Strategic responses to macroeconomic challenges

Insurance Governance Leadership Network

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Tapestry Networks

Strategic responses to macroeconomic challenges

"The real problem I see is the diametrically opposed and mutually exclusive economic risks. On the one hand, you could see deficits, inflation, government defaults. On the other hand, you could see deflation. How can a board prepare for all of that?"

– Non-executive director, large US insurer

For many months, adverse macroeconomic trends have been at the top of the industry's risk agenda. Within the Insurance Governance Leadership Network (IGLN), participants have focused attention on the persistent low-interest-rate environment, discussing it at length during IGLN's 2013 summit.[1] But other macroeconomic concerns have also drawn their attention: continued macroeconomic uncertainty, certain recent central bank actions, sovereign debt challenges, and slow growth, all of which pose major threats to profitability. A number of possible future scenarios are mutually exclusive, which puts insurers in the challenging position of having to prepare for opposing contingencies. For their part, supervisors and regulators worry that current conditions may threaten global financial stability.[2]

On March 4 and 20, IGLN participants, including supervisors, non-executive directors and executives, and subject matter experts, gathered in London and New York, respectively, to discuss these issues. They shared thoughts on probable economic futures and the impact of various scenarios on long-term strategy and growth opportunities. For a list of participants, see the Appendix, on page 7.

This *ViewPoints*[3] captures the essence of those conversations, in which five key themes emerged:

- Central bank action is likely to increase volatility
- Emerging markets present significant challenges and demand novel business approaches
- The interaction between economic conditions and market structure in local markets worries insurers
- Infrastructure investment is a promising asset class, but has its own challenges and risks
- Insurers view deflation as a low-probability future scenario

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[1] For more information, please see Insurance Governance Leadership Network, *The Extended Low-Rate Environment: Challenges for the Insurance Industry,* ViewPoints (Waltham, MA: Tapestry Networks, July 3, 2013).

[2] For more information please see EY, *Business Pulse: Exploring Dual Perspectives on the Top 10 Risks and Opportunities in 2013 and Beyond* (London: EYGM Limited, 2013), 5; and European Insurance and Occupational Pensions Authority, *Financial Stability Report* (Frankfurt am Main: EIOPA, December 2013).

[3] *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.

Central bank action is likely to increase volatility

Quantitative easing programs, instituted by central banks in the wake of the financial crisis, have injected $4.7 trillion of liquidity into the economies of the United States, United Kingdom, Japan, and Europe.[4] Following a period of near-synchronous policy, central banks are now beginning to diverge. As programs diverge and change, companies and markets are facing volatility in a variety of forms, including returns to capital, spreads between asset classes, capital flows, exchange rates, and the term structure of interest rates. IGLN participants discussed two themes within this arena:

- **Smooth exits from quantitative easing are unlikely in developed economies.** One director remarked, *"Everyone recognizes that we have to get off the drug. We are fearful it will be done at the wrong time or the wrong speed."* Given the unprecedented size of asset purchases and balance sheets to be unwound, the potential for mistakes, false starts, and policy changes and surprises is high. One director asked, *"How do you do a smooth exit through the tapering? How violent will the shocks be? Even if the exit is smooth, the transition will cause volatility."* Another expert agreed: *"Asset values have been very high, so we will see some readjustment there, and that will impact insurers' balance sheets."*

- **Insurers seek ways to handle volatility in emerging markets.** Most participants agreed with one director who said, *"You can't flip-flop on markets. The risk to reputation is too big."* For insurers who already have a significant stake in emerging markets, there is little choice but to develop strategies to mitigate short-term risks. A corporate risk officer (CRO), commenting on recent market movements and currency sell-offs, remarked, *"We hire traders, but we are not traders. There is a lot of movement right now, but we need to focus on the long-term capital flows. How do we position portfolios over the medium and long term?"* On the other hand, insurers who are just beginning to explore new markets may pause until volatility declines – assuming it is a near-term phenomenon. One director suggested it is not: *"Volatility is here to stay, at least for now. We should be thinking about how to live with it, not hoping it will end."*

Emerging markets present significant challenges and demand novel business approaches

Participants agreed that among emerging markets, China, India, Brazil, and Mexico are of special interest. Participants were keen to discuss the unique ways in which these markets have emerged and how best to develop them further. The following themes emerged in the conversation:

- **China remains one of the most promising markets, but significant structural reforms are needed**. *"China's the country that matters,"* said one director. For significant growth, directors believe Chinese regulators need to liberalize regulations, including those for licensing and rates. Several participants agreed that recent government decisions to *"let some [Chinese] companies fail is good and deliberate."* However, one director noted, *"It will be a very long time before internationals will be successful because the system is so protectionist ... [and] it will be a 20-year build-out in any country, especially China. The government won't do anything that disturbs the social situation."*

[4] McKinsey Global Institute, *"QE and ultra-low interest rates: Distributional effects and risks,"* Discussion paper (McKinsey and Company, November 2013), 8.

- **Insurers see major hurdles in India.** *"I feel less good about India than China. They cannot deal with their corruption. It's an excellent place for education and labor arbitrage, but it's too hard to navigate in certain industries,"* said one director. Participants generally agreed that many financial services companies have found India challenging. One director observed, *"So many companies have tried and failed. The government has made promises and not kept them for the last 20 years."* One executive pointed to the government's failure to keep its promise to raise limits on how much foreign investors in insurance could own from 26% to 49%. Until this and other promises to open markets are kept, further investments will remain limited.
- **Opinions are divided on the prospects for growth in Brazil.** One director observed, *"Brazil has done better than many thought. They moved out of indexation*[5] *and switched from a military to a civil government. The stimulus from the World Cup and the Olympics will be significant … However, the relative cost of labor, cost of living, and exchange rate suggest things are not quite right there."* Another director noted, *"The future of Brazil seems tied to real fiscal reform; I am not sure the commitment is there."* The recent S&P downgrade of Brazil's credit rating seems to reflect the same opinion.[6]
- **Mexico has favorable trends and is well situated to complement other large markets.** Despite Mexico's past challenges with corruption, insurers are generally positive about it. One audit chair noted, *"The demographics of Mexico are favorable. Most would agree that its government is now 'less bad.' It also has the biggest market in the world, next door."*
- **Business in emerging markets may require innovative approaches to products, sales, and distribution.** Several participants suggested that in emerging markets, insurers should look to educate first and sell second: *"Private industry entry has to be through the education of consumers,"* said one director. Education efforts should be specific to the needs and preferred communication styles of the target audience. One expert said, *"We need to think about where the customer is in their financial development and maturity. Financial inclusion truly is a business strategy. How do we reach them? Most have mobile phones, so there is a need to be multiplatform. There is also an opportunity to focus on the small-sum insured market. It requires new business models to develop the technology to reach these customers."* Participants also discussed the opportunity for collaboration on the development of shared-delivery or distribution systems to help defray the cost of developing the technology platform.

The interaction between economic conditions and market structure in local markets worries insurers

Several participants noted that while macroeconomic trends are important, local conditions exert the most influence over businesses in both developed and emerging markets. Understanding the interplay between economic conditions and market structure is essential. Within the developed markets, Germany provides an interesting case study that pits low rates against a market preference for guarantees. One participant said, *"I think in Germany you see a range of reactions to the current environment. Some have stopped selling*

[5] Indexation is a monetary policy that was used in Brazil to combat hyperinflation. It involves adjusting and linking income payments to a price index to maintain the purchasing power of the public after inflation.

[6] "S&P Downgrades Brazil: Not junk, Not Great," *Economist*, March 25, 2014.

everything – all guarantees are gone. For some, guarantees are slowly receding." Others predicted that weak conditions and low rates in Germany would cause several companies to be subsumed by larger players.

Within emerging markets, a thorough understanding of individual market dynamics and regulatory frameworks should lead boards to reevaluate strategies periodically. An economist noted, *"[You can't] just assume growth."* If emerging markets fall into turmoil or cease to grow, a key tenet of many global insurers' growth strategies will be undermined. One committee chair observed, *"Brazil has been emerging for 30 years. When do we reasonably expect returns?"*

Infrastructure investment is a promising asset class, but has its own challenges and risks

Insurers' investments in infrastructure represent an exploration of alternative asset classes, and supervisors are watching closely. In one of several visible examples, six of the United Kingdom's largest insurers recently committed £25 billion ($41 billion) to infrastructure projects.[7] Other insurers have made similar commitments on a smaller scale. The following themes emerged in discussions with IGLN participants:

- **Infrastructure may represent a viable alternative to sovereign debt.** Like sovereigns, some infrastructure projects can provide duration match to long-term liabilities, low investment-return correlation with other asset classes, and attractive returns. Like sovereign investment, infrastructure projects provide much-needed funding for public projects, which deliver political value.
- **Current regulation is not excessively burdensome.** Legal & General CEO Nigel Wilson noted, "The terms of the [Solvency II] directive are now fixed so as to permit long-term infrastructure investment without excessively onerous capital requirements … This gives us the green light to accelerate the pace of infrastructure investment."[8]
- **The risks will require careful attention.** Both insurers and supervisors noted the many risks inherent in the asset class. For example, participants raised concerns about illiquidity risk. One director said, *"I'm not sure many companies have the in-house expertise to manage these investments. Risk and return vary tremendously depending on the type of project, location, etc."* The alternative, using third parties to access infrastructure deals, can be expensive and obfuscate project risks.
- **Insurers need to demonstrate expertise and good judgment to supervisors.** Insurers will continue to move into alternative asset classes, such as infrastructure, to increase yield, but they must demonstrate expertise to supervisors and carefully consider capital charges and other risks. *"Obviously governments are pushing for insurers to put money into infrastructure. I think most companies don't fully understand the risk,"* said one supervisor.

Insurers view deflation as a low-probability future scenario

Though deflation could have toxic effects on the insurance sector, most participants view it as a very remote possibility, and they expressed confidence that central banks would take action to prevent it.

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[7] Jim Pickard, Alistair Gray, and Gill Plimmer, "Insurers to Promise £25bn for Infrastructure," *Financial Times*, December 4, 2013.
[8] Ibid.

"I'm not at all troubled by deflation. I agree with others. Central banks will throw cash at it, and that will be the response," said one director.

Some participants, however, were less sure about the possibility of an effective response should deflation take hold, given that few tested tools remain for dealing with it. Recently, euro zone inflation slid to 0.5%, well below the European Central Bank's 2% target.[9] If rates do not stabilize and rise, European policymakers may face pressure to take action. Other stimuli, including asset purchases, may divide policymakers and could be resisted by some stakeholders.

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Current macroeconomic challenges related to interest rates, growth, volatility, and public policy could lead to a variety of economic futures. For board members, these challenges raise a number of concerns related to portfolio optimization and geographic strategy. Several participants stressed the importance of seeking knowledge and expertise from multiple inputs – beyond their own economists – and vigorous dialogue. IGLN will continue to pursue these topics as economic and policy events unfold.

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[9] Claire Jones, "ECB Seen as Unlikely to Act Despite Deflation Fears," *Financial Times*, April 3, 2014.

About the Insurance Governance Leadership Network (IGLN)

The IGLN addresses key issues facing complex global insurers. Its primary focus is the non-executive director, but it also engages members of senior management, policymakers, supervisors, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy insurance institutions. The IGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the IGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

About Tapestry Networks

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. To do this, Tapestry forms multistakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable, and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the Insurance industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients, and for its communities. EY supports the IGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

Appendix: Meeting participants

- Mr Mike Arnold, Risk Committee Chair, Audit Committee Member, Nomination Committee Member, Old Mutual
- Mr Alastair Barbour, Audit Committee Chair, Investment Committee Member, RSA
- Mr Mark Chaplin, Group Enterprise Risk Director, Aviva
- Mr Tom de Swaan, Chairman, Governance and Nominations Committee Chair, Remuneration Committee Member, Zurich Insurance Group
- Mr John Fitzpatrick, Finance and Risk Committee Chair, Audit Committee Member, American International Group
- Ms Kirstin Gould, Executive Vice President, General Counsel, and Secretary, XL Group
- Ms Jane Hanson, Risk Committee Chair, Corporate and Social Responsibility Committee Chair, Direct Line Insurance Group
- Mr Simon Harris, Managing Director, Financial Institutions Group, Moody's Investors Service
- Mr Shawn Henry, President, CrowdStrike
- Ms Sue Kean, Chief Risk Officer, Old Mutual
- Ms Joan Lamm-Tennant, Chief Economist and Risk Strategist, Guy Carpenter
- Mr Michael Losh, Audit Committee Chair, Aon
- Mr Patrick Montagner, Director, Insurance Supervisory Department, Autorité de contrôle prudentiel et de resolution, 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 Andrew Palmer, Audit Committee Chair, Investment Committee Member, Risk Committee Member, Nomination Committee Member, Remuneration Committee Member, Direct Line Insurance Group
- Mr Ronald Rittenmeyer, Technology Committee Chair, Audit Committee Member, Compensation and Management Resources Committee Member, American International Group
- Ms Paola Sapienza, Investment Committee Member, Risk and Control Committee Member, Assicurazioni Generali
- Mr Giri Sivanesan, former UK Head of Cyber and Information Assurance, Lockheed Martin
- Mr Bob Stein, Nominating Committee Member, Remuneration Committee Member, Risk Committee Member, Aviva
- Mr Stan Talbi, Executive Vice President, Global Risk Management and Chief Risk Officer, MetLife

EY

- Mr Steve Bell, Partner, Financial Services Advisory
- Mr Shaun Crawford, Global Insurance Sector Leader
- Dr Andreas Freiling, EMEIA Insurance Leader, Financial Services
- Ms Carolyn Myers, Director, Financial Services
- Mr John Santosuosso, Global and Americas Insurance Assurance Practice Leader
- Mr George Tsantes, Principal, Financial Services

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- Mr Dennis Andrade, Principal
- Ms Leah Daly, Senior Associate
- Mr Jonathan Day, Senior Adviser
- Mr Peter Fisher, Partner