabilities are on demand.[8] Derivatives also demonstrate a degree of

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[7] International Association of Insurance Supervisors, *Insurance and Financial Stability*, (IAIS, 2011), pp 12–13.
[8] Ibid., page 18.

interconnectedness between insurers and other financial institutions that creates substantial counterparty risk. Many insurers counter that insurers use derivatives for hedging, not speculation, particularly with respect to VA products. In a hedging capacity, derivatives reduce risk exposure. Insurers argue that limiting use of derivatives for hedging would make products and associated companies less safe. One director further challenged the supervisory focus on derivatives, noting, *"[Regulators] are worried about the derivatives market collapsing, but [insurers] can live without the derivatives markets functioning for weeks. Central bankers would need to fix the derivatives markets for banks before insurers were hurt."*

- **Insurance-linked securities (ILS).** These securities, which include catastrophe bonds, transfer insurance and reinsurance risk to capital markets. While ILS is still a relatively small market, the IAIS cautions that poor underwriting or management of securitization products could create risks similar to those seen in the securitization of subprime loans.[9] Insurers counter that ILS products are often cash-based, so they do not incorporate systemically risky leverage.

Impending regulations will be substantial and need to be clarified

Following closely on designation, the IAIS will need to issue revised policy measures related to the three elements of G-SII regulation: higher loss absorbency (HLA) capacity, recovery and resolution, and enhanced supervision.[10] The six months following designation will be critical, as regulators will need to provide clarity on the methodology for determining HLA and the basic elements of recovery and resolution planning. Enhanced supervision, and the supervisory coordination it will require, will evolve over a longer timeframe. At the same time, some nations may pursue domestic SIFI designation and regulation processes, as is the case in the United States. Other nations, like the United Kingdom and Canada, are considering or imposing elements of G-SII regulation, such as recovery and resolution plans, on large insurers without attaching the "systemically important" label.[11] At the summit, participants discussed questions and concerns related to the three IAIS policy elements.

HLA capacity

Requiring G-SIIs to hold more capital, or have HLA capacity, serves four functions:

- The insurer would be more resilient in the event of a low-probability, high-cost event.
- Higher reserves could create disincentives for firms to accumulate risky activities.
- Supervisors could intervene earlier to address risk.
- Any implied subsidy or benefit derived from SIFI designation would be eliminated.

Insurers have seemed somewhat relieved that HLA will apply predominantly to NTNI activities. As one regulator noted, *"The important thing to remember is that we will only impose the higher capital*

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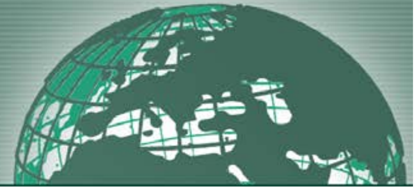
[9] Ibid., page 25.

[10] For a listing of proposed G-SII policy measures see Appendix 3, on page 52.

[11] EY, *Recovery and Resolution Planning* Senior Executive Update (EYGM Limited, March 2013), page 4.



requirements on those parts of the business that are systemically important; unlike banking, it is not the whole business."

However, preliminary language relating to HLA raises questions for insurers and increases the level of uncertainty as to the final capital treatment of G-SIIs. Supervisors clearly acknowledge that HLA calculations must also account for the ability of NTNI activities to damage a large group, and must neutralize any potential benefits firms might gain from designation. To this end, a calculation of HLA derived solely from NTNI activities will be subject to a not-yet-developed multiplier that captures the interconnection of NTNI activities with the broader group and negates designation benefits. Many summit participants welcomed the effort to neutralize any perceived benefits. As one director observed, *"The capital add-on should offset any perceived benefit of naming … Regulators really don't want a benefit from being too big to fail. They will set the capital sanction [as a] counterbalance."*

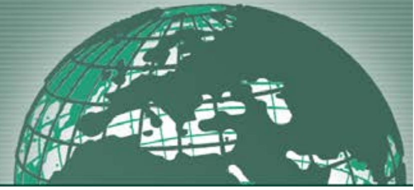
However, the desire to offset any benefit, coupled with the need to capture the interconnectedness, implies the calculation of such a multiplier will be a complicated task. It will require a precise quantification of NTNI impacts and an accounting of both the positive and the negative effects of designation on the designee. The HLA calculation seemingly would need to be unique to each G-SII, yet the complexities of each insurer's book of business would make those sorts of calculations very difficult. IGLN participants raised the following as-yet unanswered questions with respect to the HLA multiplier:

- Given the scope of the application of HLA and the diversity of books of business, how tailored to individual insurers will it be?
- What effects could an incorrect or standardized multiplier have on companies and the industry? What if companies face an HLA that is too high or does not completely offset any designation benefit?
- What are the processes for evaluating the HLA calculation to ensure it is appropriate?
- How will the IAIS and supervisors adjust or recalibrate HLA to improve accuracy and effectiveness over time?
- How might uncertainty about the HLA calculation affect insurer behavior relative to pricing, products and business models?

Although HLA requirements do not go into effect until 2019, regulators expect the IAIS will finalize its initial multiplier methodology by year-end.

Recovery and resolution planning

Directors shared their concern that becoming compliant with new regulations will be burdensome and costly. Perhaps more worrisome is that many participants, including insurers and supervisors, acknowledged that there is no guarantee that recovery and resolution activities would work as intended in a future crisis. Insurers are concerned that resolution plans could end up being a very expensive paper exercise. Even so, most directors recognize that planning could very possibly be a future requirement, and they therefore seek to understand how plans will affect their operations.



Discussion on recovery and resolution planning revolved around the following concerns:

- **Directors disagree as to the necessity of resolution planning.** Some directors believe resolution planning is superfluous, since, as one director noted, *"capital is already trapped in subsidiaries to protect policyholders."* In addition, insurers historically have fared relatively well and avoided insolvency even in crises, a fact that directors and executives have stressed in light of insurers' mostly positive experience in the recent financial crisis. To that end, there is little evidence that existing liquidation and resolution processes are insufficient.

  However, some see benefits in resolution planning. One summit participant countered, *"We don't actually know what would happen if a large, internationally active group failed. I'm pretty sure it would be quite ugly."* Still others go one step further, arguing that if supervisors have confidence in resolution planning, it could reduce or even eliminate the need for HLA. One director asked, *"Why do you need more capital? Isn't all you need a recovery and resolution plan?"*

- **Shared services are not easily allocated in recovery and resolution plans.** Directors have basic questions about how to construct recovery and resolution plans, such as how to allocate shared service expenses across group activities. Groups derive efficiencies from shared services, and misallocation or simply not accounting for complexity could compromise the quality of a resolution plan. One director asked, *"[Within the group structure,] how do you allocate shared services, etcetera? It gets complex."*

- **Local laws may trump cross-border planning.** *"Resolution will be a question of where your resources are when you get into trouble. Bankruptcy laws will dictate a lot,"* one director said. Several directors noted that local bankruptcy and related laws largely determine resolution and liquidation processes. Planning should account for local idiosyncrasies, but countries may differ in their legal treatment of an international group. One director noted, *"When insurers fail, it will all come down to local laws. There are dozens of European countries and 50 states. We will find that in even in the 50 states there are things that are not consistent and involve unequal treatment. Certain states have advantages over others in a run-off, for example. I bet the policyholders don't know that. We will find that resolution is more complicated than 'orderly' or 'disorderly.'"*

- **Plans may not work in a crisis.** One non-executive noted, *"Regulators want to take care of their own people in a crisis. They stop talking to each other, try to ring-fence, etcetera. So resolution is a pre-agreement. You still don't know what would happen in another crisis."* Supervisors and directors question supervisors' ability to stick to a plan in a crisis. Directors point to the recent crisis as a time when some supervisors became increasingly siloed and competitive. Another director echoed a sentiment shared by many, saying, *"We will throw [the resolution] plan out in a crisis. You have no way of knowing what the environment will be."*

Enhanced supervision

Enhanced supervision of G-SIIs is largely an extension of the more intensive supervision facing all global groups following the financial crisis. Specific G-SII supervisory requirements will call for insurers to improve

liquidity management, explore separation of NTNI from traditional activities and reduce systemic risk. Insurers raised the following concerns about enhanced supervision and the supervisory coordination it will require:

- **Supervisory coordination is essential but challenging.** National supervisors can be very siloed – more so in insurance than in banking, claimed one supervisor. Insurers doubt supervisors' willingness to defer to their peers on group actions, especially in a crisis.
- **Bank-like regulation will not work for insurance groups.** G-SIIs may face regulation by entities and individuals trained in regulating banks, a very different type of enterprise and regulatory framework than the one required for insurance.
- **Supervisors may need training and additional capacity.** Some insurers worry that supervisors may not have sufficient training to understand insurer reports and models, or may lack the capacity to effectively supervise consistently with voluminous new requirements.

While the full impact will not be realized for years, G-SII designation will generate a host of potential challenges and benefits

Participants agreed that the strategic and policy implications of G-SII designation and related regulatory requirements will not be clear for many years. Unlike their banking-sector counterparts, G-SIIs will be designated long before policy measures are finalized. Markets and insurers will not fully react to measures until they are finally defined and implemented from 2016 through 2019.

Among insurers and supervisors, theories abound as to how new regulations will affect companies and markets. There is no consensus among insurers as to whether SIFI designation will ultimately help or hinder complex insurance groups; however, summit participants agreed that changes would propagate through markets. Some directors and supervisors saw G-SII challenges as opportunities for other firms, while others expressed the fear that designation could backfire, making named groups even more systemically important. Participants discussed the potential challenges and benefits of designation and its impact beyond SIFIs.

Potential challenges of designation

Summit participants raised numerous concerns about the possible harmful consequences of new G-SII regulations:

- **Capital movement will be constrained.** Directors questioned how HLA and resolution and recovery requirements will influence where capital is maintained within a group, noting the tension between where insurers and supervisors want capital to be allocated. One director asked, *"Is it better to have capital retained within subsidiaries or to be more centralized? The regulatory view is that companies should be compartmentalized and self-sustainable. This relates directly to their view of group supervision. Supervisors are not in line with many companies' centralized models. Our model is becoming more national for this reason."* Resolution plans will have to answer one important question: *"If something goes wrong, what capital is available at the group level and who has first call?"* Some supervisors may pressure insurers to keep more capital at the local level, which will impact

group-wide capital allocation and will have to be accounted for in resolution plans. *"Should a local regulator take into account excess capital at the group level?"* asked one director. *"They won't,"* responded another.

- **Higher capital and liquidity requirements will impede competition.** Since policy measures are still in the proposal phase, directors are concerned about what the new capital and liquidity requirements will be. One director observed, *"If I have to lock up more capital, for businesses or the whole group, it just makes it harder to compete."* In his testimony before the House Financial Services Committee, William Wheeler, president of the American's division of MetLife, said, "[SIFIs] would have to hold more capital and maintain higher liquidity levels, which would reduce returns on equity for shareholders and impose higher prices on customers."[12]
- **Compliance is expensive.** New regulations will increase the regulatory burden for executives and boards and usher in additional direct and indirect costs. *"The costs of SIFI [status] will be onerous. How will shareholders react? They may just invest in those companies just below the cutoff,"* one director said. Holding on to capital that could be deployed, developing elaborate resolution plans and new reporting and supervisory activities will raise operational costs. In particular, directors highlighted the obvious price tag for resolution planning activities, including legal and consultative services, and noted that large banks have already spent many millions on their plans. SIFIs will face additional reporting requirements and may face regulation by new supervisors with different reporting and monitoring systems. A director asked, *"What are the expectations of those of us determined to be G-SIFIs? What international reporting requirements or other requirements will be required beyond those required by national regulators?"* In addition, G-SIIs will pay fees to cover the costs of new regulation. Taken together, new fees and additional compliance expenses could require insurers to increase product prices.
- **Less diversification and risk pooling could increase risk.** Some insurers noted that establishing higher capital buffers, separating businesses through ring-fencing or selling off certain NTNI businesses would limit the diversity and pooling of risk in a group's portfolio. One director observed, *"Insurance is all about risk pooling. The more diversity in risk the better."* In a position paper responding to IAIS proposed policy measures, the Global Federation of Insurance Associations said, "We are concerned that some of the proposed measures may lead to wrong incentives. This may result in insurers taking steps which have a negative impact on financial stability rather than reducing risk originating from the sector e.g. certain requirements may give insurers incentives to sell invested assets, or reduce their size and global spread."[13]

  Furthermore, directors and other industry representatives caution that changes in business models could lead to more risk correlation within the industry. In response to domestic SIFI designation rules

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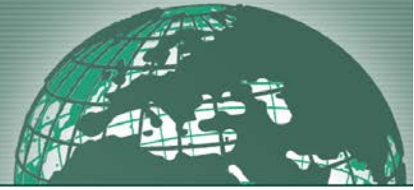
[12] *The Impact of the Dodd-Frank Act: What It Means to Be a Systemically Important Financial Institution: Hearing Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services, U.S. House of Representatives* 112th Congress, page 42 (2012) (testimony of William J. Wheeler, president, Americas, MetLife, Inc.)

[13] Global Federation of Insurance Associations, *GFIA Response to IAIS Consultation on Proposed Policy Measures for G-SIIs* (GFIA, 21 December 2012), pp 1–2.



in the United States, David Hirschman, president of the US Chamber of Commerce Center for Capital Markets Competitiveness, remarked, "This rule may force companies to start changing their business model or cease offering certain products and services. We need diversity among capital sources for the markets to operate efficiently, and homogenization of the financial industry will not get us there."[14]

- **Introduction of moral hazard.** Since the first IGLN discussions of G-SII, directors have warned that new policy measures could increase moral hazard instead of reducing it, as intended. Participants disagreed as to whether or not SIFI status would be viewed as an implicit government guarantee. Despite policymakers' intent to reduce the need for future government bailouts, as one director commented, *"The label 'systemic' clearly says it is a company the government wouldn't let fail. 'Globally systemic' means too expensive for any one budget to rescue."* Before the summit, one director commented, *"Capital requirements – if you need to benchmark on [return on equity], you might take on more risk, yet you'd know you will be bailed out. This is the SIFI benefit and this is moral hazard."*
- **Distorting the competitive landscape.** In his Congressional testimony, Mr Wheeler summarized, "It seems certain that naming a handful of insurance companies as too-big-to-fail will needlessly distort the competitive landscape and misallocate capital in the insurance sector."[15] One director asked, *"What are the processes to adjust the markets after the announcement? Markets will be distorted."* Establishing two tiers among leading global insurers could inadvertently create a barrier to entry or make it more difficult for SIFI competitors to emerge. Jeb Hensarling, chairman of the US House Financial Services Committee, criticized the system as "bad policy and even worse economics," noting, "It also becomes a self-fulfilling prophecy by giving these firms market advantages over their competitors, helping to make them even bigger and riskier than they otherwise would be."[16] Whether viewed as an advantage or disadvantage, some directors have cautioned against regulators picking winners and losers.

Potential benefits of designation

Directors and executives were more likely to see possible benefits for designees than supervisors, although there was no agreement among the first group as to the existence or extent of any benefit. In 2012, Robert Benmosche, chief executive of AIG, now designated a domestic SIFI, commented: "There may be some value to being a SIFI someday – borrowing costs, perception, the strength of an organization, how well regulated you are."[17] Supervisors generally remained skeptical of any upside, with one supervisor commenting, *"With respect to designation, I don't see evidence of the benefit of it – in pricing or funding."* Even so, supervisors clearly acknowledged markets might view the label this way, resulting in the need for supervisors to neutralize any possible benefit through additional HLA requirements.

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[14] US Chamber of Commerce, "U.S. Chamber Warns of Economic Consequences to FSOC's Final Rule on Systemic Risk Designation," news release, 3 April 2012.

[15] *Hearing Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services,* page 42.

[16] Tom Braithwaite, *"US regulators name groups for more supervision," Financial Times*, 4 June 2013. Subscription required.

[17] "US regulators name groups for more supervision," *Financial Times*.

Assuming markets view the G-SII label as a guarantee, participants identified the following benefits that might arise with designation:

- **Lower cost of capital.** Several directors argued that if SIFIs are viewed more favorably, they will be able to attract capital at lower costs than their competitors. One director noted, *"I do think there will be a sort of halo effect if you are designated a SIFI. How could there not be? Clearly if AIG is designated a SIFI and seen as the gold standard, then some investors will have to be in that stock. They won't be in other stocks. Some will lose out."* Summarizing this view, Mr Wheeler observed, "Some commentators believe … the implicit backing of the federal government could strengthen perceptions of our creditworthiness and may give us a significantly cheaper cost of funds than our peers."[18] Some non-executive directors noted that credit rating agencies would surely take note of the G-SII label. As one participant said, *"Banks got two notches more on credit ratings from SIFI status."* Indeed, following the recent designation of US domestic SIFIs, Moody's Investors Service reported that designation is considered credit positive for those insurers.[19] However, not all directors believe this will be the case: *"I don't buy that they'll be viewed as more secure. There is a lot of not highly rated capital moving into markets right now and it is still getting a lot of business,"* one director said in a conversation before the summit.

- **Higher pricing in product markets.** Several non-executives suggested that the halo effect could carry through to pricing. In a conversation before the summit, one director remarked, *"Supposing annuity providers realize this SIFI benefit, then capital and product markets should manifest the benefit in the form of higher annuity pricing for the same promised benefit, because it is lower risk to the customer."* Other directors questioned whether markets would make those assumptions, given supervisors' continued insistence that SIFI status does not confer a *"government backstop."*

- **Creation of market advantage from reputational boost.** Some directors and regulators acknowledged that marketers may try to benefit from the G-SII label. *"I saw advertising for a mutual fund made up only of G-SIFIs in a Japanese newspaper,"* one summit participant said. However, a director cautioned against confusing a marketer's spin with actual, tangible financial benefits. Many directors questioned whether the SIFI "badge" would create a broader competitive advantage in the marketplace and whether firms would be able to increase market share based solely on a reputational boost from the designation. Several directors surmised that marketers would use SIFI status as the new gold standard or AAA rating.

- **Lower counterparty risk.** Several directors observed that some firms could experience a significant lift from a perception of lower counterparty risk. Counterparties could view SIFIs as having a lower probability of breach of contract, making them more attractive than competitors.

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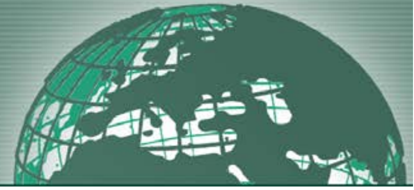
[18] *Hearing Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services,* page 42.

[19] Warren S. Hersch, "SIFI Designations are credit positive for insurers," *LifeHealthPro*, 6 June 2013.



Some industry participants also pointed to some of the likely practices insurers may adopt in response to being designated as G-SIFIs:

- **Structural simplification.** Several directors acknowledged that recovery and resolution planning is compelling their groups to simplify and make changes that the groups would not have made absent new regulatory requirements. One director said, *"One benefit of recovery and resolution is that it can make the insurance company structure clear to the group itself."* Another agreed, *"Recovery and resolution is healthy. It lets us focus on how we could simplify organizations."* One director acknowledged his firm had consolidated European operations in part to facilitate compliance with growing regulations. For supervisors, *"Simplification is an intended consequence of recovery and resolution planning … [and] also an opportunity boards should consider."* However, several participants cautioned against the pendulum swinging too far: *"If there is oversimplification, we will lose the benefit of diversification,"* one non-executive director said.
- **Ring-fencing or divesting of NTNI activities.** Directors and industry experts believe that SIFIs will choose, or be required, to adjust strategy by de-risking in areas of the business that are most systemically important. Although new requirements are still in flux, the prospect of enhanced recovery and resolution planning and ring-fencing could force significant changes in business models. In an IGLN conversation in 2012, one industry expert commented, "I can imagine certain lines of business might cease, [especially if] they aren't cost effective or they drag the rest of the company down."
- **Increased communication among key stakeholders.** Recovery and resolution planning should prompt more robust discussions between insurers and their supervisors, as well as among the many supervisors of internationally active groups. One director observed, *"Resolution is a way to force insurers and supervisors to have a discussion in normal times ... It will spark discussion."* Some directors thought having important conversations outside of a crisis environment would help cement insurer-supervisor relationships. Likewise, planning should force supervisors to communicate with each other regarding global groups operating across borders.
- **Better information collection and sharing.** Participants agreed that recovery and resolution planning will require boards to understand their structures, which will call for more information collection and analysis. *"Insurers will have to try to have better information,"* one director said. Supervisors will have access to better information as well. Sharing data and analysis will be a requirement, but may also help improve insurer-supervisor relationships.

Will designation improve decision making?

Unlike many of the other implications, which can be more clearly defined as positive or negative, insurers are squarely divided as to whether new regulations will help or hinder decision making:

- **Improve decision making.** *"Getting simpler should lead to better decision making,"* noted one director. Another commented, *"The place to start [recovery planning] is the intragroup transactions."* Even if recovery and resolution planning does not directly lead to structural simplification, directors agreed it would improve the common understanding of group structure and shine a light on intragroup connectivity. Participants generally agreed that if the board and management better understood group structure and interconnections, they would be able to improve strategic decision making.

- **Complicate decision making through increased supervisory involvement.** Some directors asserted that decision making would become more complicated for G-SIIs and, perhaps, less effective. Several directors noted G-SII designation would increase supervisory interaction and involvement in decision making. Supervisory powers authorized through the SIFI process could allow national supervisors to prohibit or require certain actions by insurers, affecting board decision making and strategy development. Before the summit, one executive defined SIFI supervision as *"two levels of regulation,"* as opposed to the single level the rest of the industry would face.

Impact beyond SIFIs

Several directors also noted that HLA could negatively affect those insurers that fall just below the threshold for G-SII designation. In a meeting in 2012, IGLN members suggested that investors might force near-SIFI insurers to hold as much capital as SIFIs. One director said, "Investors will not want to be subject to the risk of immediate capital-raising on the chance the insurer becomes a SIFI – remember, it's a relative rating, so others' performance may push an insurer into SIFI territory." [20] Another noted, *"Near-SIFIs may suffer a disadvantage as de facto capital requirements rise, while the cost of capital and other advantages enjoyed by designated SIFIs does not materialize."* [21] In this case, market – not regulatory – conditions would place requirements on near-SIFI insurers. If this were to happen, it would be better to be a SIFI than a near-SIFI. Some directors wondered whether these circumstances, while somewhat hypothetical, would compel borderline organizations to become G-SIIs.

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Regulatory discussions and, in particular, the SIFI debate elicit a variety of opinions. However, in recent months discussions have shifted from the question of whether insurers can be systemically risky to what happens when they are. To some degree, the G-SII debate is simply layered on top of a broader discussion

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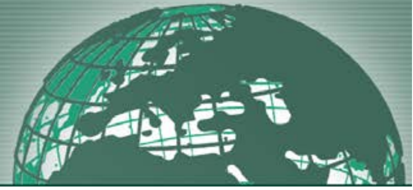
[20] Insurance Governance Leadership Network, "Insurers Face Significant Challenges Implementing Solvency II," *ViewPoints*, 29 November 2012.

[21] Ibid.



about the new regulatory requirements and regimes emerging in Europe, the United States and elsewhere – regimes that will require more capital and more supervision.

Insurers seem eager to understand how G-SII measures will influence individual insurers and markets, but they are resigned to the fact that impacts won't be known for many years. Participants are also gearing up for more action, whether pressing supervisors for clarity on new requirements or more actively planning for life after designation.

Cross-border supervision: the next big challenge

> *[Cross-border supervision] is the next big [regulatory] challenge, one that will take five years to complete.*
>
> – Insurance non-executive director

Indeed, in many ways, the SIFI dialogue is a microcosm of the broader regulatory push toward enhanced supervision of internationally active insurance groups (IAIGs), which, whether designated or not, will likely face tougher supervision. Two key issues that came out of the summit are likely precursors to future IGLN discussions:

- There are clear challenges in implementing a new model for cross-border supervision
- Supervisors will need new skills and frameworks and common regulatory and supervisory expectations

There are clear challenges in implementing a new model for cross-border supervision

Group supervision, if done effectively, would signal a new phase in overseeing IAIGs. As one director noted before the summit, *"This is a major regulatory challenge. Supervision is much less developed than in banking. Insurance supervision is much more siloed. Some still argue that you don't need to supervise the group in its totality. Supervisors need the overall picture – for example, [supervisors should see] intra-group transactions."*

The International Association of Insurance Supervisors (IAIS) Common Framework for the Supervision of Internationally Active Insurance Groups, or ComFrame,[22] is the most ambitious attempt globally to harmonize supervisory approaches for this important subset of the industry. The intent is to enable supervisors to review all group entities, including those that are unregulated or have a different lead supervisor. One summit participant summarized, *"The aim is to make [supervision more] comparable."*

In addition to ComFrame, in January 2012, US and European supervisors began the The EU-U.S. Dialogue Project, an initiative aimed at "enhancing understanding and cooperation for the benefit of insurance consumers, business opportunity and effective supervision."[23] Among the key objectives of the project are to understand differences and commonalties between European and US supervisory regimes, and to pursue strategies intended to improve and strengthen international supervision and supervisory coordination.

Despite efforts to improve coordination, directors are skeptical on a number of fronts:

- **Likelihood of effective dialogue.** Before the meeting, one director asked, *"Are they talking to each other? I don't hold out hope. They are only talking so they don't get left out of the planning. I am not sure it is very constructive."* However, one summit participant said that although there is real room for improvement, supervisors "are already having better discussions than before the crisis."

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[22] International Association of Insurance Supervisors, "Common Framework," accessed 11 June 2103.
[23] EU-U.S. Dialogue Project: The Way Forward December 2012.

- **Structural barriers to cross-border supervision.** The fragmented nature of insurance supervision is seen as a major hurdle to progress. *"A big question will be, 'How does this regulator[24] deal with 50 [US] state regulators and 100 other national regulators?'"* one director said before the summit. Another amplified that concern: *"We've made a lot of progress in Europe on supervisory coordination in insurance. I am not sure that is true in the US. The fragmentation in the US system is appalling, so coordination is that much harder."* In essence, it comes down to what one summit participant asked: *"How will they organize cross-border supervision?"* Another participant asserted, "The lack of success of Solvency II highlights the need for a consolidated single European supervisor for insurance. It is the only answer."

- **Extent to which collegiality holds in times of stress.** Directors and executives believe it is easy to design a cross-border supervisory model that works in theory, but the real test is when that model is put under stress. Said one director before the summit, *"The day-to-day is fine; the problem is what happens in a crisis. Who pulls the strings then?"* Another said, *"National interests always come first. The US won't submit to other higher authorities on regulation."* Summit participants were equally skeptical.

  The relative role of individual supervisors is important, particularly in the case of home versus host supervisors. One director noted ahead of the summit, *"In banking, the home supervisor has a bigger say than any host supervisor. It took a while to work this out, but most accept it now … Is this possible in insurance?"*

- **Whether a new model is being proposed to aid supervision or as a means to press firms to be more conservative.** Supervisors emphasize that the objective is to have a more informed group-wide view on the state of the internationally active insurance companies. However, there is an underlying concern among some industry participants that the aim is to promote a view of risk that is more conservative than that of management. Insurers operating in the United States have an additional concern: some large insurers will also be overseen by the Federal Reserve, which may take a more conservative view, in part because it is applying bank theory to insurers. One director said, "*The Fed has a lengthy history of regulating banks. We have a very different asset and liability profile."*

- **Continuing political will.** While ComFrame and related efforts to coordinate supervision are being spearheaded by IAIS and the supervisory community, political trends in various nations could influence, stall or undermine work being done within the supervisory community. For example, at a recent US House Committee on Financial Services hearing, policymakers seemed divided on the benefits of US participation in ComFrame discussions. Subcommittee on Housing and Insurance Chairman Randy Neugebauer voiced concern about supervisory coordination efforts through ComFrame, remarking:

  The consolidated bank-like model favored by the IAIS could disproportionally impact US policyholders and insurers. [In this hearing] we would like to learn more about what NAIC and FIO are doing to prevent the importation of European bank-like regulations into the US. We also want to

[24] In this document, "regulator" refers to any agency responsible for the development and implementation of rules-based regulatory regimes, and "supervisor" refers to any agency responsible for oversight of management and board actions within those regulatory regimes.

know more about the ComFrame [which would] create a one-size fits all regulatory regime for all insurers.

The recent challenges to enacting Omnibus II, the bill to implement Solvency II, also stem largely from political challenges within individual nations, and further highlight the importance of sustained political will in creating a common set of insurance standards.

Supervisors will need new skills and frameworks and common regulatory and supervisory expectations

Supervisors will need new skills and frameworks to conduct more effective cross-border supervision, as has been foreshadowed by the work of the Financial Stability Boards's Supervisory Intensity and Effectiveness (SIE) group.[25] It highlights several areas where new competences will be required within the supervisory community:

- **Risk aggregation.** Supervisors should ensure that they have appropriate data collection and processing abilities to measure and monitor risk exposures across product, asset class and geography.
- **Clear mandates, independence and resources.** Supervisory independence and appropriate resourcing is essential.
- **Financial strength measures.** Supervisors should have all necessary powers, including the ability to impose dividend cuts or additional capital or liquidity requirements. In some jurisdictions, this may include additional powers to ring-fence capital.
- **New modes of intervention and engagement.** Mandates should encourage early intervention and increase the frequency and quality of interactions with boards and management.
- **Necessary skills and talents.** Supervisors need high-quality supervisors and skilled technical staff.

Directors and executives are concerned that the supervisors are not well placed to execute a fully functioning cross-border supervisory model. As one director noted before the summit, *"Sometimes you have a strong regulator in one country and a weak regulator in another country … It could lead to a form of regulatory arbitrage."* Several summit participants agreed, with one using risk-model validation as a live example: *"Lack of expertise among regulators means we can't get models approved. Right now, model approval takes more time than development."*

The macroeconomic situation amplifies these concerns: although supervisors aspire to develop new approaches and train or recruit capable staff to implement them, supervisory budgets may be constrained, given the pressure on public spending generally. Until these budgetary pressures abate, supervisors will need to prioritize the most critical changes that need to be implemented.

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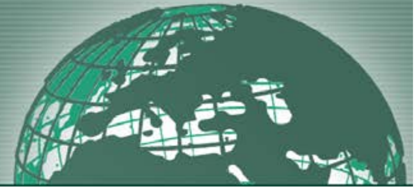
[25] For more information, see Financial Stability Board, Intensity and Effectiveness of SIFI Supervision: Progress Report on Implementing the Recommendations on Enhanced Supervision (FSB, 27 October 2011) and Financial Stability Board, *Increasing the Intensity and Effectiveness of SIFI Supervision: Progress Report to the G20 Ministers and Governors* (FSB, 1 November 2012).



Inevitably, as will be the case for Global Systemically Important Insurers (G-SIIs), supervisors will need to develop new and enhanced supervisory requirements for IAIGs. The most obvious areas where enhanced requirements will prevail are governance, risk management and internal controls. However, drawing on the G-SII framework and prior IGLN dialogues on international regulation, there are three other areas where enhanced regulation may be necessary to make effective cross-border supervision practicable:

- **Capital standards.** One summit participant asked, *"Can you achieve good group supervision without a common capital standard?"* In response, another participant said that, in the end, regulators and supervisors may not be able to agree to common capital requirements globally (other than for G-SIIs), but they will push for more consistent frameworks: *"Supervisors want to make the [capital] number comparable. [They] want a consolidated view of economic capital so companies are comparable. There should be a common benchmark."* Another participant said, *"Global players … should benefit from a global capital standard. Regulatory arbitrage happens. The [Financial Stability Board] may come in and set up a global standard in insurance."* Another acknowledged that, while one could debate how global insurers truly are, *"Capital is global, as is the way [insurers] explain it to shareholders, so it is important that [supervisors] determine how the capital is calculated."* Naturally, once disclosures are mentioned, it is difficult to avoid the fact that different accounting standards globally make it yet more difficult to trend toward a common capital standard that can be implemented and communicated in a consistent fashion across borders.
- **Recovery and resolution plans.** Thus far, the international debate on recovery and resolution plans has focused on G-SIIs. However, it is not hard to imagine that as cross-border supervision evolves, all IAIGs will need to develop some kind of recovery and resolution plan; countries like Canada and the UK are already moving ahead with such requirements. After all, these plans could help alleviate any bias toward protecting national interests in times of stress, assuming they have been developed, discussed and implicitly or explicitly approved by key supervisors. As one summit participant said, *"Recovery and resolution may accelerate moves to more effective cross-border supervision."*
- **Liquidity management plans.** Supervisors will expect that G-SIIs develop plans to manage liquidity risk, particularly for non-traditional business. Such plans will need to address all types of liquidity risk, in both normal and stressed market conditions. Here, too, the same concept may eventually apply to IAIGs.

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The insurance industry is at the tail end of its debate about systemic importance, with the global designation process almost complete. Already, the US Financial Stability Oversight Committee has designated AIG and Prudential as non-bank systemically important institutions. By year's end, the first list of G-SII designees will be known, as will the requisite new regulatory and supervisory requirements. However, an even more challenging period lies ahead. The G-SII phase is quite elongated, so the full effects may take years to materialize. At the same time, insurance policymakers, regulators and supervisors will focus their attention on arguably an even more consequential regulatory challenge: how to supervise IAIGs. The debate on G-SIIs may seem like child's play in retrospect.

Improving risk identification processes

We spend less time looking around the corner than we do looking down the road.

– Insurance chief risk officer

Insurance Governance Leadership Network (IGLN) conversations in the first half of 2013 focused participants' attention largely on ways insurers are improving risk governance. Network meetings in London on 13 February and New York on 11 April were dedicated to the structural components of risk governance at the board and executive management levels.[26] In addition to establishing sound risk governance structures, IGLN participants pointed out that many boards are determined to improve risk identification practices. In an environment of complex and ever-changing risks, directors hope to understand better how their companies might improve the processes for identifying emerging risks and evaluate these potential risks from new perspectives.

Participants' appetite to focus on identifying emerging risks underscores the importance of the board and risk committee engagement in light of competing priorities for management teams. In a recent EY survey of chief risk officers (CROs) and senior risk executives, only 5% said they would devote more attention in the next year to emerging risks than they did in the previous year.[27] Perhaps more striking, only 10% of respondents identified emerging risks as the biggest challenge facing the industry, while 45% said low interest rates and economic conditions were the top concern.[28] Ultimately, the success of the risk governance process depends on its ability to be forward-looking so insurers can better identify, measure, mitigate and price risk.

The inaugural Insurance Directors Summit in London on 16–17 May featured a session dedicated to discussing ways leading insurers and their boards go about identifying top and emerging risks. The dialogue incorporated perspectives from non-executive directors, CROs and key regulatory authorities. Summit participants focused on the following key themes:

- Current practices and mechanisms for identifying risks
- The role of the board and risk committee in the identification process
- Challenges facing boards and management

Current practices and mechanisms for identifying risks

In recent years, large insurers have invested significant time and resources to improving their risk identification methods as part of further bolstering their overall risk governance process. Despite these efforts, processes differ across insurers, and no best practice exists. In all cases, participants were eager to learn how their peers think about these challenges and approach them within their own organizations.

[26] Insurance Governance Leadership Network, "The Evolution of Risk Governance Continues," *ViewPoints*, 10 May 2013.
[27] EY, *Increasing Urgency and Evidence of Opportunity: A Survey of Chief Risk Officers in the Insurance Industry* (EY, 2013), page 10.
[28] Ibid.

Firms approach risk discussions in a number of ways

Directors and CROs highlighted several different approaches:

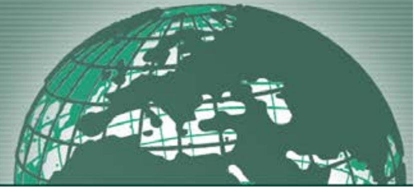
- **Dialogue around risk heat maps.** One director said, *"We have a very intense [enterprise risk management] process. The CRO does a risk heat map, which is discussed in the risk committee. The committee looks at it, asks questions and discusses it to make sure it is right."* Another said, *"The heat map is a good tool – you can look at frequency and severity of risks, whether they are increasing or decreasing. It is very dynamic. It also ties risks to the impact on the balance sheet."* Some insurers also discuss the heat map at the full board level.

- **Board-level review of risk lists.** Many firms list key risks for board- or committee-level dialogue. The dialogue can help unearth new risks or ensure sufficient thought is given to those listed. *"Recently the risk committee identified a risk not on the list: regulatory risk,"* said one director. Sometimes the lists are by category of risk or in the context of the risk appetite statement. One director said, *"We look at risk pockets, like [natural catastrophes], sovereign debt."* Another said, *"We review the risk appetite statement by every category. It is very granular."* One director pointed out that the preparation of annual public filings is a valuable mechanism for identifying and discussing risks: *"Risks have to be identified for proxies and 10Ks. They capture them and we review them."*

- **In-depth topic discussions.** Often it is only by immersing directors in dialogue about a specific business or risk that new thinking emerges. "Deep-dive" sessions are now more commonplace and serve as a welcome educational opportunity for non-executive directors. One said, *"The risk committee does deep dives into timely topics – for example, the emergence of a specific risk in one geography. They started that in 2010 in response to the financial troubles and to see what [management] could be doing better."* Another director said, *"Once or twice a year, we see the main threats [or opportunities] that we have not yet focused on. We look at the probabilities as well as the potential costs. We then have to have a series of discussions … The CRO presents the various risks and likelihoods of happening."*

- **Open-ended dialogue.** So-called "blue-sky thinking" or open-minded thinking can help. Said one director, *"The risk committee spends about four and a half hours on identification and responses around each board meeting."* One CRO commented on his team's effort to broaden the collective thinking: *"On emerging risks, we offer a prize for the most creative new risk. That might not be a significant [innovation], but it is about getting people to think creatively."*

- **Stress testing.** Increasingly, directors and executives are using stress tests to spark dialogue on future risks and potential responses and mitigation options. Several directors noted that stress testing has become an essential part of understanding both discrete risks and the impact of multiple risks. Before the summit, one director remarked, *"I've been pretty amazed by the notion of stress testing. In most businesses the base case is how you run your business. It is very different now with the new focus on stress testing."*



Ideas from the banking industry on identifying risks

At a Bank Governance Leadership Network meeting in 2012, members identified a number of practical ways banks could improve their identification and evaluation of top and emerging risks:[29]

- **Explicitly allocate time to discuss emerging risks.** Overburdened executives and board risk committees are left with limited time to focus on emerging risks and limited insight into the ways that other institutions are thinking about these risks and the potential exposures. To address the problem, one bank CRO proposed that risk committees "set aside time in every risk committee meeting to have blue-sky thinking."

- **Expect more from the non-executive directors.** One bank CRO said, "Ninety to ninety-five percent [of the information flow] to boards and even regulators[30] is one-way from management." This need not be the case. Directors could bring more to the discussions, particularly because they "sit on other boards and can bring different perspectives." Another CRO said, "There is a difference between who provides the data, i.e., management, and who can start the dialogue, i.e., the board. Directors can make valuable observations and bring different perspectives."

- **Encourage employees to be creative and communicative.** A bank CRO said, "There is no computer that can churn out a list of emerging risks. We have a lot of people, [and they] have a lot of ideas. So we are working on ways to get them to communicate their concerns or ideas to [the risk function]. They may have an idea that we haven't thought about."

- **Ignore probabilities and focus on potential impact.** Few executives or boards have an appetite for unbounded discussions of what-if scenarios. One bank director asserted, "Trying to identify black swans is useless." Problems often arise, however, not from complete unknowns but from risks that are recognized while at the same time perceived as having a very low likelihood or not much potential impact. Many people warned of the risks of the real-estate asset bubble, subprime mortgages and syndication prior to the crisis, but few heeded those warnings. One bank CRO made the case for investing in understanding the implications of even low-probability risks: "Boards are still talking too much about probabilities. We prefer to take a risk, run the stress test [and] identify the amount of potential impact so we are all comfortable with that level of risk."

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[29] Text box content is an abridged version of a list of practices featured in Bank Governance Leadership Network, "Improving Risk Identification," *ViewPoints*, 26 March 2012.

[30] In this document, "regulator" refers to any agency responsible for the development and implementation of rules-based regulatory regimes, and "supervisor" refers to any agency responsible for oversight of management and board actions within those regulatory regimes.

Ideas from the banking industry on identifying risks *continued*

- **Focus on second- and third-order effects.** A bank CRO noted, "We are not in the business of trying to look around corners – but what is the range of risks you need to understand are possible, and the possible outcomes?" Another CRO noted, "One of our lessons of the past few years is that we are pushing our thinking harder and harder on the second- and third-order issues." A bank supervisor said, "The trigger events are almost irrelevant. It's the transmission mechanism that's most important."

The role of the board and risk committee in the identification process

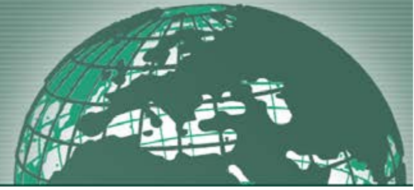
Directors, regulators and executives alike seek additional clarity around risk ownership. Several warned that while responsibility overlaps may be inefficient, coverage gaps could be fatal. But most see significant benefit in a separate board risk committee and say the committee has an essential role to play in improving risk identification. Prior to the summit, a CRO advised, *"There should be clarity of the role of the board as advisor or owner of strategy."* He then articulated an essential question: *"Where is the line between board and management? If the board gets too active, that leads to confusion about where decisions should lie."* Another summit participant concluded, *"I think a focus on emerging risks is what differentiates a valuable risk committee from one that isn't."*

Balancing the roles of management and the risk committee

Despite significant improvements to the overall risk governance process, accountability for identifying specific risks remains an area of continuing debate. A focused risk committee can engage in greater detail on a broader range of risks than could the full board or other committee, such as the audit committee, which has a range of other oversight responsibilities. But this focus raises questions about the role of the risk committee vis-à-vis management and the full board. One director observed, *"The role of the risk committee is to sit above compliance … to stay at a high level."*

Even with a committee focused on risk, it may be difficult for management to determine which emerging risks should be brought to the board and which ones the risk committee should devote its scarce time and attention to, since *"it is impossible for the risk committee to assess every risk."* Management needs to consider the probability of the risk occurring, and its potential impact, in order to determine which risks could result in material harm to the company and, therefore, need to be discussed with the risk committee. A CRO raised an important point in preparation for the summit: *"Another issue is assertion versus management information. Boards are beginning to learn that they need each. Some boards don't receive any assertions; it is just an information dump. Management needs to give the board a clear understanding of what they are getting – is it a legal requirement, part of management's job to report or an area where management needs input?"*

Given the rising CRO profile at many global insurers, there is also a risk that the executive function may feel their expertise outweighs that of the non-executives and preclude emerging risks from being fully conveyed to the board for additional evaluation. As one non-executive director pointed out, *"Who should push the*



risk agenda? Management knows better, but there is a challenge if they are the ones driving risk discussions." Board members may not have the same depth of engagement or knowledge of potential risks to the business as management, but they bring unique perspectives from a range of past and current career experiences, including serving on the boards of other companies. They may see and hear things that might not capture management attention but which are worthy of consideration.

The process is often as much about probing management's thinking about identified risks as it is about identifying new risks or emphasizing understated risks: *"The risk committee examines the mitigating action management takes on risks,"* said one director. Another director commented, *"In the case of regulatory risk, we challenged management. How do you mitigate the risk? The point is to ensure we don't have our heads in the sand on it. We are exploring courses of action, however limited they may be."* Management welcomes the dialogue; it helps affirm their view on risks, and occasionally changes their view on risks. One CRO said, *"We will tweak the list based on comments from the board."*

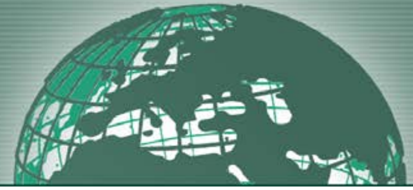
Engage the full board when necessary

Participants discussed the specific types of situations that call for a particular risk to be addressed by the full board. A director summarized the challenge: *"What to discuss at the board level is not [yet] well organized. Emerging risks have to be an ongoing discussion. I think we rely a bit too much on the risk committee."* He added, *"The risk is that [other] board members become passengers."* Participants agreed on at least one particular risk area that calls for full board discussion, *"Strategic risk issues are for the whole board."* Another director added that each layer of review adds a somewhat different point of view, *"Risk committees must spend time asking what additional perspectives we bring to the table. The risk function will tend to focus on economic risks. The chair should elevate strategy issues to the full board."*

Risk appetite and risk culture in the broader context of effective enterprise risk management (ERM) frameworks

Many insurers are actively developing formal risk appetite frameworks and working to articulate their firm's risk culture. While these efforts may seem only indirectly related to risk identification, they serve as an important contextual component to the equation. As boards and management define a holistic position on risk, integrating thinking across a broad ERM framework is critically important. Operationalizing a risk identification process is key to establishing the risk culture and demonstrating a disciplined approach to risk appetite.

continued overleaf



Risk appetite and risk culture in the broader context of effective enterprise risk management (ERM) frameworks *continued*

A participating regulator challenged the group, saying, *"Risk culture has room for improvement. A company's reaction to any problem has always been, 'This is nothing – not a big deal – and there are no lessons here because it is just rogue people.' How do boards really deal with something that goes wrong? Is it fixed? Do you learn lessons?"* The regulator then indicated that firms would be increasingly held to account for their approach: *"The next step will be taking a better look at risk culture. We want to understand how ERM is implemented. We want to ensure that risk culture is shared by all."*

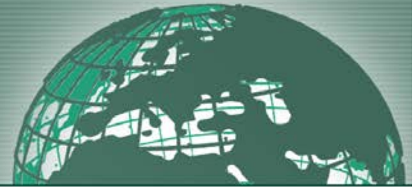
Participants discussed the intricate system of roles required for risk appetite and culture to be effectively implemented. One director emphasized the importance of the board's role in establishing the appropriate components: *"The board needs to challenge [whether] the risk appetite is the right one. The ultimate test is, as a non-executive director, are you being as diligent as you can?"* Another participant reminded the group that there is an important executive element simultaneously at play: *"Companies that view the CRO as owning the process, but the lines as owning the risks, are the most successful."*

Another director focused on consistency, saying, *"[For the board,] discipline is knowing what our risk appetite is and that it is consistent with the market position. The question is then, 'Are you staying within your risk appetite and, if not, why not?'"* Another participant concluded that the key is working within an agreed system of rules and roles: *"At the end of the day, it is about judgment applied within a strong ERM framework. It has to be done through the ERM process."*

Challenges facing boards and management

Beyond the concerns related to models, directors and CROs highlighted other challenges in their risk identification processes:

- **Unknown unknowns.** While many agree that attention should focus on identifiable risks, directors are nevertheless often concerned about the "black swan" events. Said one, *"In terms of process, I think we have it right, but you always worry about the unknown unknowns."*
- **Difficult-to-capture qualitative risks.** Insurers, like most financial service firms, are analytical in nature – perhaps even more so given their dependence on models. In this context, it can be challenging to determine how best to define, measure and monitor qualitative risks such as brand, reputation and culture. Said one director, *"We are all quantitatively driven. It is much harder to get the qualitative risks into the process."*
- **Information limitations.** An evergreen challenge in risk governance is obtaining high-quality and timely risk information. One director said, *"Boards have to ask, 'What is the quality of the information we are getting? How timely is it?' There are lots of infrastructure and [information technology] barriers*



to better information." Another director commented critically, *"The problem is that companies can't get timely information. You can be outside your risk parameters and not know it. In some areas, there is a 30- to 60-day lag on product sales and pricing information."* Another director agreed, saying, *"What are boards doing to test management's information? The first assumption should be that information is not reliable."* Executives acknowledged these difficulties and pointed to the potential inadequacy of risk metrics as much as that of the data. Said one CRO, *"Monitoring and metrics are a challenge."*

- **Ability to benchmark approach.** It is not easy for insurers to evaluate the effectiveness of their risk identification processes. Some rely on periodic benchmarking by third parties, but this is a relatively new phenomenon, and such benchmarking often focuses on risk governance or risk controls. One director admitted, *"We haven't benchmarked our risk identification process."*

Despite these and countless other challenges, participants remain committed to ensuring the safety and stability of their firms. Most agree that there is little question of whether there will be another financial crisis or significant liability event. When there is, those best positioned will be the teams that have developed and implemented sufficient risk identification, mitigation and resiliency measures to withstand the cycle or event. In light of the interconnected nature of large financial services organizations, supervisors are keen to ensure that the entire industry is properly prepared, and not just the particularly smart or lucky ones that avoid the spotlight in the next downturn.

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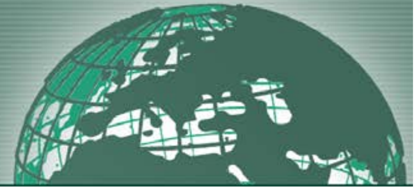
Enhanced risk governance practices are emerging as a result of renewed scrutiny, energy, regulation and standards to protect insurers. Executives, directors and their supervisors are united in their desire for a sound set of frameworks that support a vibrant and sustainable insurance industry that also continues to meet market needs. While regulation plays an important role, many risk officers and board directors see legislation and supervisory oversight as a starting point, insisting that internal standards should be even higher. IGLN participants agreed that while meaningful strides are being made in identifying emerging risks, important work remains to be done.



Top and emerging risks for global insurance

The reverberations from the global financial crisis have spurred firms both in and outside of financial services to devote more time and resources to considering a broader range of identified and emerging risks that could have a significant impact on their firm or industry. A recent EY survey reveals, and IGLN participants agree, new regulations and the extended low-interest rate environment as key sources of risk for the industry.[31] However, increasingly directors are exploring the impact of additional risks related to information technology (IT), operations, outsourcing, the need to protect consumers, the use of internal models and competition. A participant noted, *"The little part we don't focus on could be the part that creates systemic risk."* At the summit, directors engaged in a lively conversation on these risks and, in particular, how the confluence of various risks will likely impact company structures, business models and competition within the sector. Discussions in preparation for and during the summit focused on the following topics:

- Operational risks
- Consumer protection and conduct risk
- Model-related risks
- Business model changes and competitive threats

Operational risks

Prior to the summit, a CRO highlighted the importance of improving monitoring and governance of operational risk:

> *Insurers probably underestimate operational risk. Operational risk and risk controls are very important … The regulators[32] are starting to talk about it ... It is really about how you run operations and look at them from an operational risk perspective. How do you identify operational risks, escalate them and address them within a risk tolerance framework? … There is a lot of talk about the capital charge for operational risk, but the real topic is, how do I identify a risk early on as an operational risk?*

When operational problems do occur, they often create reputational damage, and, as one CRO said, *"Reputational risk can kill a company."* The challenge, according to another CRO, is that *"managing operational risk has a cost, so how do you get the balance right with a clear statement regarding your risk tolerance?"* In an environment in which firms are under pressure to improve profitability and reduce costs, operational risks can increase, so the importance of striking this balance correctly is magnified. A summit participant observed, *"Debate with the first line and risk function is great. As they look for cost reductions, you want to go into a lower-cost environment, but can you ensure control and quality are the same? Will it be positive overall?"*

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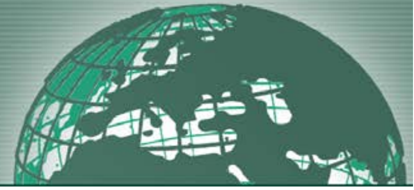
[31] EY, Business Pulse: Exploring dual perspectives on the top 10 risks and opportunities in 2013 and beyond, page 1.

[32] In this document, "regulator" refers to any agency responsible for the development and implementation of rules-based regulatory regimes, and "supervisor" refers to any agency responsible for oversight of management and board actions within those regulatory regimes.



Organizational design

A director described how organizational design can contribute to risk: *"[That there is] limited interaction between departments is a risk – claims, actuarial, pricing. When a product is priced, you take into account claims experience and reserving experience. Some organizations do this in silos. The information may not get back to pricing. The question is, how efficient is the business model in informing pricing?"* Another said that although these challenges are not unique to insurance, they may be particularly acute in the industry: *"Operational risk is similar across industries. The problem is we are functionally organized, and as things change, the result is a fragmented structure. Fragmentation means problems persist because no one is empowered to manage across functions in a crisis. Other industries are accountable end-to-end. We need to be as well."*

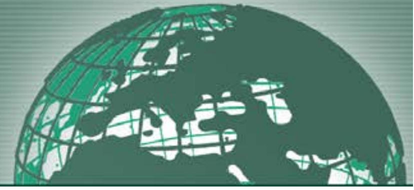
IT risks

Inevitably, discussion of operational and organizational risks leads into a dialogue about the risks associated with rapid changes in IT. Summit participants highlighted two main concerns in this area:

- **Updating and adapting systems.** In a discussion in preparation for the summit, a director observed, *"IT in insurance is not very good. We have clunky, creaking and expensive legacy systems, especially in life insurance. What do you do with a dependence on legacy systems?"* Another director agreed, saying, *"[The problem with IT systems] is a legacy issue and also that existing systems don't integrate. For example, pricing, underwriting and product systems are all distinct."* One non-executive observed that most large insurers have grown through numerous acquisitions, and many have not effectively integrated systems. As companies consider ways to improve efficiency and explore opportunities for growth by expanding into new markets, addressing these issues becomes increasingly important. A summit participant noted, *"The East is more comfortable with dealing with things digitally. Are our products set up for that? What do we need to consider? Consumer attitudes are changing rapidly and are different in different economies. How do you, as a company, respond to that?"*

- **Addressing IT security vulnerabilities.** During the summit, IT and data security were a major focus of discussion. A CRO identified *"two new sources of IT risk: One, the digital side of retail and how to control that process end-to-end, because it is very complex. Data transfer is instantaneous, and you don't own most of the chain. And, two, the cyberattack element and the secondary implications. For example, how do you manage your infrastructure?"* A director agreed, saying, *"Cybercrime is a major concern and an emerging risk. You get hacked all the time. How do we communicate and stay safe?"*

  Directors recognize the importance of cyberrisk, but one said, *"People within the company are looking at cyberissues, but it isn't yet at the board level."* They are looking for guidance as to how to improve oversight. One asked, *"As a board, what questions should we be asking?"* A CRO said, *"[Addressing] data security and IT risks can be costly. So, you have to consider, what is your [risk] tolerance?"* Another said that boards should ask of management, *"What is the golden treasure data that you must protect at all costs, and what data is ok if it gets accessed?"*



Outsourcing and the use of third parties

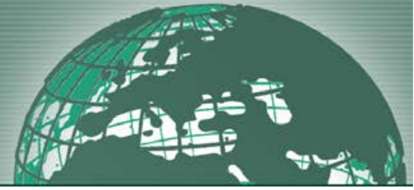
The use of third parties – vendors, brokers and agents, etc. – can exacerbate data risk as well as other forms of operational risk. A CRO noted, *"We don't know how secure the chain is. We don't look at vulnerability in outsourcing. Accountability is not clear because we don't know what the infrastructure is."* Several directors stressed the downside of outsourced distribution, and one asked, *"What are the risks of the bancassurance model?* [33] *… What are the risks if you don't have full control because of a distribution network agreement?"* Another director expanded on possible areas of third-party risk: *"There are challenges around joint ventures and distribution schemes. You devolve control, so you take bigger risks, but you are still responsible."* At the summit, a director noted that because relationships with third parties – especially outsourcing relationships – are common, particularly with current pressures to reduce costs, *"you need to build the risk of outsourcing in as a cost in your business case."*

Participants discussed the risks associated with the use of third parties:

- **Change in control.** Directors generally agreed that the insurer should retain *"strategic control of whatever is outsourced."* The question becomes what functions or parts of functions can be effectively outsourced? What does strategic control mean? One CRO noted, *"If you outsource the whole function, you know where accountability is,"* though another participant countered that, *"People work better when they feel they are part of the company. If the function is fully outsourced it doesn't work as well."* Some directors thought that all core functions and expertise should reside within the insurers, though they recognize that this can be difficult to achieve and limits savings.
- **Lack of flexibility.** According to one executive, contract length is an essential consideration: *"Entering into long-term outsourcing is dangerous because the world changes, your needs change. [Outsourcing] is a good tool, but only if you understand the risks."*
- **Quality and reputational risk.** Working with partners requires diligence to ensure those partners adhere to the quality and ethical standards of the company. The firm's reputation will be affected by the actions of the partner. One participant noted the risk with vendors is that *"the customer sees them as us."* A director suggested a strict policy response: *"[In joint ventures,] we ought to ask the brokers what the processes are for distribution and compensation. Strike them off the list if [their practices are] not consistent with your own practices."*

Ultimately, a participant asserted, *"If you are outsourcing a problem, you will have a problem. You are sending the function away for the wrong reasons."* So, it is important for directors to ask questions to ensure they understand where outsourcing and partnerships are being used, the nature and length of contracts and what controls are in place. Only by doing so can they be sure they are comfortable with the trade-offs between efficiency and risk.

[33] Bancassurance is a partnership between a bank and an insurance company that makes it possible for the insurance company to sell its products to the bank's client base.



Behavioral or cultural risks

Several participants expressed concern over what one director called *"softer risks … the ones that will overtly or subliminally impact our risk taking,"* which is to say, a company's risk culture. At a recent Insurance Governance Leadership Network (IGLN) meeting, an executive noted, *"Risk culture is one of the most important, most difficult challenges as CRO. It has a very strong link to governance. Risk regulation is not difficult to comply with, [whereas] culture covers a wide range of things and is much more difficult to manage."*

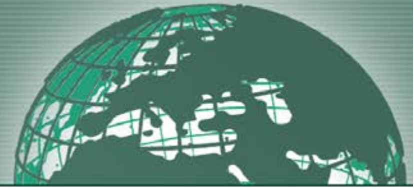
Participants acknowledged that assessing culture is a difficult task and represents a new frontier for some companies. A director observed, *"We spend very little time on behavioral risk and have little knowledge of it."* Another asked about how to assess the organization's culture: *"How do we define and measure culture to ensure we have the right one?"* And, if the culture is found wanting, how can an organization instill and support desirable cultural attributes? One participant asked, *"How do we approach behavioral risk, compensation issues and adverse incentives, especially in a low-rate environment?"* Another observed, *"There is … a tension between short-term performance and long-term performance. How do you create the right incentives to balance that?"*

Consumer protection and conduct risk

Participants agreed that there is an increasing supervisory focus on consumer protection or so-called "conduct risk," which include any activities or practices that could be seen as running afoul of supervisors' perception of "fair" outcomes for customers. Industry participants worry that new regulations could be retrospective, raising challenges to practices that were seemingly appropriate when implemented. A director predicted, *"I believe regulators will use reputation damage as a stick."* One director asked, *"What is reasonable for the customer to take on as a buyer and what is reasonable for us to take on?"* Another expanded, saying, *"We all build business models around privacy – our marketing information and risk information. Extreme European laws would require us to get specific authorizations from consumers on all kinds of information. It raises questions as to whether the retrospective issue could arise. Then we find out later that we were not using the data appropriately."*

A summit participant commented on UK regulators' focus on conduct: *"Conduct supervision is very new and needs to be examined more closely. [In the UK], the Financial Conduct Authority is receiving 83% of the old [Financial Services Authority]'s budget and resources … You can tell where the focus is."* A supervisor emphasized that the regulatory focus on conduct and consumer protection is not limited to the United Kingdom, but is a global focus for regulators: *"The G20 stressed conduct. It is very high on the political agenda. It is at the top of the agenda in Europe, the US and Asia."* Another said, *"One important workstream globally is on supervisory intensity. It is extremely important. Not just on systemically important financial institutions but all IAIGs [internationally active insurance groups]. Conduct is an important part of that agenda."*

Recently, misselling and misrepresentation has been the most prominent conduct risk. One director summarized, *"One of the intrinsic risks to the industry [is] related to sales misrepresentation. It has been an*



extremely expensive problem for the industry." The voluminous claims handling process is another source of potential problems.

Boards have a heightened sense for their responsibility to ensure a customer-centric approach is adopted across their firms. Often, a director observed, *"Our discussions don't connect to the customer. We need to be better about how to benefit the customer."* Participants discussed ways they can mitigate conduct risk:

- **Reconsidering product design.** A participant said the disconnect between business discussions and the focus on the end customer can sometimes be so extreme that *"what we are doing is creating products that aren't good for consumers."* Another participant observed that insurers *"are used to looking at macroeconomic risk, but we are not as good at thinking about product types and product design."* A third participant suggested insurers need to reevaluate the way products are designed: *"There are possibilities that can be built into products, but then you create complexity. So, how do you explain that to consumers? Why would you [sell the product] when the product could be questioned later even if you operate within the contract?"*

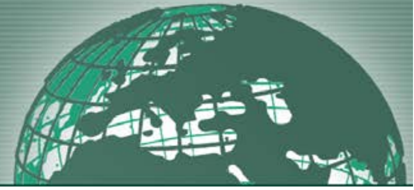
- **Improving conduct risk monitoring.** A CRO said, *"We are redoing risk and compliance to focus on conduct. Right now we don't get all the information we need. We don't have our ducks in a row yet."* Another participant described some of the metrics and monitoring tools that risk functions and boards can use to improve monitoring and help to escalate potential conduct issues: *"I want customer complaints and backlogs in the risk dashboards. There are probably 20 to 30 issues for each complaint. Boards haven't spent a lot of time on this."*

Model-related risks

Insurers are dependent on internal models for identifying, measuring and pricing risks, and they are becoming more dependent given the direction regulators and supervisors are taking on risk-based capital standards. However, directors expressed several concerns about the supervisory and internal focus on modeling, and the potential risks that could arise from overreliance on models:

- **Data inputs have limitations.** Models are only as good as the assumptions that drive them and the data put into them. Many participants acknowledged major deficiencies related to data. One supervisor said, *"In 2008, we saw what could happen with banks and the importance of quality of data … Given what happened to banks, did we have a choice to act differently [in terms of focusing on model and data risks]?"* Another supervisor agreed, saying, *"I would say … better information is the objective."* Directors had the same concern. Said one, *"We are spending an enormous amount of money to get the right inputs into the risk models. The issue is about the quality of the data feeding risk management. Data quality needs attention. There are places where the local subsidiaries don't have the resources to support requests from the group, so they [have to] come up with a reasonable proxy."*

- **Models are imperfect.** Said one director, *"I don't think there are any models that really model crisis risk well."* An executive at a recent IGLN meeting expressed a similar sentiment: *"You've heard the saying, 'All models are wrong, some are useful'?"* Before the meeting another director put it bluntly: *"The biggest issue we struggle with is that as we measure risk, how do we ensure that our models remain*



relevant? We had a comprehensive set of models, most of which proved irrelevant after [hurricanes] Rita and Katrina. Most US companies struggled with weather models after 2005. Our models were well regarded by everyone, but it didn't matter; they were irrelevant."

- **Models interact with one another.** One director said, *"There is less clarity for the board about the intersection of economic models and the arcane methodologies used by the actuarial profession. Board members should look more closely at the interaction between pricing and actuarial work. In general, the level of understanding about the intersection of risks is not as [good] as it should be."*

- **Directors hold varying views on their role in evaluating model integrity.** Directors play a critical role in assessing model integrity, but they are constrained in their ability to test detailed calculations and many directors view that as being beyond their role. One director suggested that boards need to ask, *"How much do companies rely on models? What are they doing now where they know their models are wrong?"* Several directors stated that the board did not need a *"deep understanding of the models"* but should understand model limitations and assumptions. Most directors agreed with one who said, *"You have experts in management who understand the models. [Directors] need to know, what are the sensitivities? What are the loopholes?"*

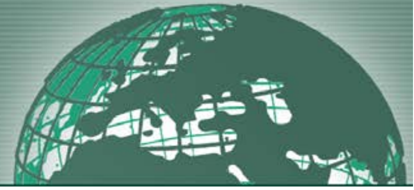
  However, testing models is challenging. Some firms use third parties to test models and assumptions. One director asked, *"How on earth can supervisors and boards deal with that level of sophistication?"* Another director suggested a simple test: *"How many members of the board can understand the model? … If they cannot, it is the wrong model."*

- **There is a danger that models might replace judgment.** Directors worry that the sheer sophistication of today's models could lure insurers into thinking they are more powerful about predicting future outcomes than they are, thereby muting the need for dialogue and judgment. Directors believe strongly that, as one director said, *"The model is just a tool. Risk governance is about asking the right questions."* A supervisor agreed, saying, *"We would be concerned if the presence of the model led to a limitation or constraint on the what-if culture of governance."*

- **Model convergence could increase risk.** Some directors worry that the cost of internal models and the intensive supervisory review process are pushing insurers back to simple, standardized models. Said one director, *"Companies are retreating under the standard model, under what they see as too high cost, too much pressure under the internal model approach. But doing the internal model focuses [the firm on properly evaluating risks] versus depending on a crude, standardized formula."* As insurers seek to comply with new prescriptions for internal models, or increasingly rely on standard models, one CRO cautioned that models could become more similar. The danger, then, would be that insurers begin to view and react to risks in the same way, creating additional systemic risk.

Business model changes and competitive threats

Successfully navigating the risk environment will require significant changes in the businesses of complex insurers. In particular, responding to continued low rates and regulatory pressure will necessitate strategic and operational adjustments. In continuing IGLN discussions directors note the following likely responses to



the current climate: insurer relocations; significant business, product and geographic changes including entering and exiting markets and lines; price increases; and market consolidation.[34] While boards consider responses to key risks, several directors caution that insurers should not lose sight of core functions and activities. Likewise, insurers should be prepared to address competitive threats arising from novel sources like new market players or disruptive technologies and innovations. Participants discussed the following themes:

- **Acknowledge that business model changes are a response to, and source of, risk.** Insurers agree that business models will continue to shift in reaction to regulatory and economic changes and also caution that business model changes, in and of themselves, create new risk. New regulations, be it Solvency II in Europe or the Solvency Modernization Initiative (SMI) in the United States, will continue to exert pressure on existing businesses. As regulatory capital requirements are established, insurers will shift strategies, but directors question to what degree. The persistent low-interest-rate environment will exacerbate pressures on insurers to identify new ways to generate returns, and likely contribute to what could be significant structural changes in individual insurers and the sector more broadly. At the same time, a summit participant cautioned, *"The thing to remember is that change is an indicator of risk. Every change to a business model introduces risk."*

- **Retain a focus on core activities and functions.** Though boards may find themselves reacting to risks and exploring new strategies, directors should remain focused on core activities and ask basic questions. Prior to the summit a director observed, *"There are some business model questions – is it right that insurers manage other people's money through asset management or third-party asset management?"* Another observed, *"Boards don't spend enough time on product allocation and pricing. They should be more worried about this."* Furthermore, as *"the hunt for yield"* picks up again, boards need to be cautious about *"strategic creep,"* whether in the form of pursuit of opportunities outside core competencies or increased investment in potentially riskier assets.

- **Assess competitive threats from non-traditional sources and innovation.** One risk is the emergence of new competitors from non-traditional sources. Participants discussed the pressure from hedge funds, private equity funds and so-called sidecars, which allow investors to assume the risk and return of a book of business written by an insurer or reinsurer. Prior to the summit, a director described the challenge these can present:

  Within [property and casualty insurance], there are lots of alternative investment vehicles with capital flowing in. It is coming from pensions, etcetera. They are primarily backed by hedge funds. They will be managing liabilities and setting companies up … Pension and hedge funds see insurers as a new and separate asset class. They are creating their own entities in Switzerland, Ireland, Bermuda … It is very damaging to traditional reinsurance pricing. On the life insurance side, you are seeing alternative capital coming into the annuity space. The regulators are behind the times on this. I'm not sure how much anyone is thinking about these risks.

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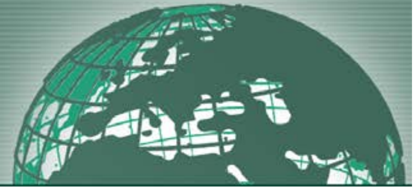
[34] For more on the impact of new regulations on business models, see Insurance Governance Leadership Network, "Global Insurance Leaders Actively Seek Clarity On Standards," *ViewPoints*, 8 March 2013; and "Leadership In A Time Of Great Uncertainty," 1 August, 2012.



Additionally, innovations and technological changes bring what one director called *"the game-changer risk."* In a discussion before the summit, one director said, *"What about the Google car? How does that affect car insurance? You have to try to account for these [new developments] as well."*

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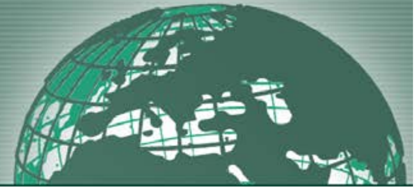
In the current environment, the potentially damaging effects of a range of emerging risks emphasize the need for strong governance and empowered risk and control functions. Boards need improved tools for monitoring, measuring and ensuring management is mitigating these sometimes underrepresented risks. These include "softer risks," related to people, culture, and governance. Said one director, *"It is very important that we understand the risk imposed by things that are not immediately apparent, like inadequate boards, runaway management and glass ceilings on risk managers ... We don't always see these things as risks."*



The extended low-rate environment: challenges for the insurance industry

We've certainly done a lot of thinking about extended low rates, but we don't have all the answers. We run projections, and we know the implications. They are not attractive. It's just a slow bleed.

– Insurance director

Banks die of a heart attack; insurance companies die of leukemia.

– Insurance chairman

Over the past five years, as a result of the unprecedented monetary policy response to the financial crisis that began in 2008, official interest rates and capital market rates of return in developed economies have fallen to historic lows. Ten-year government bond yields in the United States and Germany have fallen below 2%, and equivalent yields in Japan have been below this level for more than 10 years. The outlook for the future appears to be for continued low levels until developed economies have significantly improved, approaching levels close to historic growth and employment norms. Federal Reserve chairman Ben Bernanke has noted, "At the present time, the major industrial economies apparently cannot sustain significantly higher real rates of return; in that respect, central banks – so long as they are meeting their price stability mandates – have little choice but to take actions that keep nominal long-term rates relatively low."[35]

The effects of low rates on the insurance industry are slow because only income from current premiums and maturing investments are invested at market yields. The risk, as one prominent researcher pointed out, is that the delayed impact on the investment portfolio gives insurers time to react but can also "[tempt] them to postpone necessary remedial action in hopes that interest rates will rebound."[36]

Low market rates of return may necessitate, in the long run, lower insurance industry equilibrium returns on capital as investment portfolios and underwriting practices adjust. However, it is not yet clear that providers of capital have internalized this fact. One director noted, *"The mid-teens [returns on equity (ROEs)] from several years ago are no longer realistic. If you are shooting for those ROEs, I don't know where you will get them. Low double digits are a possibility, but it is a different reality today than it was a few years ago. Insurers ought to be redefining ROE goals. People need to accept realistic goals."*

Not surprisingly, this continuing environment of low rates of return and its impact on insurance profitability and operations are a major concern for participants in the IGLN. Joining the summit dialogue was Dr Kurt Karl, chief economist at Swiss Re and the author of several significant research papers on the effects of the low-rate environment on the insurance industry.

This *ViewPoints* describes this historic period of extended low rates, identifies the many ways in which low rates influence the insurance industry and documents the summit discussion of how insurance sector supervisors, boards and management might best address these challenges:

- Why low rates of return are a significant concern

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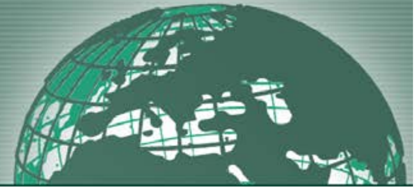
[35] Ben Bernanke, "Long-term Interest Rates," (speech at the Annual Monetary/Macroeconomics Conference: The Past and Future of Monetary Policy, San Francisco, CA, 1 March 2013).

[36] Swiss Re, "Swiss Re's Latest Sigma Study Explores How Interest Rates Affect Insurers, and Why Low Interest Rates Are Particularly Strenuous for Life Insurers," news release, 10 September 2012, page 1.



- How insurers are adapting
- Risks of a rapid rise in rates
- How boards and supervisors should respond
- Why the industry should reach out to policymakers

Why low rates of return are a significant concern

Low rates of return not only reduce portfolio investment returns directly, they also affect premium and benefits flow. Longer-duration and guaranteed products are especially vulnerable.

Direct reduction in portfolio investment returns

As interest rates decline, the income from investments will fall. The effects on portfolio returns increase the longer rates remain low. One director observed, *"The implications are continued low returns. As the book matures, yield goes lower as companies reinvest at lower rates."* Also as interest rates decline, the value of fixed income assets rises. Future liabilities, discounted by the lower interest rate, will also rise and by the same amount as long as assets are duration matched with liabilities. The extent to which these effects are reflected in insurers' books also depends on mark-to-market policies under different accounting standards.

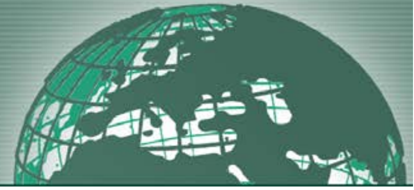
Direct valuation effects on premium and benefits flow

The reduction in market rates has more significant effects on longer-duration financial flows, whether premium revenue or paid-benefit expenses. Longer-duration premium streams will see more significant increases in present-value income, while longer-duration liabilities will experience more significant increases in present-value liabilities. Whether the net effect is positive or negative will depend on the relative timing of premium income and benefit expenses and on the magnitude and shape of the shift in the rate curve. Interest rate movements will have a greater effect on products that are of longer duration (e.g., life savings products, life insurance, casualty) than on shorter duration products (e.g., property). Insurers will be motivated both to change terms on existing products to align the present value of premium income and expenses, and to change the sales mix across products lines to adjust to the new rate environment. As one director observed, *"We need structural reform, but the political will is not strong. One would think the pain would push in that direction. You are seeing a huge reform of savings products. You need savings products with the demographics changing the way they are."*

Effects on longer-duration and guaranteed products

Life savings products are more sensitive to interest rates than life risk and non-life products.[37] Longer-duration investment products suffer particularly from the extended low-rate environment because the present-value liability stream is magnified by low long-term rates. These products become unattractive for

[37] Ibid. However, it should be noted that the liability structure of some non-life products can exhibit characteristics similar to life insurance liability structures. This is particularly true of periodic payment order (PPO) structures for some forms of motor and injury insurance in the United Kingdom, for example, where benefit payouts for catastrophic events are structured over the life expectancy of the claimants, and thereby take on the economic characteristics of life insurance products.



providers, particularly when rates of return are guaranteed. At the same time, the market demand for newly issued long-duration products is dampened because consumers are put off by pricing that appears high by current standards and by low yielding guarantees. Casting a further pall on these products is the fact that if rates were to rise significantly, the lapse incidence on existing contracts might increase as customers chose to upgrade to higher yielding products, thereby causing providers to redeploy capital. As one director noted, *"We are deemphasizing long-term guarantees. We've dropped floors and are moving away from investment risk and into mortality risk."* Another executive summarized clearly: *"What can companies do to mitigate? In property products, they can simply reprice. For casualty, it is manageable, and claims changes are helping. In life, we see companies creating new products that are more easily hedged. There are fewer guarantees, but then you struggle because policyholders don't want the products. In general, firms may be reorienting towards more traditional lines that have a clear risk transfer in the product."*

How insurers are adapting

Low rates exert downward pressure on the investment portfolio returns of insurers and have a variety of direct and indirect effects on the underwriting portion of the business. Since total profitability in property / casualty insurance is determined by the combination of investment returns plus underwriting profitability (through the combined ratio[38]), any reduction in portfolio returns can also shift focus to underwriting as the primary source of total profitability. One director observed, *"The possible benefit in disguise is to make companies make infrastructure more efficient in order to get the combined ratio down. You can no longer make money off investments. Underwriting must be more efficient, either through managing cost or raising premiums."* But another director sounded a cautionary note: *"In adapting to the new reality, insurers need to be careful about taking on incremental risk. They think, 'I need to squeeze a little more juice out of the lemon, so I'll take a bit more [asset] risk.'"*

Portfolio actions to adapt to low rates

Summit participants identified several ways in which the reduction in returns creates strong incentives for portfolio managers and chief investment officers to shift asset allocations toward higher yields – "reach for yield" – to replace the lost investment returns. This can be a creative process, uncovering previously unknown opportunities. It can also introduce additional risk that may or may not be fully recognized and acknowledged. On this topic, one director commented, *"With more yield, you are taking on more risks, and in some cases (such as the subprime markets), the risks are hidden. There is no such thing as a free lunch."*

One executive observed, *"I believe the search for yield is creeping in. You see insurers getting into corporate bonds. Is the risk priced in? The returns that are needed will require more risk. You are also seeing some movement into real estate. Do we have the skills for real estate? Infrastructure lending is also moving in – with the implicit government guarantee on some projects. Again, you need to ask if the insurer, and the board, have the skills for this."*

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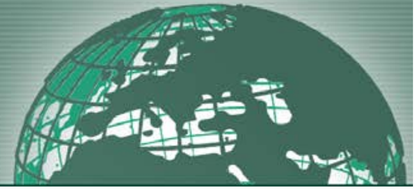
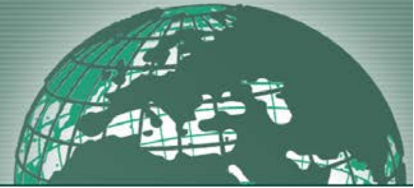
[38] The combined ratio is defined as insurance losses (claims) plus expenses from underwriting operations divided by the total earned premium. A combined ratio less than one indicates underwriting profit, while a combined ratio greater than one indicates an underwriting loss.



However, the reach for yield is also constrained by the realities of regulations and markets: *"Capital is not infinite. We've realized we can't afford the optimal portfolio. Even if we want to go into infrastructure, we have to choose. Regulatory requirements are impacting those choices,"* observed one director. Summit participants also noted that when the reach for yield leads companies into global investments, there is the issue of currency risk. One director said, *"In some countries, the depth of corporates isn't there. Markets are thin – there isn't enough volume. Then you have to go somewhere else. That can create a currency risk and a mismatch."* Participants in the summit said that the most common areas for yield reach are in asset-liability duration mismatch, credit risk premiums in fixed income, and illiquidity premiums in real estate and infrastructure. Additionally, some insurers have turned to risky sovereign debt in the quest for yield.

- **Duration mismatch can raise returns, but also increases interest rate risk.** Insurer portfolios generally attempt to match the duration of their assets with that of their liabilities to minimize risk that investment returns will be misaligned with the timing of claims and benefit payouts. Particularly for short duration liabilities, however, the return on corresponding short duration investments can be quite low, requiring a greater up-front investment to fund a given expected liability. A low-rate environment creates an incentive to increase the duration of the portfolio to benefit from higher returns, at the risk of creating some misalignment in the duration of assets and liabilities. At the margin, this may be a risk worth managing for the benefit of higher returns. However it does introduce greater risk exposure, particularly to a rise in rates, which could cause significant investment losses on longer duration instruments. There are methods for hedging these risks, but those methods can be costly, and the hedging is not always complete, either because of expense or inadequate markets to hedge fully. In addition, hedging strategies usually introduce additional counterparty risk. One director observed, *"The liabilities are getting a bit shorter, but the assets need to match them."*
- **Some insurers have pursued higher credit risk in fixed-income allocations to enhance return.** Insurance portfolios can also deliver higher returns by having fixed-income portfolios assume higher credit risk. However, the greater risk exposure can impose high costs, particularly during economic downturns. In addition, if many investors are pursuing the same investment strategies simultaneously, the return available for assuming higher credit risk can be driven down. One director commented, *"As a board, you have to be keen on resisting riskier investments. If you are in bonds, the incentive is to get into riskier corporates. It used to be AAA government bonds; now it is BBB corporates. The role of the CRO is increasingly important and needs to protect against this."* Another observed, *"Most general insurers have been heavily focused on fixed income. They've moved from government bonds to corporates and now to loan lending. There is credit risk in this."*
- **Illiquid investments are a common avenue for enhanced yield.** Investing in illiquid or thinly traded assets (e.g., real estate, private equity, venture capital, emerging-market corporate debt) can deliver a beneficial illiquidity premium on the investment return, but at the expense of less liquid capital. Capturing this return premium can be beneficial to insurers, their customers and to the macroeconomy when done in the right measure and when accounting adequately for the inherent added principal and illiquidity risks. Limited-partner shares in some long-term illiquid assets can be sold to other investors before the contractual terms expire, creating some added liquidity. However,



it can be expensive to exit an illiquid investment prematurely, and such sales frequently occur on a widespread basis when a systemwide event is unfolding, depressing asset prices.

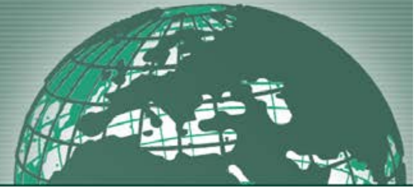
Several directors at the summit observed that illiquid investments had become attractive. *"Illiquidity is the preferred form of risk taking,"* said one. Successful investing in such asset classes takes skill, however. One executive observed, *"Insurers often end up outsourcing investment management to private equity and venture capital firms. It rarely makes sense to bring in real estate expertise."* At the same time, some private equity investors are entering the insurance field directly: *"Private equity and hedge funds are buying [insurance] books because of the search for yield. They are betting they can get better returns. Sidecars are putting pressure on pricing,"* said one director.

- **Sovereign debt with elevated risk is a less popular source of enhanced return.** Sovereign debt that has elevated returns due to perceived high default risk can be attractive in the search for higher yield, particularly if the debt instruments receive low official risk scores from regulatory authorities. In this case, the insurer's portfolio realizes higher investment returns, assumes higher credit risk and business risk, but is not proportionately penalized in risk-weighted asset evaluations. Regulatory statutes generally encourage holding government debt relative to corporate fixed income to minimize credit risk. However, as sovereign debt loads rise to unprecedented levels, governments' risk of default may increase to levels comparable to the risk for corporates, especially if market rates rise and make debt repayment more onerous for the most heavily indebted. The attractiveness of higher-risk sovereign debt is also constrained by the actions of credit ratings agencies. One director commented, *"An insurance company is also 'regulated' by ratings agencies, so we'd get punished for being in Greek sovereign debt."*

Underwriting actions to adapt to low rates

Extended low rates of return also affect the underwriting function, which becomes the focus of attention as a means of recapturing lost profitability. A director observed, *"The industry is cautious. When you see low rates, companies need to have a lot of underwriting discipline."* Summit participants identified premium increases and well-considered risk selection as among the ways in which underwriting behavior is adapting:

- **Premium increases are sustainable in some product markets, but not all.** If the market allows, there is benefit from raising premium rates for existing products, thereby enhancing income and aligning it more closely with rising costs. The ability to increase premiums depends on favorable demand elasticities and regulatory assent. However, the fact that the first insurer to raise premiums is likely to suffer a first-mover disadvantage acts as a disincentive. As one participant noted, *"It can be very difficult to reprice because you can push yourself out of the market."* The situation is somewhat different if insurance coverage is required by law. One director observed, *"You'll see a new equilibrium over time. Prices will go up, but most people need to insure their home and their car. What stops us from believing the industry won't adjust pricing?"*
- **Selling to higher-risk prospects through modified risk selection can enhance returns, but warrants close oversight.** Underwriters may wish to sell existing products at current premium

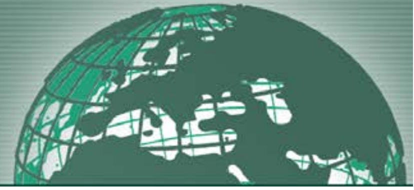


levels to prospects who represent higher underwriting risk than was previously accepted. The result is higher immediate premium income, with the additional underwriting risk realized in the future as increased or greater claims. The additional underwriting risk may not be immediately apparent to higher levels of management and supervision unless underwriting practices and incentive structures are closely examined and monitored.

Product offering changes to adapt to low rates

Some firms are redesigning products and introducing new ones in an effort to address the low-rate environment. Since life and savings products are among the most vulnerable, changes have been attempted in those areas, but many of the new products are not sufficiently attractive to potential buyers, and other contemplated changes carry risks.

- **Product redesign is a common response to low rates.** Insurers may modify product design and distribution policies to reduce exposure to extended low rates through benefit reductions, more stringent risk selection, reduction or elimination of guarantees and modification of sales incentives for newly written business. However, some legacy product areas have clear redesign limits. One director questioned the fate of insurers in those areas: *"What will be left of large insurers with large blocks of guaranteed business? Do we just let the sector go?"*
- **New product introductions are possible, but can be risky.** New products can generate additional premium income and boost underwriting profitability. However, because new products have limited underwriting history, the underwriting risk may be poorly understood. As one director remarked, *"There are a lot of temptations. You can have a nice whiz-bang idea and get a lot of money from it, maybe even make some headlines. However, you need to be very careful about the [underwriting] risks. Do you know what they are? Or, you might have too much of a good thing. It is a decent product, but you push it too far."* Another director observed, *"Audit, risk and financial committees need to ensure things don't get pushed too far."* But new product introductions will also be constrained by new regulations, which is why *"you are just not going to be able to do razzle-dazzle savings products."*
- **Changes in product offerings are most pressing in life and savings products.** Certain products, insurer types and sectors are especially vulnerable to the continued low-rate environment. One participant noted, *"The real movement is in savings products. This is where you see the biggest changes in embedded value."* A significant problem for the life sector is that newly designed products that have improved solvency characteristics are not attractive to the market. One summit participant noted, *"The concern on the life side is movement out of the industry. Policyholders will move into equity or something else. It is very troubling for life companies."* And another observed, *"On product design, there are possibilities that can be built into products, but the issue is complexity. How do you explain complex products to consumers? Why would you add complexity when the product could be questioned later even if you operate within the contract?"*



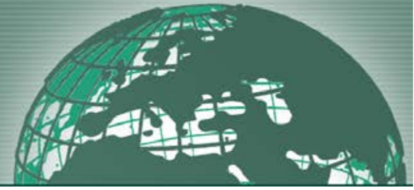
Management actions to adapt to low rates

Management's reactions to the low-rate environment include seeking efficiencies and reducing costs, discontinuing writing new contracts for certain books of business, pursuing consolidation and modifying reinsurance practices.

- **Aggressive cost management is a common reaction to low rates.** Many insurers pursue efficiency gains throughout their organizations, including efficient and meticulous claims management, centralized operations (including the claims function), outsourcing of subscale or high-cost activities to third parties and spin-off of non-critical activities. However, many in the industry believe that the majority of cost reduction benefits have already been realized or are currently being pursued. One executive noted, *"I think everyone is [reducing costs] as much as possible."*
- **Book-of-business actions are likely as low rates persist.** Insurers who find selected books of business sufficiently unattractive may reduce risk, allowing an existing book to move into runoff by discontinuing writing new contracts and even selling existing lines of businesses.
- **Insurers can also pursue economies of scale advantages through consolidation.** A common method for reducing expenses is through consolidation and economies of scale at the level of product category, business line, geography or customer segment. The result will likely be a decline in the number of subscale insurers as companies consolidate, with implications for market pricing power and growing systemic importance. Some subscale insurers may simply need to merge or wind down. One participant mused, *"I wonder who pays for the requirement to hold excess capital or capital charges? Moving to a new equilibrium is not easy. Someone has to go to the wall."* On this front, the experience in Japan may be instructive: *"What happens if [the low-rate environment] lasts 10 years, like Japan? You would expect to see the selling off of blocks of business and mergers and acquisition. There was some bail-in in Japan. Instead of receiving 100%, policyholders received 90% or less."* According to another, much depends on when the recovery gains momentum: *"The present situation is untenable, but we need to stay in it a little while. Hopefully it won't take so long to start recovering that it will kill off sectors."*
- **Modifying reinsurance practices can enhance profitability.** With increased pressure to find additional profit, some insurers may choose to reinsure less risk than previously, thereby internalizing additional risk but gaining a higher financial return. One director observed, *"It is similar on the commercial side. Companies are moving into self-insurance."* There may be legitimate risk-return gains in adjusting the reinsurance balance of the book, but management, boards and supervisors should scrutinize these decisions closely.

Risks of a rapid rise in rates

While the threat of prolonged low interest rates is concerning, several directors, CROs and regulators at the summit were also quite apprehensive about the possibility of market rates rising relatively suddenly from current levels, either as a result of inflationary pressures igniting, central banks phasing out accommodative policies or some combination of the two. One director observed, *"Some think the Fed waits too long, then*



they overreact." Mr. Bernanke indicated in June that the Fed may be "pulling back its $85 billion-per-month bond-buying program later this year,"[39] validating concerns participants expressed at the summit regarding the eventual winding down of the Fed's bank balance sheets: *"The release of this much liquidity has never been done, so the central bank will overshoot. We will get volatility when they release assets off of the balance sheet."*

Regulatory authorities are voicing concern

Regulators and global authorities share directors' anxiety about a rapid rate rise. In its recent annual report, the Financial Stability Oversight Council warned that "a sudden spike in yields and volatilities could trigger a disorderly adjustment, and potentially create outsized risks."[40] The International Monetary Fund (IMF) voiced its concern in its recent global financial stability report:

> A prolonged period of continued monetary accommodation will increase vulnerabilities and sensitivity to a rise in rates … A sharp, unanticipated rise in risk-free rates could expose vulnerabilities that are currently masked by low interest rates and ample liquidity. Despite the reduction in tail risks and improvement in economic data, markets are currently not pricing in any meaningful rise in interest rates.[41]

Insurers need to prepare for a rise in rates

If rates do rise significantly, investment positions in longer-dated securities could realize a capital loss. Unless asset-liability duration matching is perfect, duration mismatch will damage solvency levels. These effects could be magnified if many investors attempt to exit positions simultaneously and insofar as mark-to-market accounting standards require quick recognition on insurers' books, regardless of trading activity. One director said, *"The industry moves as a herd. Other companies are taking similar steps. I have to worry that if everyone is doing it, the markets and environments won't be as good as you think."* Another warned, *"Because rates are so low, the perceived upside risk is rising. If rates go up on reevaluation, the hit is very large. Everyone will get whacked. Regulators have pushed everyone in the same direction, so everyone is worried. It is public information, but we could lose 10% of the loan book. A lot of it is the accounting treatment."* And another stated, *"If the whole business is based on mark-to-market and fixed income, you have a problem."*

One director suggested that boards, management and supervisors begin preparing: *"We all knew the rise would come to an end, and yet we were surprised. Now in 2013 we know we are in a world of inflated asset prices. Are we thinking about what happens next? In three to four years, if rates go up and asset prices collapse, are we preparing?"* Some have begun to prepare. One participant reported, *"To deal with spiking, we've adjusted maturities to be shorter. Declining rates create a benefit initially. It is very different than stable low rates. There is no benefit there, and we will start feeling it on the balance sheet."*

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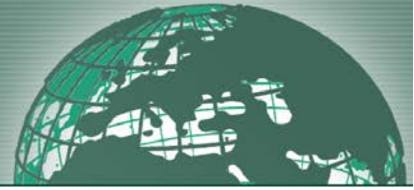
[39] Victoria McGrane and Jon Hilsenrath, "Fed Brightens Recovery View as Bernanke Sets Stage to End Bond Buys," *Wall Street Journal,* 19 June 2013.

[40] Financial Stability Oversight Council, *2013 Annual Report* (Washington, DC: Financial Stability Oversight Council, 2013), page 7.

[41] International Monetary Fund, *Global Financial Stability Report: Old Risks, New Challenges* (Washington, DC: International Monetary Fund, 2013), pp 12, 30.



How boards and supervisors should respond

Supervisors, boards and risk committees must be alert both to the direct challenges posed by low rates and to the behavioral changes low rates provoke in the areas of strategy, business models and operations. Those with governance oversight responsibilities will want to be especially alert to the risks associated with actions taken in an attempt to preserve shorter-term profitability and returns on capital.

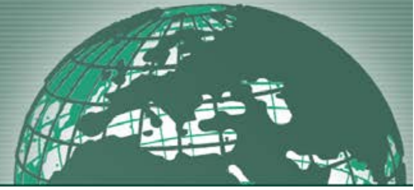
- **Supervisors.** Supervisory authorities should pay close attention to asset risk-and-return summary measures, ongoing solvency metrics and unusual growth or changes in particular product areas. They may also want to question the board and risk committee on specific measures taken to ensure adequate oversight in areas where risk is most likely to manifest in a low-return environment.
- **Boards of directors.** In addition to sharing the same concerns as supervisors, boards will likely want to monitor evolving underwriting experience, sales and distribution principles, sales compensation structures and new product introductions. Boards should also pay close attention to shifts in product mix and asset mix. One director observed, *"My opinion is the board needs to be sure management is not stretching the risk profile to make returns."* Another said, *"The industry is in a slow bleed on interest rates. The long-term consequences are pretty ugly, and I don't think many companies are realists. Should boards handicap management's view of investment returns?"*
- **Risk committees.** Risk committees will want to ensure they have strong communication both with the CRO and the chief investment officer. Evolving risk measures, solvency metrics and asset or product shifts will be areas for close scrutiny.

Preparing for the risks of a sudden rise in rates

Boards, risk committees, CROs and supervisors should engage in structured exercises to test the resilience of their business to a sudden rise in rates, particularly as strategy and operations are increasingly configured for a prolonged period of low rates. Essential tools include stress tests (including reverse stress tests), scenario planning, counterparty exposure reviews, modeling of likely consumer behavior (e.g., lapse rates, persistency), monitoring of duration mismatch and portfolio allocations, and product design ceilings and floors.

Monitoring compensation practices

With additional pressure being brought to bear on the underwriting and sales functions to generate profit, it becomes all the more important that compensation models maintain the best balance between rewarding profits and discouraging undue acceptance of additional risk. One director mentioned the issue of shareholder pressure: "*Companies need to think about how they link remuneration in these scenarios. I think insurance companies recognized the lower ROE. Most of them are adjusting compensation – the levels for bonuses, etc., are lower. Management seems to have accepted this. I am not sure the shareholders have – they still want their returns.*"



Why the industry should reach out to policymakers

Policymakers may not be persuaded that the travails of the insurance industry alone are sufficient to question ongoing stimulative monetary policy, but the insurance industry's experience highlights the more broad-based problems that the extended low rates are causing in the real economy and in asset markets. It is this combination of unintended consequences and risks that may command policymakers' attention.

Traditional pensions are feeling pressure from extended low rates

Pension funds, particularly those in the public sector, are experiencing larger present value liabilities, lower investment returns and higher risks from asset allocation adjustments in response to low rates of return. The recent IMF report described the problem:

> Slow-moving risks are also emerging for some types of asset managers amid an extended period of low interest rates. This is apparent for U.S. public defined-benefit pension plans, which have suffered from weak asset returns. Funding of those programs has deteriorated substantially in the past decade, from being fully funded in 2001 to an estimated shortfall of 28 percent as of end-2012. Risks are slow to build, as the issue for pension plans is *solvency* rather than liquidity … U.S. public pension funds – particularly the lowest-funded ones – have responded to the low-interest-rate environment by increasing their risk exposures. At the weakest funds, asset allocations to alternative investments grew substantially to 25 percent of assets in 2011 from virtually zero in 2001, translating into a larger asset-liability mismatch and exposing them to greater volatile and liquidity risks.[42]

Alternative sources of retirement income are rendered unattractive

As traditional defined-benefit pension systems disappear in many of the developed economies, investors and financial planners have turned increasingly to insurer-provided annuities to replace lost sources of guaranteed retirement income. However, the extended low-rate environment and new regulations regarding guarantees have significantly eroded the attractiveness of this product both for purchasers and for providers. One director said, *"It seems like the industry gives up its roles as a provider of savings products in the name of financial stability. [The low-rate situation] removes our role in supporting the long-term financing for the real economy. Low rates for too long are not in the interest of the real economy. The effects are that the market share of the industry shrinks with respect to other industries, like mutual funds, that are less regulated on capital."* Another observed, *"Problems are in areas where there is no tax incentive to save and policies are flexible so you can't match effectively. I see more industry consolidation. You won't be able to get any guarantees in the future because of the regulatory charge."*

Erosion of both traditional and alternative sources of retirement income occurs just as the baby-boom generation enters retirement

Aging populations in most developed countries mean the need for guaranteed sources of retirement income will become most acute during the next few decades, just as the market's ability to provide it is eroded. A summit participant stated, *"There is a government liability to prolonged rates on a pension system. We need*

[42] Ibid., page 29.

to push structural reform in pensions." Another observed, *"The issue is the savings gap at retirement. There is no incentive to save. Are regulators of pensions talking to regulators of capital about these impacts? They should be."* A final comment raised the ultimate question in this area: *"Who is going to pay for the aging population?"*

The insurance industry can give voice to broader social-welfare concerns related to extended low rates

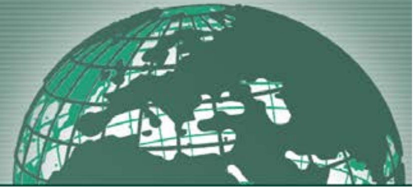
The recent IMF report described the connection between the insurance industry's problems and broader social welfare:

> Highly accommodative and unconventional monetary policies in advanced economies are providing essential support to aggregate demand, but there is growing tension between these policies and future risks to financial stability. Vulnerabilities are growing in U.S. credit markets while pension and insurance companies are under increased strain, moving into higher-risk assets. Reduced market liquidity could amplify the effects of any future increase in risk-free rates …
>
> Capital shortfalls do not appear to be an immediate risk, as the industry has built excess liquidity and capital buffers since the crisis. But a protracted period of low rates could depress interest margins further and erode capital buffers, potentially driving insurance companies to further increase their credit and liquidity risk. At the same time, life insurers operate with significant balance sheet leverage and are thus exposed to credit shocks.
>
> The "gamble for resurrection" in response to solvency risk, asset-liability mismatches, or diminishing net margins applies more broadly to insurance companies and pension funds operating in a low interest rate environment. A re-risking via changes in business models or asset allocation needs to be closely monitored.[43]

Participants at the summit concluded that these social welfare concerns presented an opportunity for the insurance industry to highlight some of the most detrimental effects of extended low rates on the economy. One director commented, "*We need to understand why the IMF has said low rates are not good long term, even for borrowers. This is where there is space for us to get involved and talk to at least a minority of central bankers."* Another observed, *"Insurer groups don't have the resources to get to the bottom of some of these issues. If the industry gets good information, it may be more willing to move forward. It is not acceptable that the industry isn't well represented at the table with the central bankers. [The International Association of Insurance Supervisors] is an exception. On bigger issues, we haven't engaged in a dialogue. Conversation would work if we present good technical papers and force the dialogue."*

One participant reflected on the rising prominence of insurance in policy discussions: *"Insurance is much more prominent in central bank and policy discussions than it was 20 years ago. We are now recognized. Through … discussions [on global systemically important financial institutions (G-SIFIs)] the industry has had more interactions with central banks. The industry and regulators should continue to work to improve*

[43] Ibid., pp 24, 30.



the relationship commensurate with how important the sector is." Finally, a director identified an ongoing challenge in today's environment: *"I see only two openings for discussion on the impact of prolonged low rates: the IMF paper on the challenges of low rates and the G20 have put growth back on the agenda. However, I don't think the central banks will ever think they have the same responsibility to savers as they have to borrowers."*

As the low-rate environment persists, the costs and risks to the insurance and pension sectors continue to grow. One summit participant spoke for many, asking, *"At what point do the macroeconomic benefits of low rates become overwhelmed by the growing costs and risks that low rates create in important parts of the economy that sustain long-run solvency?"*

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The financial crisis and subsequent anemic macroeconomic environment have made many insurers consider the unthinkable: what if low interest rates are here to stay? Many contemplate the Japanese experience and wonder what will happen to the industry if Europe or the United States has prolonged low interest rates and tepid or no growth. And yet a rise in market rates, whether gradual or sudden, carries its own risks. Participants in the first IGLN summit take back to their organizations a renewed and informed focus on these issues.

About this document

The Insurance Governance Leadership Network (IGLN) addresses key issues facing complex global insurers. Its primary focus is the non-executive director, but it also engages senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of the mission to build strong, enduring, and trustworthy insurance institutions.

The IGLN is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance. Tapestry Networks and EY are independent organizations. Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. EY is a global leader in assurance, tax, transaction and advisory services to the insurance industry.

ViewPoints aims to capture the essence of the IGLN discussion and associated research; it is produced by Tapestry Networks. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this dialogue, the more value will be created for all.

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Appendix 1: Summit participants

Directors

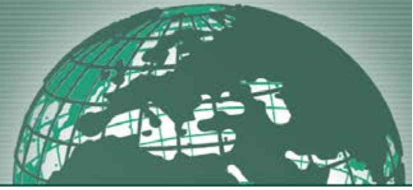
- Mr Irving Bailey, Risk Committee Chair, Compensation Committee Member, AEGON NV
- Ms Susan Bies, Audit Committee Member, Risk Committee Member, Zurich Insurance Group
- Lord Norman Blackwell, Chairman, Scottish Widows
- Ms Marcia Campbell, Audit and Risk Committee Member, CNP Assurances
- Mr Tom de Swaan, Vice Chairman, Risk Committee Chair, Governance and Nominations Committee Member, Zurich Insurance Group
- Mr John Fitzpatrick, Audit Committee Member, Finance and Risk Committee Member, American International Group, Inc.
- Ms Rajna Gibson Brandon, Finance and Risk Management Committee Member, Investment Committee Member, Swiss Re
- Mr Michael Hawker, Risk Committee Chair, Audit Committee Member, Nomination Committee Member, Remuneration Committee Member, Aviva plc
- Mr Steve Miller, Chairman, American International Group, Inc.
- Mr Andrew Palmer, Audit Committee Chair, Investment Committee Chair, Board Risk Committee Member, Nomination Committee Member, Remuneration Committee Member, Direct Line Group
- Ms Guylaine Saucier, Audit Committee Member, Compensation & Nominations Committee Member, Risk Committee Member, Strategy Committee Member, SCOR

Executives

- Dr Kurt Karl, Chief Economist, Managing Director, Head of Economic Research & Consulting, Swiss Re
- Mr John Lister, Group Chief Risk and Capital Officer, Aviva plc
- Mr Raj Singh, Chief Risk Officer, Standard Life plc

Policy and supervisory community

- Dr Yoshihiro Kawai, Secretary General, International Association of Insurance Supervisors
- Mr Patrick Montagner, Director, Insurance Supervisory Department, Autorité de Contrôle Prudential, Banque de France
- Mr Carlos Montalvo, Executive Director, European Insurance and Occupational Pensions Authority
- Mr Hugh Savill, Director of Prudential Regulation, Association of British Insurers



- Mr Paul Sharma, Deputy Head and Executive Director of Policy, Prudential Regulation Authority

EY

- Mr Martin Bradley, Global Insurance Risk and Regulatory Leader
- Mr Shaun Crawford, Global Insurance Sector Leader
- Dr Andreas Freiling, EMEIA Insurance Leader, Financial Services Organization
- Mr Ed Jervis, Partner, EMEIA Financial Services, Insurance
- Mr Marcel Stalder, Partner and FSO Advisory Leader, Insurance

Tapestry Networks

- Mr Dennis Andrade, Principal
- Ms Leah Daly, Senior Associate
- Mr Peter Fisher, Partner
- Mr Mark Watson, Partner

Appendix 2: Interviewees

Since 2012, Tapestry Networks and EY have being leading an initiative, the IGLN, which brings directors and executives (notably CROs) from leading global insurers together with key regulators and supervisors to discuss ongoing challenges confronting their institutions and the sector more broadly. Approximately 60 individuals currently participate in the network, along with more than 20 EY professionals. This issue of *ViewPoints* draws on conversations with more than 45 IGLN participants and on discussions from recent IGLN meetings. A list of individuals who attended the IGLN meetings and engaged in one-on-one dialogues follows:

Directors and executives

- Mr Irving Bailey, Vice-Chairman of the Supervisory Board, Chairman of the Risk Committee, and member of the Compensation Committee, AEGON NV
- Mr Alastair Barbour, Audit Committee Chair, Investment Committee Member, RSA Insurance Group plc
- Ms Susan Bies, Audit Committee Member, Risk Committee Member, Zurich Insurance Group
- Lord Norman Blackwell, Chairman, Scottish Widows
- Mr Richard Booth, Audit and Conduct Review Committee Member, Risk Review Committee Member, Sun Life Financial
- Mr Philippe Brahin, Head of Regulatory Affairs, Executive Board Member, Swiss Re
- Ms Rajna Gibson Brandon, Finance and Risk Committee Member, Investment Committee Member, Swiss Re
- Ms Marcia Campbell, Audit and Risk Committee Member, CNP Assurances
- Ms Alison Carnwath, Remuneration Committee Member, Zurich Insurance Group
- Mr Tom de Swaan, Vice Chairman, Risk Committee Chair, Governance and Nominations Committee Member, Zurich Insurance Group
- Mr John Fitzpatrick, Audit Committee Member, Finance and Risk Committee Member, American International Group, Inc.
- Mr Lawrence Graev, Compensation Committee Chair, Executive Committee Member, Investment Committee Member, Nominating Committee Member, The Travelers Companies, Inc.
- Mr William P. Hannon, Chief Risk Officer, Business Conduct Officer, Executive Vice President, The Travelers Companies, Inc.
- Ms E. Noël Harwerth, Risk and Capital Committee Chair, Audit Committee Member, Standard Life plc
- Mr Michael Hawker, Risk Committee Chair, Audit Committee Member, Nomination Committee Member, Remuneration Committee Member, Aviva plc
- Mr Jan Holsboer, Audit Committee Member, Supervisory Board Committee Member, ING Group NV
- Dr Kurt Karl, Chief Economist, Managing Director, Head of Economic Research & Consulting, Swiss Re

- Ms Catherine R. Kinney, Audit Committee Member, Finance and Risk Committee Member, MetLife, Inc.
- Mr Axel Lehmann, Chief Risk Officer, Zurich Insurance Group
- Mr Malcolm Le May, Investment Committee Chair, Board Risk Committee Member, Remuneration Committee Member, RSA Insurance Group plc
- Mr John Lister, Chief Risk and Capital Officer, Aviva plc
- Mr Jean-Christophe Ménioux, Chief Risk Officer, AXA Group
- Mr Robert S. Miller, Chairman, American International Group, Inc.
- Mr Bruce D. Moore, Audit Committee Chair, China Life
- Mr Wilfred F. Nagel, Chief Risk Officer, Executive Board Member, ING Group NV
- Mr Donald Nicolaisen, Audit Committee Chair, Risk Committee Member, Zurich Insurance Group
- Mr Morris Offit, Finance and Risk Management Committee Chair, Regulatory, Compliance, and Public Policy Committee Member, American International Group, Inc.
- Mr Andrew Palmer, Audit Committee Chair, Investment Committee Chair, Board Risk Committee Member, Nomination Committee Member, Remuneration Committee Member, Direct Line Group
- Mr Ed Rust, Chairman, State Farm Mutual
- Mr Sid Sankaran, Executive Vice President and Chief Risk Officer, American International Group, Inc.
- Ms Paola Sapienza, Risk and Control Committee Member, Assicurazioni Generali, SpA
- Ms Guylaine Saucier, Audit Committee Member, Compensation & Nominations Committee Member, Risk Committee Member, Strategy Committee Member, SCOR
- Mr Raj Singh, Chief Risk Officer, Standard Life plc
- Mr Paul Smith, Executive Vice President, Treasurer, and Chief Financial Officer, State Farm Mutual
- Mr Robert Stein, Nominating Committee Member, Remuneration Committee Member, Risk Committee Member, Aviva plc
- Mr Kees Storm, Nominating Committee Member, Risk Committee Member, Supervisory Board Member, AEGON NV
- Mr Stanley J. Talbi, Executive Vice President, Global Risk Management and Chief Risk Officer, MetLife, Inc.

Regulators, supervisors, and policymakers

- Mr Andrew Bulley, Head of Major Insurance Groups, Prudential Regulation Authority
- Dr Yoshihiro Kawai, Secretary General, International Association of Insurance Supervisors (IAIS)
- Mr Thomas Leonardi, Connecticut State Insurance Commissioner
- Mr Patrick Montagner, Director, Insurance Supervisory Department, Autorité de Contrôle Prudential (ACP), Banque de France

- Mr Carlos Montalvo, Executive Director, European Insurance and Occupational Pensions Authority
- Mr Chris Moulder, Head of Department, London Markets, Prudential Regulation Authority
- Mr Carlos Montalvo, Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)
- Mr Hugh Savill, Director of Prudential Regulation, Association of British Insurers (ABI)
- Mr Paul Sharma, Deputy Head and Executive Director of Policy, Prudential Regulation Authority (PRA)

EY

- Mr Martin Bradley, Global Insurance Risk and Regulatory Leader
- Mr Shaun Crawford, Global Insurance Sector Leader
- Dr Andreas Freiling, EMEIA Insurance Leader, Financial Services Organization
- Mr Ed Jervis, Partner, EMEIA Financial Services, Insurance
- Mr Rick Marx, Principal, Business Advisory Services
- Mr Pierre Planchon, Partner, Insurance Sector, EMEIA
- Mr John Santosuosso, Americas Co-Leader, Insurance
- Mr Marcel Stalder, Partner and FSO Advisory Leader, Insurance

Tapestry Networks

- Mr Dennis Andrade, Principal
- Ms Leah Daly, Senior Associate
- Mr Peter Fisher, Partner
- Mr Mark Watson, Partner

Appendix 3: Overview of proposed policy measures

IAIS policy measures for G-SIIs fall into three categories: HLA capacity, effective resolution and recovery, and enhanced supervision.[44] The table outlines the key measures under these categories.

Higher loss absorbency[45]	▪ The measures attempt to assess both targeted HLA for the riskiest activities and group-wide HLA. This would likely be an extension of, and increase to, existing capital requirements. For example, HLA "uplift" might be a 10% to 30% increase over already prescribed capital requirements. ▪ If NTNI activities are significantly separated from traditional activities, HLA will apply predominantly to non-traditional activities. For bank-like activities, existing Basel III rules would apply, and for other non-traditional activities, supervisors would need to devise appropriate rules. ▪ A group-wide assessment would be used to determine whether further measures needed to be applied at the group level. ▪ HLA will not be applied until 2019.
Recovery and resolution[46]	▪ G-SIIs will be required to submit detailed recovery and resolution plans and be subject to resolvability assessments. ▪ Their supervisors will establish crisis-management groups and create institution-specific cross-border cooperation agreements. ▪ According to IAIS, certain characteristics of the insurance industry indicate that resolution planning will need to account for separation between traditional and more risky businesses, the use of portfolio transfer and run-offs, and policyholder protection and guarantees. ▪ Effective resolution would build on existing resolution regimes that typically trigger interventions when minimum capital levels are breached.

[44] International Association of Insurance Supervisors, *Global Systemically Important Insurers: Proposed Policy Measures* (IAIS, 17 October 2012), pp 5-7.

[45] Ibid., pp 7, 19–22.

[46] Ibid., pp 17–19. See also Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Financial Stability Board, October 2011). The FSB describes the resolution requirements that should apply to all SIFIs, including G-SIIs.

Enhanced supervision[47]	▪ Elements of enhanced supervision include the following: ▫ Liquidity management. G-SIIs should have plans to manage liquidity risk, particularly for non-traditional business. ▫ Systemic risk reduction plan. Insurers would be required to develop risk reduction plans, in addition to recovery and resolution plans, to reduce systemic importance. Plans could include splitting off or otherwise prohibiting potentially risky activities. Supervisors should take action to reduce the systemic importance of firms. ▫ Separation of NTNI activities. Under these measures, insurers would legally separate NTNI businesses from traditional ones, ensuring that all entities are self-sufficient and properly capitalized. ▫ To achieve these goals, supervisors would be authorized to restrict or prohibit activities, require prior approval of activities or require insurers to diversify activities. ▪ Enhanced supervision of insurers will also focus on the following: ▫ Risk aggregation. Supervisors should ensure that they have appropriate data collection and processing abilities. ▫ Clear mandates, independence and resources. Mandates should encourage early intervention and promote a view of risk that is more conservative than the view of management. Supervisory independence and appropriate resourcing is essential. ▫ Complete tool kit. Supervisors should have all necessary powers including the ability to impose dividend cuts or additional capital or liquidity requirements. ▫ Improved standards and methods. Supervisors should focus on governance and business processes and increase the frequency and quality of interactions with boards and management. ▫ Stricter assessment of internal controls. Supervisors should set a "higher bar" for risk management and similar processes for SIFIs than for non-SIFIs. ▫ Group supervision. Supervisors should have the ability to review all group entities, including entities that are unregulated or have a different lead supervisor.

[47] International Association of Insurance Supervisors, *Global Systemically Important Insurers: Proposed Policy Measures*, pp 12–17. See also Financial Stability Board, *Intensity and Effectiveness of SIFI Supervision*: Progress Report on Implementing the Recommendations on Enhanced Supervision. The FSB's Supervisory Intensity and Effectiveness recommendations establish the basis for enhanced supervision.