

# **Insurance Banana Skins 2013**

**The CSFI survey of the  
risks facing insurers**

**In association with**



**pwc**

**CSFI**

Centre for the Study of  
Financial Innovation

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## Preface

One is always a bit suspicious when financial institutions (be they banks or insurers, or even hedge funds) complain about the allegedly intolerable burden of regulation. A cynic might (mis)quote Mandy Rice-Davies: “They would, wouldn’t they?” And yet, they may have a point. This is the second year in a row that the burden of regulation has emerged as the top risk in our survey of *Insurance Banana Skins*. Anyone who has tried to wade through the details of the Commission’s Solvency 2 proposal – and who has followed its painful process through the Brussels sausage machine – must have some sympathy with the insurers, who are having to cope with it on top of too many other European and local regulatory initiatives.

It is all too easy for managements to succumb to a ‘tick-box’ mentality, which will blind them to the real risks their industry faces, or to spend so much time meeting regulatory demands that business opportunities go by the board. In that sense, bad regulation (or over-regulation) can really be a threat – and that is clearly how it is perceived at the present time.

But, if the regulatory burden is perceived of as the insurance industry’s Top Risk in 2013, it isn’t alone. Close behind are:

- the poor investment climate (and difficult macroeconomic climate), which are making it harder and harder for the life insurance industry, in particular, to make a buck; and
- the industry’s vulnerability to the chronic problem of dodgy business practices – which carry both reputational risk and the risk of heavy civil penalties.

And then, of course, there are natural catastrophes, the perennial problem of funding ‘guaranteed’ products in a low interest-rate environment, the quality of risk management (a big riser this year)... It is a daunting list, but one that ought to provide plenty of food for thought at the Board and C-suite level.

On the other hand, our Banana Skins survey also reveals the dogs that didn’t bark (at least not this year) – notably the availability of capital, corporate governance and human resources. All of these have plunged so sharply as perceived risks (capital availability, for instance, from number two to 16) that one might be tempted to wonder if they are now so far out of management’s sight that a nasty accident is inevitable.

This year’s report is (as always) a fascinating and provocative read. My thanks (again, as always) to the CSFI’s Senior Fellow, David Lascelles, who was in charge of the project and who did most of the writing. My thanks also to Keyur Patel, who did much of the legwork (and some of the writing) this year. And, once again, thanks to our good friends at PwC for sponsoring the project – while, once again, respecting our editorial independence.

**Andrew Hilton**  
Director  
CSFI

This report was written by David Lascelles and Keyur Patel

## Sponsor's foreword

Welcome to Insurance Banana Skins 2013, a biennial survey of the risks facing the industry, which has been produced by the CSFI in association with PwC.

We're delighted to be continuing our support for this initiative. The Banana Skins reports provide valuable insights into the risk concerns at the top of the boardroom agenda and how these perceptions change over time. Many of you will be comparing the industry-wide findings against your own assessment of the current and emerging risk environment.

Regulation is once again the number one risk. While new capital requirements have been dominating the regulatory agenda as a result of Solvency II and comparable developments elsewhere, consumer protection is now coming back under the spotlight. A clear reflection of this is the rise of poor sales and other conduct of business practices from 18th place in 2011 to fourth in the latest risk ranking. Vulnerability to compensation claims and the ensuing reputational damage is escalating as many supervisors broaden the definition of conduct risk. In the UK, for example, the new Financial Conduct Authority is looking beyond how products are sold to whether they meet customer expectations and deliver value for money over time. At the very least, insurers will need to check through their existing portfolios for potential mis-selling under this new definition and judge how their product design and sales practices may need to be modified. Smart businesses will be looking beyond conduct risk as simply a compliance exercise by using it as a catalyst for sharpening customer understanding and rebuilding public trust.

The fragile economic environment and subdued investment performance also remain high on the list of concerns. Managing these challenges is clearly a critical boardroom priority. But there's a risk that by solely focusing on these short-term issues insurers could miss the even more far-reaching threats and opportunities coming up over the horizon. The industry faces transformational shifts in technology and customer expectations, which are reshaping how insurance is sold, how risk is priced and even what we mean by insurance. These developments could open the way for nimble new entrants or other financial services players to move in and pick off the most profitable business. Experience in travel, music and retail shows how quickly existing players can be marginalised if they fail to respond to new ways of doing business. It's certainly notable that innovation has come in at number 13 on the list of risks and the focus is likely to increase as the pace of change continues to accelerate.

I would like to thank the CSFI for the richness of insight and perceptive comment in this report. With people around the world living longer and with more wealth to protect, the prospects for insurers are very positive. But their ability to identify and manage emerging as well as familiar risks will be one of the key differentiators for success.

I hope you find Insurance Banana Skins 2013 useful and thought-provoking. If you have any feedback or would like to discuss any of the issues raised in more detail, please do not hesitate to contact me.

**David Law**  
Global Insurance Leader  
PwC

## About this survey

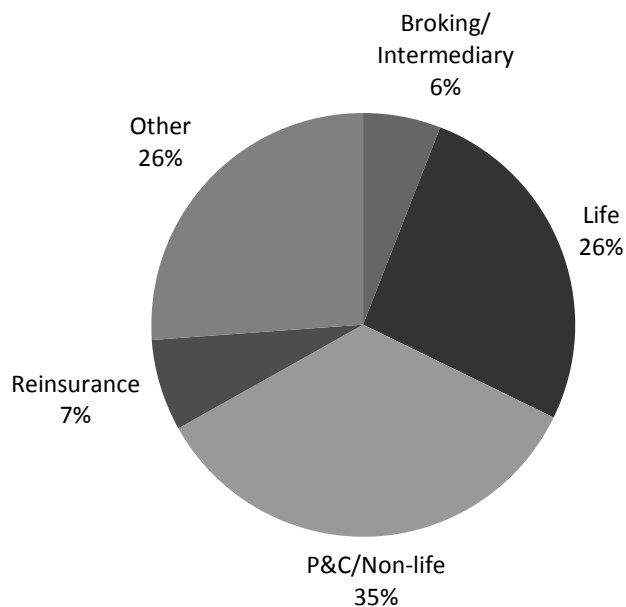
*Insurance Banana Skins 2013* surveys the risks facing the insurance industry at a time of considerable market uncertainty, and identifies those that appear most urgent to insurance practitioners and close observers of the insurance scene around the world.

The report, which updates previous surveys in 2008, 2009 and 2011, was conducted in March and April 2013, and is based on 662 responses from 54 countries.

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

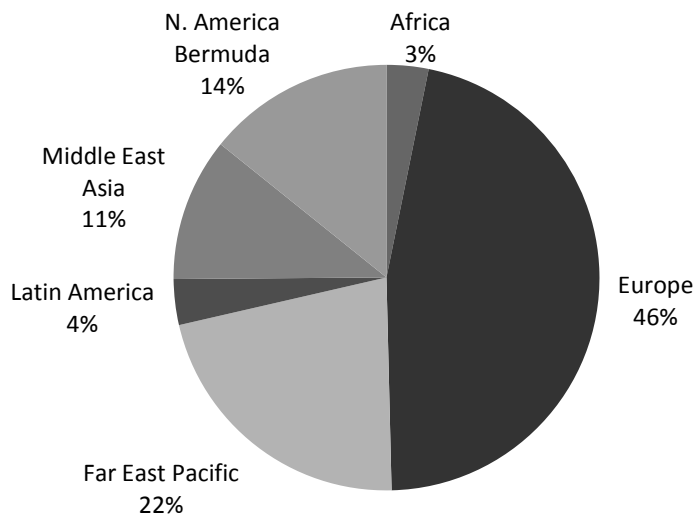
Replies were confidential, but respondents could choose to be identified.

The breakdown of responses by type of respondent was



Nearly two thirds of the respondents were from the primary insurance industry. The remainder were from the reinsurance and broking sectors, and non-practitioners such as regulators, consultants, analysts and professional services.

The breakdown of responses by region was



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

The breakdown of responses by country was

Argentina	2	Hungary	4	Poland	4
Australia	28	Iceland	1	Portugal	17
Bangladesh	1	India	39	Romania	5
Belgium	20	Indonesia	1	Russia	1
Bermuda	17	Ireland	13	Serbia	1
Brazil	19	Isle of Man	4	Singapore	31
Canada	47	Italy	3	Slovakia	10
China	13	Jamaica	1	South Africa	12
Cyprus	7	Latvia	4	South Korea	2
Czech Rep.	14	Lebanon	3	Spain	11
Denmark	13	Luxembourg	2	Switzerland	20
Egypt	1	Malaysia	14	Tanzania	1
Finland	5	Malta	3	Taiwan	3
France	2	Mexico	1	Thailand	1
Germany	4	Netherlands	28	Turkey	21
Ghana	5	New Zealand	43	UAE	5
Greece	7	Oman	1	UK	105
Hong Kong	8	Pakistan	1	USA	29

Note: in addition to the above, four respondents said they covered multiple countries.

## Summary

### Regulation is the top risk for the second year running

This survey identifies the risks facing the global insurance industry in early 2013, as seen by a sample of 662 practitioners and close observers of the scene from 54 countries. It comes at a time when the industry is still suffering from the effects of the global financial crisis and an uncertain economic outlook, as well as a persistent excess of capacity in the non-life sector which is hurting profitability. However, there are signs of improvement in what we call the industry's "anxiety level".

The top risk identified by the survey is the **burden of regulation** that is being placed on the industry by a wave of regulatory reform at international and local levels, in particular the EU's Solvency 2 Directive. The fear is that these initiatives will load the industry with heavy costs, and distract management from the task of running profitable businesses. This is the third time in four surveys that regulatory risk has topped the Banana Skins survey, identifying this as a major force shaping (many of our respondents would say damaging) the economics and structure of the industry. Concern about regulatory risk was global.

Sharpening these concerns is the fact that these reforms are being introduced at a time when industry profitability is being hurt by poor **investment performance** (No. 2), particularly low interest rates, and by a highly uncertain **macro-economic environment** (No. 3), particularly in the eurozone. Low yields have raised particular concerns about the management of **guaranteed products** (No. 6) which cannot be profitably funded in current market conditions. Excess capacity is another problem in some sectors, notably reinsurance.

A very striking riser this year is concern about the industry's **business practices** (up from No. 18 to No. 4). Part of this rise is accounted for by our broadening the definition of this risk to fit more closely with the regulators' approach, and also by the inclusion in this year's survey of a larger sample of emerging markets where business practice awareness is still growing. Nonetheless, the responses revealed concern that there had been slippage in business standards – despite stronger regulatory scrutiny – under pressure to achieve sales in sluggish market conditions. Striking, however, was the absence of any similar rise in concern about **reputation**

### Insurance Banana Skins 2013

(2011 ranking in brackets)

- 1 Regulation (1)
- 2 Investment performance (4)
- 3 Macro-economic environment (3)
- 4 Business practices (18)
- 5 Natural catastrophes (5)
- 6 Guaranteed products (-)
- 7 Quality of risk management (15)
- 8 Quality of management (14)
- 9 Long tail liabilities (7)
- 10 Political interference (11)
- 11 Distribution channels (9)
- 12 Actuarial assumptions (12)
- 13 Innovation (-)
- 14 Reputation (16)
- 15 Change management (-)
- 16 Capital availability (2)
- 17 Corporate governance (8)
- 18 Climate change (20)
- 19 Human resources (6)
- 20 Product development (24)
- 21 Social media (-)
- 22 Crime (22)
- 23 Complex instruments (19)
- 24 Reinsurance (21)
- 25 Back office (17)
- 26 Pollution (25)
- 27 Terrorism (23)

## Rising concern about the industry's ability to adapt

**risk** (No. 14) where there was, if anything, a tone of complacency in some of the responses.

Against this difficult background, concern about the **quality of management** (No. 8) and particularly of **risk management** (No. 7) in insurance companies has risen, with **long tail liabilities** (No. 9) still attracting attention. Other high level operational risks included the **management of distribution channels** in a market where choices are proliferating, the **quality of actuarial assumptions**, and the industry's mixed record in the area of **innovation** (No. 13). However concern about **back office** risk was low (No. 25).

A number of risks have undergone big changes in ranking this year, an indication, we think, of the uncertain state of the industry. There has been a sharp fall in concern about **capital availability** (down from No. 2 to No. 16) because of the excess capital now washing about the system and creating strong downward pressure on rates and margins. Similarly, changed market conditions have relaxed concerns about the availability of **human resources** (down from No. 6 to No. 19) because of the large number of people seeking work in the financial services market.

### Big movers

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

#### UP

**Investment performance:** very difficult to achieve necessary returns after five years of low yields.

**Quality of management and of risk management:** doubts about the ability of management teams to handle exceptionally difficult trading conditions.

**Business practices:** concern that standards may be slipping under pressure to reach sales targets in difficult market conditions

#### DOWN

**Capital availability:** industry now has too much capital rather than too little.

**Human resources:** soft financial services labour market favours employers.

**Corporate governance:** greatly improved after recent drive to raise board quality.

Of the new risks this year, **change management** (i.e. the industry's ability to restructure itself successfully) ranks at No. 15, reflecting the expectation that there will have to be marked structural changes in the industry in response to powerful market and regulatory pressures. We also introduced **social media** risk, to measure the level of concern about the influence of Facebook and the like on customers and their choices. The fact that it came at No. 21 suggests that it is still low on the horizon, though some respondents felt the industry should take greater notice because of its fast-growing potential to affect markets..

Among the major underwriting risks we asked about, only **natural catastrophes** achieved a high ranking (No. 5), unchanged from last time, mainly because of concern about the rise in incidents and "overdue disasters". Other underwriting risks



## Regulation is a global concern

we follow were low order, mainly because insurers felt they were in business to assess these risks and should be able to handle them, i.e. **climate change** (No. 18), **pollution** (No. 26) and **terrorism** (No. 27).

### Type of respondent

The survey shows some divergence between the concerns of different sectors of the insurance industry. The concern with **regulation**, for example, was No. 1 for the life side, but No. 2 and No. 3 for non-life and reinsurance respectively who gave a higher ranking to natural catastrophe risk. Otherwise, there were strong shared concerns about **investment performance**, the **macro-economic outlook**, and with various aspects of management quality in insurance companies. The retailing sectors (life and non-life) saw **business practices** posing potential difficulties, while the main concern on the reinsurance side was with excess capacity and soft market conditions.

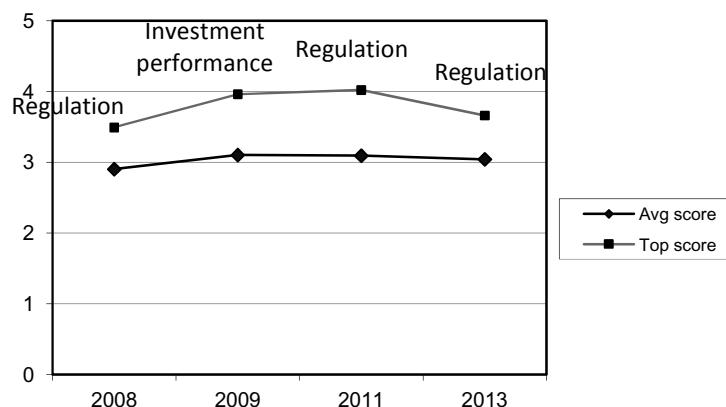
### Geography

A breakdown of responses by region also shows a strong consensus about the size of the regulatory threat, with only one region (Middle East/Asia) not placing it as their No 1 concern. Otherwise the main differences surrounded the economic outlook where Europe showed much the strongest concerns, followed by North America and, distantly, by other parts of the world. However, outside Europe and North America there was rising concern with management issues such as business practices, and the quality of management and corporate governance.

### Preparedness

Respondents were asked how well prepared they thought the insurance industry was to handle the risks they had identified. On a scale of 1 (poorly) to 5 (well) they gave an average response of 2.95 which is middling. We have changed the methodology this year so no direct comparison can be made with last time. Strong risk management was a key determinant of good preparedness.

### The Insurance Banana Skins Index



**The Insurance Banana Skins Index** provides a picture of changing “anxiety levels” in the insurance business. The top line shows the average score given to the top risk over the last four surveys, and the bottom line the average of all the risks. For the first time this year, both lines show a downward trend suggesting that the anxiety level may finally have turned.

## Who said what

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

### Different sectoral risk priorities

#### Life insurance

1	Regulation	The life insurance industry faces big regulatory changes: a tougher solvency regime, and new regulations on the sale and distribution of life and savings products. There are concerns about its ability to handle this huge agenda. At the same time, investment markets are difficult because of low interest rates and economic uncertainty. There are also longer term questions about the viability of the traditional life insurance savings model and guaranteed products. The sector's reputation could do with a polish.
2	Macro-economic envt.	
3	Guaranteed products	
4	Investment performance	
5	Business practices	
6	Distribution channels	
7	Reputation	
8	Quality of management	
9	Political interference	
10	Quality of risk mgt.	

#### Non-life

1	Natural catastrophes	Although the incidence of major catastrophes such as floods and earthquakes has been less severe in the past year, these remain the non-life's top concern. The insurance cycle is also at a low point, with little sign of recovery in a soft market and in the performance of investments. These concerns come on top of heavy regulatory demands as well as continuing uncertainty about the global macro-economic outlook. Business practices, particularly mis-selling, could be slipping under pressure to achieve sales.
2	Regulation	
3	Investment performance	
4	Climate change	
5	Business practices	
6	Macro-economic envt.	
7	Quality of risk mgt.	
8	Actuarial assumptions	
9	Innovation	
10	Long tail liabilities	

#### Reinsurance

1	Investment performance	The reinsurance market has been bearing the brunt of the surge in catastrophe claims at a time when market conditions are difficult and investment returns are poor. Regulatory pressures are growing. Conditions are intensely competitive: capacity is ample and pricing is soft. Management is under pressure to show that it can steer firms through these challenging times. It is hoping for a capacity shake-out to bring about firmer market conditions.
2	Natural catastrophes	
3	Regulation	
4	Macro-economic envt.	
5	Long tail liabilities	
6	Quality of management	
7	Change management	
8	Actuarial assumptions	
9	Quality of risk mgt.	
10	Climate change	

## Observers

- 1 Regulation
- 2 Investment performance
- 3 Macro-economic envt.
- 4 Business practices
- 5 Guaranteed products
- 6 Political interference
- 7 Long tail liabilities
- 8 Natural catastrophes
- 9 Quality of management.
- 10 Quality of risk mgt.

Observers (respondents to the survey who are not insurance practitioners but close to the industry) also have regulatory risk as their top concern. This is an important finding since it says that this risk is not just an industry obsession. Observers also share the industry's concerns with difficulties thrown up by tough trading conditions: poor investment performance and the risks posed by guaranteed products. The quality of insurance industry management is always a concern among non-practitioners.

## North America and Bermuda

- 1 Regulation
- 2 Natural catastrophes
- 3 Investment performance
- 4 Long tail liabilities
- 5 Macro-economic envt
- 6 Guaranteed products
- 7 Climate change
- 8 Actuarial assumptions
- 9 Quality of management
- 10 Political interference

Regulation topped the list of risks for almost all geographic areas covered by the survey, making this a truly global issue. In the US and Canada, concern about the cost and distraction of regulation coloured the majority of responses; in Bermuda the top concern was with natural catastrophes, the cost of which eventually ends up in the reinsurance sector. Although this region shared the general concern about the investment outlook, it was less worried about macro-economic risk than Europe because of its more buoyant economies.

## Macro-economic worries focus on Europe

### Europe

- 1 Regulation
- 2 Macro-economic envt
- 3 Investment performance
- 4 Guaranteed products
- 5 Business practices
- 6 Political interference
- 7 Long tail liabilities
- 8 Quality of risk mgt
- 9 Natural catastrophes
- 10 Distribution channels

The European response is more global than it looks because many of the respondents, particularly from London, were from different parts of the world. This ranking, therefore, reflects the broadest consensus about the risks facing the global insurance industry: burgeoning regulation, uncertainty about the economic and investment environments, and underwriting uncertainties. At the operating level, there was still concern about mis-selling, and about the new challenges presented by the burgeoning choice of distribution channels.

### Middle East/Asia\*

- 1 Business practices
- 2 Natural catastrophes
- 3 Quality of risk mgt
- 4 Investment performance
- 5 Quality of management
- 6 Regulation
- 7 Reputation
- 8 Corporate governance
- 9 Innovation
- 10 Actuarial assumptions

This was the only region which did not have regulation at the top of its list. Instead there was strong concern with institutional issues, particularly business practices such as mis-selling and the quality of risk management. There was a low level of concern with macro-economic issues, reflecting the more dynamic position of countries like India. On the other hand, management and corporate governance issues ranked high in a region where these have not traditionally been a priority.

\*Bangladesh, Egypt, India, Lebanon, Oman, Pakistan, Turkey, UAE

### Far East/Pacific\*

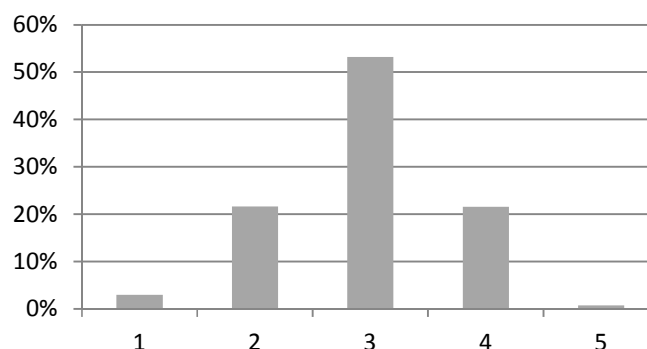
- 1 Regulation
- 2 Investment performance
- 3 Distribution channels
- 4 Reputation
- 5 Quality of management
- 6 Natural catastrophes
- 7 Business practices
- 8 Macro-economic envt
- 9 Actuarial assumptions
- 10 Human resources

Although this region contains a mix of developing and developed countries, it shares the global concern with excessive regulation: this applies as much to South Korea as it does to Australia. This was also the region which gave the highest ranking to reputation risk, reflecting the controversial response of insurance companies to the string of natural disasters which hit it two years ago. Human resource risks have always featured in this region, reflecting a shortage of talent. But macro-economic concerns are relatively low.

\*Australia, China, Hong Kong, Indonesia, Malaysia, New Zealand, Singapore, South Korea, Taiwan, Thailand

## Preparedness

We asked respondents how well prepared they thought the insurance industry was to handle the risks they had identified.



On a scale of 1 (poorly) to 5 (well) they gave an average response of 2.95, suggesting positivity and negativity in almost equal measure. More than half of respondents answered “3”, with most of the rest split evenly between “2” and “4”. Very few ranked preparedness at either extreme end of the scale, though of those that did, four times as many answered “1” as “5”. Although we have changed the methodology this year so no direct comparison can be made, the results seem to echo what we found in 2011, when on a scale of “poorly”, “mixed” and “well”, 87 per cent of respondents chose “mixed”.

The primary reason for good preparedness was the perception that the industry had prioritised risk management and has become increasingly conscious of the major threats it faces. Large, multinational insurers in particular were seen by many respondents as having adequate controls in place.

The reasons for poor preparedness included a shortage of innovation and clumsiness in adapting to changing environments, the strength of regulatory interference, a lack of quality at board and management level, and an increase in ‘black swan’ type risks which are very difficult to prepare for.

Geographically, preparedness was ranked highest in the Far East Pacific region and lowest in Middle East Asia. Broking/Intermediary respondents ranked it lower than those from the life, non-life and reinsurance sectors.



## 1. Regulation (1)

The fast-rising tide of financial regulation emerges as the greatest risk facing the global insurance industry for the second year running, as seen by respondents to the latest Banana Skins survey. And global is the word since this risk occupied first or second place in five out of the six regions we surveyed. (The exception was Middle East/Asia). Among the insurance sectors, it came No. 1 for life and No. 2 for non-life. Lest it be thought that this was just an industry complaining about unpopular controls, non-practitioners (i.e. consultants, analysts, academics and other close observers) voted it No. 1 as well. It was impossible to miss the sense of frustration, fury even, that coloured many of the responses.

The reason was clear: the sheer volume of new regulation that is seen to be swamping the industry with costs and distractions, and creating a whole new class of risk: regulatory compliance. Many respondents expected these trends to produce a shake-out in the industry between those companies which have the resources to deal with them, and those that do not.

It is ironic that regulatory change is in itself a driver of risk in the industry. Although the majority of regulatory initiatives are sound in principle they may in fact increase the risk of non-compliance, increase operational costs and reduce competition in the form of innovation.

**Chief risk officer**  
South Africa

Regulatory risk was seen to take many forms.

**Uncertainty.** Many major regulatory initiatives such as the EU's Solvency 2 regime (see box) and healthcare reform in the US are still at the planning stage so the precise impact, particularly on expensive items like capital, is still unknown. Yet insurance companies are already having to invest in order to be ready for implementation. Countries as far apart as Canada, Ghana, Malaysia and China all said that new capital regulations were in the works, some of them awaiting developments in Solvency 2.

**Quality of regulation.** The quality of insurance regulation varies widely, obviously. But a number of themes recurred, many linked to unwarranted intervention and lack of finesse on the part of the regulator. One was the failure of regulators, as one respondent said, "to understand the economics and business model of insurance" and to apply measures that were appropriate. A second was that, as regulation becomes more complex, regulators inevitably resort more to box ticking than judgment. An actuary at one of the UK's large life companies said that "judgement based supervision seems lacking, with very considerable detailed (and relatively immaterial) questioning and issues raised by regulatory teams who seem disjointed between lower and upper level of supervisors". A third was the failure of regulators to carry out sufficient cost/benefit analysis before introducing potentially burdensome new regulations.

A fourth was the growing inconsistency between jurisdictions as rules proliferated. Dan Brown, partner at SNR Denton US, said that "regulatory uncertainty at multiple levels will continue to be a drag on the industry. Regardless of the ultimate outcome, the current disagreements and infighting between (a) states, (b) states and the federal government, (c) the US and the EU, and (d) within the EU hamper growth, place a drag on capital, and force the industry to stagnate until a system (any system) is firmly put in place". Several respondents felt that their own countries would be placed at a competitive disadvantage if they became compliant when others did not.

### Solvency 2 tops the regulatory risk agenda

A respondent from a Spanish insurer said that “unless there is consistency, the need to adopt several new regulations could significantly damage the insurance business, and consume a significant amount of resources”.

**Cost.** The high cost of regulation, both as to capital requirements and compliance, was a major concern. The CFO of a large Canadian insurer said: “Continual regulatory burdens [are] being pushed onto the industry without appropriate consideration of cost and business impacts”. Several respondents said that the added costs would have to be absorbed in ways that would affect the quality of the service. The CEO of an insurer in Singapore said: “The best intentions to protect our customers will inevitably increase cost to insurers, reduce value to customers, and stifle innovation”. A related issue was **management distraction**. The CFO of a large international company in Singapore said that “the high level of regulatory change is resulting in a management team focused on the outside not on the business at hand”. Some also felt that regulation was putting good managers and directors off joining the industry. A Canadian risk officer said that “given the specialized knowledge of the industry and various industry segments, it is a concern to keep pace with the number of changes within the regulatory environment, and ensure management and the board are aware of the increasing amount of knowledge required for appropriate governance and control”.

The world of insurance regulation is rich in acronyms. Here is a selection from our responses.

S2, RDR, IFRS, FAIR, RBC2, FOFA, LAGIC, IRAG, ORSA, IPSA, ERM, IBNR, MGA, FSCO, GFC, PRA, FCA, APRA, AUM, OSFI, GASB, ABI, IoA, MGA, TCF, KYC, PPI, IMD2, EIOPA, UL, TIV, FPD, IAIS, CBI, NIC, TVOG, IBNR, D&O, IRDA, PS09/13, GSII, IAIG, COMFRAME, IOIS, NAIC, FSB, SAM.

## Solvency 2

If concern about regulation has a single focus, it is the Solvency 2 Directive, the EU’s ambitious and much-delayed attempt to set capital rules for the insurance industry.

Now in its seventh year and counting, Solvency 2 still has no firm timetable which means that the industry has to plan in an environment of great unknowns. The chief risk officer of a large Belgian insurer said that “the uncertainty concerning the implementation date of the Solvency 2 directive is a risk that has to be followed up on a regular basis, as this has both strategic and operational implications.”

Although Solvency 2 only affects the EU market directly, other jurisdictions are modelling their own solvency regimes on it, meaning that uncertainty is much more widespread. Respondents from China, Bermuda, South Africa and Singapore were among those for whom uncertainty about solvency rules was a concern.

**Quality of the service.** The consequences for the **client** were frequently mentioned. A respondent from South Africa warned that resources would have to be deployed “to develop systems and processes to comply with new regulations, rather than focusing on the development of innovative solutions for clients”. Although insurers might be expected to say that the regulatory bill would end up with the customer, one respondent (from Australia) identified a potential perverse outcome: even more regulation, driven by popular demand, to keep prices down and force insurers to make particular products available (e.g. car and homeowners insurance). A related issue was **competition**. Many made the point that rising costs favoured large

companies and could lead to a shake-out of smaller companies. The financial controller of a large company in London said: “Excessive and burdensome regulatory changes will negatively impact the industry due to the cost of implementation by insurance companies. Many small to mid-size companies will not be able to handle additional regulatory filings and disclosures with current staffing levels.”

Nonetheless, a small number (about 15 per cent) of our respondents felt that regulation was a good thing. Daniel Vanderkemp, regional CFO of ACE Asia Pacific in Singapore, said that “this is part and parcel of being in the financial services industry so it should not be considered a risk.” Several also said that improvements to regulation were necessary and well intentioned, particularly insofar as capital requirements were concerned. An Indian respondent observed that “in an emerging insurance sector, a good regulator would be a boon” and a respondent from Greece added that regulation was only a risk “to the extent that insurers pursue strategies that depend on lax supervision”.

### A global concern

What is striking about concern over regulatory excess is how global it is. Here is a selection of responses to illustrate this.

**Denmark.** [The concern is] the aggregate of many regulatory initiatives which, seen in isolation are sensible and reasonable, but where the consequences of the sum of them is unknown and potentially of a very large size.

**Ghana.** The regulatory framework continues to be sub-divided instead of consolidated to bring efficiency and completeness. An example is the set-up of a separate regulatory entity for health insurance and pensions, outside the purview of the National Insurance Commission.

**Hong Kong.** [Our concern is] regulatory risk, in particular changing regulations, and inconsistencies across jurisdictions for multi-national players such as ourselves. [But there is] an expectation that all should apply (e.g. both local and international) which is complex to manage, and there can be contradictions.

**India.** Regulatory oversight is fine, but regulatory over-indulgence may spell doom for the industry.

**Latvia.** The regulatory burden is increasing...The [low] profitability of the Latvian insurance market may reduce the cover and consequently the trust of customers.

**Malta.** Regulatory issues continue to take up a lot of resources and represent an unknown area as to when they will be implemented and to what extent.

**New Zealand.** Regulation is overwhelming the industry, and impacting heavily on productivity and resources to such an extent that niche insurers like us may struggle to continue.

**South Korea.** Government regulation [is having] an adverse effect on insurance companies.

**US.** This is the biggest problem in the business and more damage is coming.



## Five years of record low yields are taking their toll



## 2. Investment performance (4)

Five years of low interest rates are putting pressure on an industry which has become increasingly dependent on investment earnings to make up for declining insurance business returns. The concern is not just about low yields in the bond markets but the pressure that insurance companies face to compensate by taking on more risk in new markets. This Banana Skin was ranked No. 1 by reinsurance, no. 3 by non-life and no. 4 by life.

As with many of the top risks in this survey, this is not a localised concern, but global because of the linkage between markets. A reinsurance risk officer in Switzerland said that “the main risk for life insurance is continuing low interest rates. Similarly, the very weak investment returns for P&C insurance will jeopardize its profitability. I see the main risk for the insurance industry coming from the weak economy and the low return achievable on the financial markets”. In India, a respondent said that “as barely any insurer is making a substantial underwriting profit, the poor investment climate is bound to harm”, and in Australia, a respondent said: “Like most insurers, we rely on investment income to maintain a prudential level of capital. Poor investment returns will translate to higher premiums”.

Furthermore, respondents expect sluggish economic conditions, and therefore low interest rates, to continue for a while. In Canada, an insurance regulator said that “persistent low-long term interest rates are forcing Canadian companies to increase reserves on long-tail business, thus straining earnings and capital and reducing their return on equity. This situation could continue for some time due to eurozone uncertainty and high US debt. In response, companies may look for higher risk/return investments to increase long-term yields or improve RoE”. However a chief risk officer at a Canadian life company had a further concern: “We just experienced largest deliberate action to manage rates down that we have seen in our lifetime, so we may naturally expect this to be followed by the largest up spike in rates we’ve ever experienced”.

The last point about companies chasing higher returns was picked up by many other respondents. In the Lloyd’s market, Sir Adam Ridley, chairman of Equitas Trust, said that “competitive pressures in a low return environment are the ideal recipe for tempting foolish managers into taking excessive and unhedged risks”. One non-life insurer in the Netherlands was disarmingly candid: “We rely too much on investment income; this could hit us in the face easily.”

Some respondents were especially gloomy about the outlook for traditional life/savings /pensions because of the difficulty of designing appealing products. Jozef Koma, director of risk management, actuarial analysis and reinsurance at Union Insurance Company in Slovakia said: “It is possible that traditional saving life insurance will be wiped out if reasonable returns to clients cannot be achieved. Similarly, the poor performance of investment funds could weaken interest in unit-linked products”.



## 3. Macro-economic environment (3)

The uncertain state of the global economy is having a major impact on all aspects of the insurance industry: growth prospects, investment returns, balance sheets etc. Macro-economic risk was a particularly strong concern in Europe (where it ranked

No. 2), compared to North America (No. 5) and Asia/Far East (No. 8). However, there is some comfort in the fact that the score given to this Banana Skins was the lowest since 2007, suggesting that the absolute level of concern is falling.

The survey was conducted in the aftermath of the Cyprus crisis, meaning that euro turbulence was very much on people's minds. The chief actuary at a large UK mutual said: "The euro is unsustainable in its current form, and low economic growth is going to make change inevitable. Europe cannot manage change quickly enough which will lead to volatility in financial markets". The CFO of a large Swiss insurer said that "the threat is biggest in Europe with both low growth and low interest rates".

### What it feels like to be selling insurance in Cyprus

"The general financial distress and the subdued economic activity prevailing in Cyprus during the past three years have taken their toll on the Cyprus insurance industry as well. Extremely limited opportunities for business growth, intense market competition and continued deteriorating results, coupled with a complete asset meltdown, have been the main areas of concern for the industry. The application by the Cyprus Government for financial aid by the Troika and the terms of the Memorandum of Understanding signed on 2nd April 2013 for a €10 billion support programme, as well as the resolution and restructuring plan of the two largest banks in Cyprus, point to a prolonged recession period. It is anticipated that these developments will have a further adverse impact on the activities of insurance companies, in terms of their opportunities for growth and profitability. A sharp rise in relation to fraudulent and/or exaggerated claims, growing receivables as well as lack of liquidity are some of the many challenges that insurance companies will need to address in the next 2-3 years."

**Managing director**  
General insurance company

Responses from other parts of the world give a flavour of wider concerns.

**India:** "[The macro-economic environment] is a big risk given the current conditions".

**Australia:** "The 'miracle economy' is slowing as the mining investment boom slows. Other sectors struggle. This is a significant threat."

**Brazil:** "If the US and the EU fail to recover and start buying again, Brazil could engage on a longer period of low growth with high inflation."

**South Africa:** "Continued economic uncertainty, as well as related volatile and potentially under-performing investment markets will impact negatively on the performance of the insurance industry."

Although there is a school of thought which says that insurance operates to its own cycle and that people need insurance whatever the weather, most of our respondents believed that an extended period of sluggish growth would hit sales of savings and protection products, while low yields would squeeze financial returns and complicate the guaranteed yield market. A respondent from the US said that "the markets are the key to capacity. Insurance is not an isolated market sector". Commenting from Turkey, a market with a different perspective, a composite insurer said: "The current economic turmoil seems set to continue for the coming 2-

3 years and will continue to affect the insurance industry, especially in the economies with low insurance penetration”.

Another concern was that the poor economic environment would increase competitive pressures among existing players and from new entrants seeking opportunities to deploy excess capital. Greg Carter, director of market services at Capita Commercial Insurance Services in the UK, said that “low growth rates globally, together with an abundance of capital, mean that competitive pressures are likely to depress earnings for the industry, leading to losses for some, or potentially many, in the sector”.

Many respondents also saw tougher conditions bringing on higher lapse and claim rates. Cheung Wai Man Raymond, chief risk officer at AIG Asia Pacific in Singapore, said that “the insurance sector is often known to be neutral to the macro-economic environment as, whether in good or bad times, people need insurance. However, studies also show that claims tend to increase during times of economic downturn”.



## 4. Business practices (18)

The sharp rise in the position of this Banana Skin comes partly because of redefinition. In previous surveys, we focused on Retail Sales Practices, but we decided that we should survey Conduct of Business more widely, not least because that is what the regulators are watching.

Even so, we judged that this Banana Skin would have risen anyway. Despite the huge amount that has been done by companies and regulators to clean up business practices, this is still an area of high risk particularly at a time of economic stress when pressure to generate sales is strong.

Regionally, this risk was seen to be highest in the Middle East and Asia (No. 1) followed by Europe (No. 5) and the Far East/Pacific (No. 7). It only ranked No. 17 in North America. Among the types of respondent, the highest level of concern was among brokers (no. 4) with both life and non-life at no. 5.

For many respondents, the difficult economic environment made this risk particularly hard to manage. The CFO of a non-life company in the Czech Republic said that there was “pressure on quantity, not on quality” and the head of marketing at a large Indian insurer observed that “chasing only the top line without any regard for the quality of risks may lead the insurance company into the red”. The head of R&D and actuarial services at a Belgian reinsurer said that the fact of “the market being increasingly competitive, rapid and professional increases the risk”.

Despite recent improvements, there was still a sense that insurers lacked full commitment to eliminating this risk, particularly in emerging markets where regulation has yet to catch up. A respondent from India said that “the current position in India does not bode well for the industry”, while another from Brazil admitted that “this market is not the most ethical or transparent one in the world. It could face confusion as the market changes”.

A point of debate among respondents was whether this risk was financial or reputational. Some argued that the financial penalties were still relatively small, and offered little discouragement to the unscrupulous salesman compared to the

**Standards may  
be slipping under  
pressure to  
produce sales**

reputational damage suffered at the corporate and industry level. For example, an Australian respondent remarked: “High risk, but not a high \$ impact overall”. But a US respondent added: “This industry has such a horrible public image that any misstep or perceived shady practice will be dealt with harshly”.

The aspect of this risk most often identified by respondents was the difficulty of managing distribution, particularly through agents. The country president of a non-life company in Singapore, said “this depends on channels. For agency, the risk is much higher than for sales in a controlled environment e.g. within a call centre, where sales are closely monitored”. In India, an insurance industry consultant said that the greatest risk to the industry lay in banks which became agents “and dictating their insurance subsidiaries to create policies and thrust them on unwary customers at exorbitant rates”.

Other aspects of the risk lay in enforcing Know Your Customer rules and controlling questionable practices such as policy churning. The quality of products themselves is a further issue: are they transparent and straightforward (not always easy when regulators demand strings of conditions)?



## 5. Natural catastrophes (5)

In the 2011 *Insurance Banana Skins* survey this risk jumped 17 places, following a string of major natural catastrophes which included severe earthquakes in New Zealand and Japan. Though the intervening period has not been quite so volatile, the fact that it holds its position this year suggests that it is still at the forefront of the industry’s concerns. Sectorally, it was the top risk among non-life insurers and brokers/intermediaries, while geographically, it ranked second in North America and Middle East/Asia.

For many, the main concern was that increased frequency of extreme events in recent years will become the new normal, especially in heavily populated and insured areas – a fear aggravated by climate change and the anticipation of ‘overdue’ disasters, such as on the fault lines of New Madrid and San Andreas

in the US. At the extreme end of the scale, one risk manager from New Zealand said natural catastrophes “could wipe out the industry given a big enough or simultaneous events across different geographies”.

“If the ‘big one’ happens soon, coverage is still far too high and products are still poorly designed. Catastrophe models are simply wrong. We will be in a real mess”.

**Manager**  
New Zealand

Others pointed to the underpricing of catastrophe risk – partly due to the intensity of competition in the sector – and the shortcomings of current models. The chief financial officer at a non-life insurer in Singapore said: “As players look to grow by penetrating new markets, products, demographics and exposures there is a risk that historical data and/or models simply are not adequate. Recent catastrophes in both developed and developing markets have shown that not all risks are well understood or modelled.”

But one respondent from the US disagreed, saying: “The sophistication of models seems to be working for insurers; the run of natural catastrophe events over the last five years has barely made a dent in the sector. This is one of the few bright spots in the industry where the traditional approach has worked for the insurers”.

Others were wary of a knee-jerk reaction to recent disasters. “That’s why we are here... if we stay focused and disciplined in price this risk should be manageable”, said one vice president at a reinsurance company in Hong Kong. A non-life respondent in the US cautioned against insurers panicking and unduly raising rates or withdrawing from markets. “Sometimes we forget that everything will not always be as it once was. Swings in severity have to be anticipated and priced for. Underwriters can’t turn over their responsibilities to modelling companies – they have to think for themselves,” he said.

Nick Kirk, chief executive of Calliden Group in Australia, a country which has historically struggled with flooding, said insurers had responded logically to the challenge by making coverage more widely available but ensuring that for those most in need of it, the premiums were commensurate with the risks. “This means that we have probably moved the issue from availability to affordability”, he said. But he added: “In the event of more wide scale flooding there must be an increasing risk of further government intervention, perhaps challenging the insurers right to risk rate”.



## These products are ‘a potential menace’

## 6. Guaranteed products (-)

Savings products that offer guaranteed returns were the rage a few years ago, but now they have returned to haunt the insurance industry – at least those parts that offered them – with the slump in yields.

This is the first time we have tested the ranking of these products, and the fact that they came No. 6 suggests they are an important concern. Not surprisingly, perhaps, they were highest on the rankings of life insurers (No. 3) compared to non-life (No. 16).

Many respondents said they had no exposure to them, either because they had never offered guaranteed products or had laid off the risk. But some saw it as a live issue. The vice-president of a reinsurer in Hong Kong said this was “Very hot at the moment. We are already seeing some companies struggling with their big in-force sold in more prosperous times which is now dragging them down. On top of that, the low interest environment is not only affecting the in-force badly, but slowing down the new business as well.” A Portuguese life company said their main concern was “financial risks on products with guarantees”.

Other respondents were unsympathetic. A respondent from one of the London insurance trade associations said that “Guarantees are a potential menace”. Another said: “Managers need to look back at similar examples when promises could not be met. Recall the Equitable.” This was an issue of close interest to the regulators, respondents said.



## 7. Quality of risk management (15)

Concern about the quality of risk management in insurance companies has risen sharply this year for reasons that are not immediately obvious. There have been no insurance disasters, and huge amounts of work are being done, under strong regulatory pressure, to improve it.

One possibility is that risk management awareness is growing in emerging markets, and that this is beginning to tilt the balance. The highest ranking this Banana Skin got, for example, was in the Middle East/Asia region where it came No. 3. It ranked No. 6 in Latin America where a respondent from Brazil said his country was “still in its early days with strong risk management”. By contrast it came No. 8 in Europe and No. 11 in North America. In the insurance industry itself, the brokers ranked it highest at No. 5 versus No. 7 for non-life and No. 10 for life.

What was striking about the responses is that they were clearly divided between those who thought risk management was improving, and those who thought it still had a long way to go.

Starting with the more upbeat, those who had good things to say about insurers’ risk management record stressed the amount of work that had gone into it. In New Zealand, an actuary observed: “There is a greater focus now. Indeed chief risk officers appear to be flavour of the month and appear to have no difficulty getting budget to grow their teams. The challenge will be for CROs to gain acceptance of their business peers, which will come through understanding the business properly and doing more than ticking compliance boxes. A senior vice-president at a Canadian life company said that “It used to be a higher risk for the life companies compared to the banks, but it is now under control and better monitored,” and from Switzerland: “The industry has made huge progress; risk is reducing.” Many acknowledged that regulatory pressure had played an important part. A respondent from Belgium that said: “Insurers are becoming more risk sensitive. Solvency 2 is enhancing this evolution”.

### Modelling risk

“From a risk management perspective, there are huge challenges for modellers to keep pace with emerging risks and, in some cases, the increasing severity of natural catastrophes. Models are only as good as the last time they were calibrated, and there are no good models for risks like contingent business interruption (CBI), so underwriters have in some cases insufficient data to enable them to underwrite increasingly complex risks.”

#### CFO

Reinsurer  
Bermuda

On the downbeat side, respondents focused on what they saw as the shallowness of insurers’ commitment to risk management: the fact that a risk “culture” was often missing, that company main boards were not closely involved, and that risk management could be sacrificed to cost pressures. An overdependence on models was frequently mentioned. The head of audit at a large Swiss reinsurer said that insurers should go beyond “formal risk management [and gain] a substantive understanding of the risks that may hurt the company”. A respondent from Canada had a similar comment. She said: “There is still lots to do. The tendency is to believe we have seen the worst. At times where interest rates are at their lowest and everyone is scrambling for net income, risk management needs to be strong to prevent short time thinking”.

As noted at the top, many of the sharpest concerns came from emerging markets, focusing mainly on the early state of risk management techniques. From Malaysia, Kong Meng Chin, senior vice-president MSIG Insurance, said that “the fundamental risk management frameworks are in place, but they are not so robust”. A similar comment came from Honggang Liu, head of the risk management office at the Great Wall Life Insurance Company in China, who said: “At present, comprehensive risk

management and its related technical methods are not perfect". In India, K.G. Krishnamoorthy Rao managing director and CEO of Future Generali India Insurance, said that "although many insurers have put in place proper RM frameworks, regular updating and action is required".



### 8. Quality of management (14)

Concern about the quality of management in insurance companies has risen noticeably since the last survey, mainly because this is becoming more of an issue in emerging markets. It was highest in the Middle East, Asia and the Far East and lowest in Europe and North America. Among the insurance types, it was higher on the life side (No. 8) than the non-life (No. 11).

#### Difficult times for management

For example, the head actuary in a South East Asian insurer said that the lack of suitable talent had produced a "'learn as you go' mentality which has resulted in companies not having in-depth expertise", and a Chinese respondent was concerned that "operational risk brought by ill management would bring huge losses to insurers".

But concern on this front appeared in developed markets as well. A Belgian respondent felt that management risk was increasing "as memory of the past disasters is fading and greed for high results is emerging" and a UK respondent felt that there were "a number of very complacently-run companies with inadequate performance".

The specific concerns listed by respondents included short-termism, bonus fixation, and the quality of talent available, a Banana Skin which we look at more closely in No. 19. Many respondents feared that the growth of regulation was putting good people off from joining the industry. A US respondent warned that "as regulation increases the quality of the people willing to go in the business will decrease". A director at a UK life company offered a similar view: "I think the insurance industry is blessed with good management; the fact that they are doing the wrong things is driven by regulation and accounting principles".

However there was also a strong body of respondents who felt that management was doing well. The chief risk officer of a South African composite insurer said that there was "poor judgement due to commercial pressures possibly but not necessarily poor management as a general theme. Broadly my view is that management teams tend to be well experienced and qualified". Paul Murphy, managing director of brokers Australian Risk Advisers, said that "management practice has greatly improved. The question abides: have this risk averse group of managers got the ability to innovate and grow the market?"



### 9. Long tail liabilities (7)

Although long tail liabilities came close to last year's position in the ranking, suggesting little change in risk perceptions, this remains a problematic area for a number of reasons: the problems of reserving in a difficult financial environment, the unpredictability of new and unfamiliar risks, and ever-changing regulatory and accounting rules.



### Long tail risk is growing in emerging markets

The group who ranked this risk highest were the reinsurers who put it at No. 5, followed by non-life at No. 10 and life at No. 12. The geographic region which ranked it highest was North America at No. 4, possibly because of what one respondent described as a more litigious culture.

This concern with uncertainty was widespread. A Swiss insurance auditor said that “the risk is more with the unknowns - there will likely be some exposure that we don’t know about, which will materialize at some point”. The chief risk officer at a Canadian non-life company was concerned about “long term liabilities on risks that insurers don’t know about yet. For example, the next asbestos, tobacco or medical; (medical advances may lead to more risk as diagnosis may take years).” The medical/life area got several other mentions because of longevity and health issues. They were summed up by the chief risk officer of an accident compensation firm in New Zealand: “[The risks are] partially caused by a population that not only gets older but also lives a less healthy life: people are getting older, fatter and less healthy than before.”

Other emerging areas that were mentioned included climate change and the long tails created by the increased frequency and severity of natural catastrophes.” The head of risk and compliance at an insurer in New Zealand, said that “the earthquake rebuild programme is years from completion”.

Awareness of long tail risk is growing in emerging markets. Rosanne Bachman, managing director of Pinwheel Consulting in the UK, said: “As we move into developing markets, while they may not have had long tail issues in the past, it would be easy to see in some cases how long tail liabilities would show up in the future, e.g. pollution levels in China”. Indian insurers have a special problem with motor third party liability: the insurance law puts no time limit on claims. Govind Johri, a non-life consultant, said this resulted in “multiple claims at various locations and over periods stretching up to 7-8 years”.

Much of the commentary focused on the difficulty of getting reserving right for these liabilities, which also means getting the pricing right. Many thought the industry was under-reserved in this area. Reflecting the concerns of the broking community, a US broker/intermediary said that “With under-reserving, this is a large risk to the industry”, and a chief risk officer in Belgium said that “by nature we are underestimating such impacts”.

There is also the issue of the cost of reserving where persistent low long-term interest rates are forcing companies to increase reserves on long-tail business, putting a strain on earnings and capital, and reducing their return on equity. One Canadian life insurance respondent said that “this is one risk that could trigger consolidation in the market as some won’t be able to settle on all their long term commitments”.



## 10. Political interference (11)

Political risk rose sharply in the 2011 survey over concerns about sovereign risk in Europe and uprisings in the Middle East. The question we asked this year was narrowed to focus on government interference in the industry rather than political stability more widely. That this risk nudged up into the top 10 suggests a deterioration in the often troubled relationship between governments and insurers in much of the world.



## Politicians ‘don’t care how insurance works’

The key concern was around political influence on this year’s No. 1 risk – regulation – though its urgency varied regionally. The Banana Skin came in at No. 6 in Europe, one respondent pointing out that “European regulation is often guided by a political agenda based on the desire by some to promote greater convergence”. It also came in the top 10 in North America, with reform of auto insurance coverage in Ontario seen as a big concern in Canada. But the risk was ranked much lower in the Middle East Asia and Far East Pacific regions, particularly in Singapore, where the regional chief financial officer of a non-life insurer noted: “Regulators and governments are slowly become more segregated”.

The level of sympathy for politicians’ objectives was mixed. Some took the view that political interference may be well-intentioned but was often counter-productive. A respondent from Switzerland said: “As social and economic pressures cause governments to include sustainability responsibilities in insurers’ duties to policy holders and shareholders, without parallel reductions in the financial reporting and other current legal duties, insurers will be at risk in ways that defy current risk management capabilities”. Graeme Easton, chief life actuary at Zurich International, though giving this risk the maximum severity rating, commented: “but only because we as an industry have laid ourselves open to it by not adopting best practice”.

But many were more scathing. “There is no situation so bad that government interference cannot make it worse”, said a US respondent, while another in the UK said “Insurers constantly under-estimate this threat, believing that politicians care about how insurance works. They don’t – though luckily they can be frightened by what happens when insurance doesn’t work”. The head of risk management at a Lloyds syndicate, giving the risk a “4” out of “5” rating for severity, said: “It would be a ‘5’ but [the Solvency II Directive] has been a shining example of wasted resources. This should reduce inclination to launch further campaigns of similar magnitude”.

Others saw the industry as a convenient punching bag for politicians pushing a populist agenda. “Insurance is seen as a soft target that has no way to oppose the expenses imposed on them by opportunistic politicians and regulators remote from the business”, said a non-executive director of a UK life insurer. Thomas Kaiser, President of SeaVista Management in the US, said: “people in government today are anti-business, tend to see insurance as a benefit and have continued to weaken underwriting”.

A related point was that the industry was – some felt unfairly – still under heavy political scrutiny after the crisis. One respondent bemoaned its treatment “as if it were as dangerous as the worst of the banks” and the common perception that it was susceptible to systemic risk – both erroneous views, he said. Another said that although the increased focus on financial services more widely was natural, political uncertainty made it “harder or impossible to design new long term products”.



## 11. Distribution channels (9)

Although the risk in managing distribution channels is no longer among the Top Ten Banana Skins, it is still seen as one of the major strategic challenges facing the industry. Get it wrong, and you could lose the whole of generation Y’s business. This was a risk of particular interest to the life industry (No. 6) and to brokers (No. 10).

### Products 'too complex' to be sold on the internet

The great majority of our respondents agreed that the insurance industry had been very slow to adopt new distribution technology for reasons of conservatism, cost, failure to understand etc., but also out of a pardonable belief that traditional personal contact and advice were essential parts of the offering.

A respondent from Hong Kong said there was "an unwillingness to change - or adopt new technology. Too many believe that the complexity of the product requires direct contact with a financial adviser." A Danish respondent said that the industry had been "saved" by the fact that many of its products were too complex to be sold on the Internet.

The question of whether, and how far, agents and financial advisers have a role to play in the new world of electronic distribution lies at the heart of the debate, and we found a clear division of opinion. One Canadian insurance company, for example, stated quite bluntly: "We are loyal to the broker channel". But another countered: "Brokers are getting older and it is harder for them to attract new clients (new generations). There is a need to redefine how business is sold because it is not fully meeting the new generation's needs as it stands". Some even saw brokers standing in the way of change: "Whilst the IFA stream continues to dominate and use old practices to distribute product and attract clients, advanced technology will not be developed or embraced". And some saw room for both. A Czech respondent said: "There is no risk in new distribution channels; there will be always personal contact".

But change is occurring. Many respondents saw the spread of new distribution techniques happening, spurred by competition, cost saving and regulatory pressure for greater transparency. In New Zealand, an insurer said: "Insurers need to get to grips with how society - especially younger society - interacts, and especially with how they want to compare products and buy stuff".



## 12. Actuarial assumptions (12)

Although actuarial issues are normally associated with the life side of the business, successive Banana Skin surveys have shown that it is the non-life side which worries about them most. This year, again, the non-life ranking (No. 9) was much higher than the life side (No. 18).

The reason for this seems to be that uncertainty on the non-life side is growing on a number of fronts. Many respondents mentioned the high level of economic/political uncertainty which currently affects the business, as well as policyholder behaviour. A Belgian respondent said that "High volatility on the financial markets is impacting the reliability of actuarial assumptions." Many also mentioned what seems to be mounting natural catastrophe risk: a New Zealand respondent said that "catastrophe models failed in Christchurch and Japan", and another respondent from Australia said: "It's getting harder with ever changing weather issues for an insurer to get this forecasting correct".

On the life side, the risks lie, as always, in demographics and longevity. A life insurer from Hong Kong was concerned that "the markets may [have] a low interest rate for too long which will impact assumptions". Another from Denmark said: "I think the risk is especially medical development which affects longevity - elements which actuaries struggle with in regards of assumptions".

### Uncertainty growing on the non-life side

On the quality of actuarial input, there was the familiar division between those who felt comfortable with the soundness of their actuarial work and their own financial position, and those who believed that actuaries always tended to veer on the side of excessive caution and were out of touch with the real world. The quality of models was another issue where some respondents wished there was more room for “common sense”.

But a respondent from a London trade body said that this was “a relatively minor issue. Actuaries tend to believe their own predictions with rather greater certainty than is warranted for a profession whose existence is predicated on uncertainty, but this is really a matter for management scepticism”.

The role of regulation was seen to be mixed. Some countries such as China said that all actuarial assumptions were imposed upon them by the regulator, leaving no room for uncertainty. Others said that the pressure of Solvency 2 was forcing them to improve and validate their assumptions. But others said regulation was part of the problem: because it was always changing it added uncertainty to the process.



## 13. Innovation (-)

The risk of insurers being slow to adopt innovative techniques – for example, analysing online customer data to improve risk analytics, pricing and digital interactions – is included in this survey for the first time this year. That it makes the top 10 risks in the European, Far East Pacific and Middle-East Asia regions shows it has some urgency.

Taking a view that was echoed elsewhere, Zahir Petiwalla, group head of finance at Torus Insurance in the UK, said: “As the macro-environment evolves and customers are more interconnected, integrated and global the approach to analytics needs to evolve as well”. Also in the UK, the strategy director of a life insurer warned: “Consumers’ expectations are changing and insurers could be left behind due to legacy systems”.

But for many, innovation is not something that comes easily to insurers. “The industry faces deep cultural resistances to the adoption of, and reliance upon, the emerging tools of science and technology as a data generator and analytics as an interpreter of that data”, said Richard Murray, from the Geneva Association, a global insurance research centre. In Canada, one respondent said: “Insurers have been followers more than innovators due to the complexity of their products. That is a challenge to address”.

Some saw the uptake (or lack thereof) of innovative techniques as a driver of efficiency in the marketplace. “Slow, stupid companies will be hurt; quick, bright companies will adapt and innovate”, said a non-life respondent in the US. In the UK, the head of tax at a life insurer agreed: “The industry will continue to be split between those who adopt new techniques and can write profitable business and those who do not and therefore are forced to exit”

But others cautioned that smaller and local insurers would be hit hardest by its slow adoption. “It will likely harm small to mid-size companies that did not invest in technology before the economic downturn,” said one respondent, while another added: “the need for large amounts of quality data is a barrier to smaller niche companies”.

A few respondents flagged up the risk of overdependence on new technologies. “Risk analytics are tools and not a replacement for business understanding”, warned one, while another said that new techniques, though very valuable for process efficiency, could not be allowed to replace common sense. There were also financial concerns: in Singapore, the chief financial officer of a multinational insurer pointed out that “first movers are likely to burn money. It is better to be a fast adopter/copier”.

Others argued that the industry was misfocusing its efforts. “With low returns in the market, the industry will innovate for efficiency rather than for growth. What the world’s emerging consumers need -- and what will change the game -- is innovation for growth”, said Brandon Mathews, managing director Stonestep in Switzerland. A respondent in Hong Kong argued that “some of the most recent innovation has been a complete disaster”.

“I believe the biggest risk facing the insurance industry is the lack of innovation in response to the changing needs of the knowledge economy. The insurance industry is not innovating (in terms of products and business practices) in the face of its business model slowly decreasing in value and relevance to the knowledge economy. At the same time, the insurance companies are using ever more sophisticated models to select against the insured, to the point where clients are increasingly finding their genuine and serious exposures to be uninsurable.”

**Tom Ricketts**  
Managing director  
GoldRIN



## 14. Reputation (16)

Banks may have borne the brunt of reputational damage to the financial services industry after the crisis, but insurers have not escaped unscathed. This risk has risen a couple of places since last time. In some regions it is seen as more serious still: it came in the top 10 in the Fast East Pacific (No. 4) and Middle East Asia (No. 7), though it was placed only third from the bottom in North America.

Respondents from the London market in particular pointed to a loss of trust in the industry resulting from unfair business practices and opaque policies. “The UK market is declining because it got a reputation for overcharging and misselling products. Unless it can remediate that reputation and persuade people of the merits of providing for oneself and the benefits of long term saving the decline will continue”, said the head of tax at a life insurance company.

In New Zealand, which suffered two severe earthquakes in six months from 2010-2011 and a national row over claims, the head actuary at a life insurance company said: “The claims issues from the Christchurch earthquake have had a contagion impact on the whole industry – reinforcing a perception of claims not being paid”.

Others thought that reputational risk was likely to rise as the gap between what insurers can provide and what customers demand becomes apparent. “Failure to explain properly what insurers can and cannot do will inevitably lead to reputational damage as the industry fails to meet the expectations it has created”, said a senior adviser at an economics consultancy in the UK.

For some, this Banana Skin merited a low severity ranking only because they wondered whether the industry’s reputation could deteriorate any further. “Cannot

**A growing gap  
between  
expectation and  
delivery**

be worse – individual companies could be damaged but the industry not”, was the frank assessment of one respondent from the Czech Republic.

Others maintained that the public image of insurers has always been poor – but that this has ultimately had little material impact. Adrian Rossignolo, actuarial manager at Provincia Seguros in Argentina, said: “As long as there are few alternatives to traditional insurers, poor reputation will have no bearing on the industry”. But it was also pointed out that especially in the social media age, customers are more likely to abandon particular brands as a result of negative coverage.

A few respondents were more sanguine, comparing the industry’s perception favourably with that of banking. “Still a much better image than the banking world, with the banks taking the heat for PPI [Payment Protection Insurance]”, said one. But David Thomson, director of the UK’s Chartered Insurance Institute, warned: “the potential [of reputational damage] could be considerable if the insurance industry believes that the lessons of banking are not a salutary warning to get its own house in order to anticipate future reputational issues”.



## 15. Change management (-)

We introduced Change Management as a Banana Skin for this first time this year because it seems that the insurance industry might be on the threshold of important structural changes, under pressure from difficult markets and new regulation – among many other considerations. The result put it in the middle of the rankings, but with clear indications in respondents’ comments that they are giving this issue thought.

This was a special concern for the reinsurance industry where it came No. 7. Non-life ranked it No. 14 and life No. 16.

The chief risk officer of a large Australian non-life company said that “given the pace of change in response to current economic challenges, organisations now face heightened execution risk through major transformation initiatives.” Michel Dacorogna, deputy group CRO of SCOR in Switzerland, said that change management was “certainly a point of concern. The reshaping of the industry has brought together different companies, and integration issues can be important, particularly in IT.”

The pressures include the need to rationalise operations to save costs, to respond to regulatory pressure to improve financial strength, to protect market share, and to achieve a more solid position in what are by any standards difficult times. More opportunistically, respondents also saw insurance companies going for riskier deals driven by managerial motivations, as one said, “that lack shareholder control”. A vice-president at a large Swiss insurer said that such risks lay “especially with the current high focus in some high growth markets e.g. Indonesia - where the chance is high that it gets overheated.”

The trouble, as many respondents acknowledged, is that the insurance sector is not good at restructuring. Peter Heinen, quality manager at DEKRA in the Netherlands, said that “investments in new markets/companies have proven to be a black hole, or at least dark grey.” An actuary in New Zealand said that “modern companies certainly are aware of, and may focus on, change management. However change management is often poorly executed and thus typically fails.”

However some respondents felt these concerns were overdone. A Canadian insurance regulator said that “these activities are well regulated and it is unlikely a regulator would approve a transaction that would place policyholder’s benefits at risk” and a UK insurance director said: “I would expect the opposite. After run-off costs, profitability should improve.”



## 16. Capital availability (2)

A huge change in the position of this Banana Skin. Last time it came No. 2 amid fears of a critical capital shortage as insurers scrambled to meet the new regulatory requirements of Solvency 2. This time, the risk has been turned on its head: the problem is an oversupply of capital, and the risk is a return to overcapacity and cut-throat competition.

**Capital excess,  
not shortage,  
is the problem**

That, at least, is the headline story. There is more detail in the numbers. Concern about capital availability is higher in Europe (No. 13) than in North America (No. 21) and the Far East (No. 19) suggesting that Solvency 2 concerns remain strong. Among the sectors, concern was highest on the life side (No. 13), followed by non-life (No. 18) and reinsurance (No. 21).

A respondent from the Canadian life sector said “it has amazed me that capital costs have remained as low as they have despite a very challenging environment”, and the chief risk officer of a German insurer in London said “It seems to be swilling around freely.”

What was striking was how global capital availability seemed to be. Respondents from virtually all the markets surveyed reported that capital was in abundant supply, even to the point where it was creating problems. Rupert Atkin, CEO of Talbot Underwriting in the UK, said that “the biggest risk at the moment is having too much and diluting the return on equity as a result”. In Singapore, the country president of a non-life company said that “excess capital and capacity have resulted in some insurers not adopting underwriting discipline in their drive to grow the top line; becoming more price-driven as opposed to service-driven or value adding services, e.g. risk management. Ultimately, there will be casualties for insurers adopting such approaches.”

Concern was not just that excess capital would damage the market, but that broader economic conditions could change and put the process into reverse. Kristmann Larsson underwriting manager at Vordur Insurance in Iceland said that “a changing climate must rank very high on what insurers must look out for. The availability of capital is relatively high now in the industry, [but] the industry must be ready to accept that if serious losses occur, capital may go elsewhere, especially if economic conditions improve.” Some even welcomed the prospect of tighter capital conditions because this would produce a capacity shake-out. A respondent from Romania said this would get rid of “dumpers”. A respondent from a US non-life company said that “a reduction would actually help bring pricing back to soundness”.

However some respondents saw a capital shortage. In the Far East they said that a further set of natural catastrophes would put severe strain on their capacity. Others said that capital was very conservative and was not available to support new products and innovative business models.



## 17. Corporate governance (8)

The perceived risks in corporate governance have fallen quite sharply, reflecting the view that much has been done to strengthen insurance company boardrooms, though possibly with some way still to go. This perception applied broadly across the industry.

The corporate finance director of a UK reinsurer said: “I think governance and insight have been improving at a fast rate.” In Singapore the head of finance at a large international life company said that “corporate governance has already gone through a step change and the risk is now much lower than previously.”

But others were more cautious. Andrew Cunningham, of corporate governance advisers Darien Middle East, said that “corporate governance, across the financial industry, has improved over the last few years, but it takes time for skills on the board to be upgraded, and for cultures of control to be strengthened. Governance therefore remains a threat to insurance companies.” Some expressed a similar concern in the context of growing pressure on insurers to raise profits in difficult economic circumstances. The chief risk officer of a large Belgian composite insurer said: “I see an increasing focus on unrealistic results coming back”.

“Economic stagnation in the developed countries and the current growth in emerging or high growth markets might lead to a power shift over time. But this has its implications as societies with different cultures and values will come into the focus of the insurance industries, and this could lead as well to a change in the way insurance actually works and the value proposition it has to provide. This shift leads, at least for a certain period of time, to a power vacuum and political instability.”

**Strategy analyst, reinsurance**  
Switzerland

There were also concerns about the quality of boards and directors. The head of risk at a Dutch insurer said the governance scene in the Netherlands was “still a bit of an old boys’ network. Board members say they have changed, but this is not shown in their actions.” Some also felt that boards did not contain enough insurance experience. In Turkey, a finance director said, “A lot of company boards are dominated by bankers.” The CEO of a UK underwriter said “The main risk here is getting enough high quality and skilled execs and non-exec’s prepared to take the risks of operating in a heavily regulated business”.

Regulation is clearly having a big impact on this issue. A respondent from Canada said that the country’s insurance sector was well governed “with continuing regulatory focus likely to ‘up the ante’ and another from New Zealand said that “new regulations have put an increased emphasis on this, and boards appear to be cognizant of their responsibilities”. In Italy, an insurance broker said that “regulations are stringent and boards of directors are often poorly prepared. It may be that the fear of punishment will lead [them to raise their] guard. We will see”.



## A 'known unknown'



## 18. Climate change (20)

Since coming in at No. 4 in the aftermath of Hurricane Katrina six years ago, this risk has plunged down the rankings and nudges only slightly up the list this year. But the responses we received suggest its position reflects, in part at least, the long-term and uncertain nature of climate change rather than the size of its threat to the industry. Unsurprisingly the risk also varies widely by sector: property and casualty insurers placed it at No. 4 and reinsurers at No. 10, while life insurers had it third from bottom.

The most serious concerns were related to its sheer unpredictability and the inability of forecasters to produce accurate models. "It's a known unknown, and impossible to plan for. It will emerge over such a long time that we won't be able to react", said the chief risk officer of a multinational financial services company in the UK, giving this Banana Skin a maximum severity rating. Another respondent in New Zealand said: "The risk of climate change cannot be fully quantified, but that in itself is a risk."

Several respondents noted the difficulty of assessing this risk because of the discrepancy between the short and long-run threats. "It depends on timescale: over one year, negligible; over fifty, if mass floods/droughts are the new norm, there will be no insurance industry", said the head of financial management at a life insurer in Singapore, who nonetheless gave it a 2 out of 5 severity rating.

A minority were sceptical about the evidence supporting climate change; one said frankly that its inclusion in this survey was "political and not rational". Others believed it was happening but that authorities would struggle to resist the political pressures to pile more of the compensation burden on insurers, whatever the damage to the industry. "The climate cycles - we have to recognize that and price for it. The greater risk is the public relations issue attached to the issue, and the chances that the regulators will mash the panic button", said one vice president at a US underwriter.



## 19. Human resources (6)

## Benefiting from the banking shake-out

After coming surprisingly high in its inaugural entry in the 2011 survey, the risk of insurers failing to attract and retain the right talent is the biggest faller this year. The Far East Pacific region was the only one in which it made the top 10; in Europe, it ranked fourth from bottom.

Rampant unemployment across much of the world is a major factor. "This is not a difficult employer environment", said one underwriter in the UK, while another from Italy said: "with the current crisis, many talented people are out of business and many people of little talent are working". In countries with low unemployment such as Brazil, however, the reverse was noted.

Many also felt that pursuing a career in insurance looks an increasingly plausible alternative to banking with its tarnished glamour. "People want jobs, banks are under the cosh. Insurance companies still feel a little in the necessary evil/helpful category", said one.

Still, several respondents took the view that insurers were not doing enough to sell the industry. "Insurance should be an exciting and influential place to work. Old



practices and predominantly old-school male environments do not attract the best people,” warned an actuary in New Zealand.

Others bemoaned the lack of specialist expertise around, particularly at higher levels “The insurance market lacks senior knowledgeable people in a number of areas, and the new guard coming through is not learning,” said the head of department at a multinational broker. This is exacerbated by the increasing complexity of the industry. “The skill levels required are considerably higher than they were five years ago and there is a dearth of people with the necessary expertise,” said another respondent in the UK. But one US broker pointed out: “as the talent pool shrinks, technology should take up the slack”.

On the other hand, the chief risk officer of an insurer in South Africa said: “Regulatory change and the increasing focus on risk are attracting highly qualified and technical people”. But he added that the retail side of the industry will find this more difficult because other financial services are still considered more ‘sexy’. In this year’s survey, the broking and intermediary sector was the only one where this Banana Skin was a top 10 risk.



## 20. Product development (24)

This Banana Skin always throws up sharp disagreement between those who think the insurance industry is innovative, and those who don’t. The division has not altered much this year, and the risks in product development continue to be seen as low order.

The risks fall into two main areas. One is the danger of losing business by failing to keep up with client needs. The other is the risk of trying to be too clever with innovation, and ending up with wasted resources and possibly reputation damage too. This Banana Skin was rated much higher by the life side (who voted it No. 15) than to the non-life side (No. 25).

Those who thought that insurers lacked innovation focused on their conservatism and the risk of loss of market share to more inspired and aggressive competitors. Many of these respondents argued that the market was changing with customers now shaping the pattern of demand whereas previously insurers took a “take it or leave” approach. The vice-president of a US insurer said that “the market is now consumer driven. Adapt or die. We can no longer dictate to the consumers”.

But others felt that what passed for innovation in the insurance industry was often less than it seemed. An actuary at a New Zealand insurer was concerned about “spurious innovation on features not benefits. The AU-NZ industry seems to over-invest in a cycle of product development which offers little in innovation and under-invests in improving the experience of customers and advisers (using digital tools).” From Germany, Volker P. Andelfinger CEO of Palatinus Consulting, said

“The main risk is ‘lack of risk ownership’ by major insurance buyers. The overall culture is that people in organizations see themselves as part of a process without a high regard to the purpose, objective or outcome of that process. This detachment inhibits a culture of ‘risk ownership’.”

**James Portelli**  
General manager  
United Insurance Company  
UAE

### Little urgency in product development

that “new products mean just slightly changed wordings, most of them untransparent.”

A brake on innovation, some respondents felt, was regulatory risk now that regulators were taking a close interest in products and “treating your customer fairly”. A respondent from a large Canadian company said that: “The biggest issue is the increased scrutiny of regulators who want the right to veto products before they get to market. This will increase the time and costs of getting products to market and can only reduce the range of products available to consumers”.

Another brake is the growing difficulty of achieving differentiation in what is largely a commoditised market where all products are the same except for a few frills. A respondent from a Canadian life company said that it was “getting tougher to be unique and it is also taking more and more time to develop due to multi platforms (web, broker, etc.) and adding costs hence reducing returns.”

But some respondents argued that the industry was doing well on the innovation front. The CEO of an Irish non-life insurer said that “the market is very innovative and generally responds very quickly”, and a Canadian insurer said there was “some risk, but product innovation seems strong.”



## 21. Social media (-)

With Facebook alone hitting a billion users in 2012 and financial services providers increasingly using online platforms to interact with customers, social media makes its inaugural entry as a Banana Skin in this year’s survey. That it ranks towards the bottom of the pile is perhaps less to do with its severity than the fact that insurers have been slower than most to take to the new technology: the message coming through is that this is a risk on the rise.

The main concern is that social media amplifies reputational risk because of the speed and unpredictability with which it enables negative stories to escalate. “Any grievance can go viral very quickly, leaving insurers facing what is in effect a class action,” said Jonathan Hall, general manager at Friends Providence International. Others described the medium as “a complete pest used by the discontented” and “the elephant in room”.

This is exacerbated its perceived lack of oversight – “a law unto itself; so much unedited script”, as one respondent put it – and the ensuing difficulty of controlling damaging rumours, even if they are untrue. The country president of an insurer in Singapore said: “Misinformed readers will form certain perceptions of organisations. Rightly or wrongly, insurers must brace themselves and be prepared to respond to and mitigate any adverse comments or feedback”. Another respondent in Turkey said: “Loyalty in the retail insurance industry is relatively low. Misleading information spread by social media may cause irrecoverable damage”.

Many focussed on the positives, however, and several argued that the biggest risk comes from firms failing to embrace the new platforms. “Insurers need to stop worrying about the risks and start thinking about the benefits... it seems to be the last industry to adopt social media,” said Chris Sandilands, a consultant in the UK. Others were optimistic that the increased transparency could reward companies with good business practices and compel those that behave poorly to improve. A New-Zealand based actuary said: “Insurers will have to recognise that they cannot control

### Facebook risks are appearing on the horizon

social media like perhaps they could traditional media. They will have to act openly and fairly at all times”.

“Most insurers are well behind in recognising and considering social media risks and engaging appropriately,” said Mike Looney, national manager at Australia’s Blue Broking. “This is not surprising, though, because it is generally rare to find large mature businesses with a real culture of innovation; they typically follow one another instead of leading”.



## 22. Crime (22)

No change in position for this risk, which has never made much of an impact on this survey. Respondents generally saw crime as a manageable if widespread frustration, though among brokers and intermediaries it ranked at No. 10.

The link between recession and fraud was widely noted. “It’s almost a given these days”, said the vice president of a US underwriter. “The fight continues but the best we hope for is to minimize the size of losses.”

**Crime is ‘almost  
a given  
these days’**

Several respondents opined that insurers had not been vigilant enough. “Rampant fraudulent claims are being paid without any perceptible effort to tackle the bull by the horn”, said one respondent in India. This may be because it is cheaper to treat it as a cost of doing business than to try and stamp it out. Damon Burke, claims supervisor at United Fire Group in the US, said: “Insurance carriers are not as quick to place any importance on detecting and fighting fraud where the legal expenses will be far greater than the cost to negotiate and settle a questionable claim.”

The other main concern was cyber-crime, particularly around data theft, online fraud and identity theft, which can affect insurance companies directly and the risks they insure. “Scarcely a month passes without warnings that the risks of cyber-crime and poor security are tending to exceed previous expectations”, said one respondent, while others described the threat as “fast growing”, “highly underestimated” and “not attracting enough attention at board level” – especially as more businesses adopt cloud technology and export their back offices to cut costs.

Others were more sanguine. In the US, one respondent said: “internal controls tend to be good and insurers have been very cautious in their adoption of technology. This is not a fertile area for cyber-crime”. Others suggested that this was more a risk for banks than insurance companies.



## 23. Complex instruments (19)

**The temptation  
of higher  
returns**

Four years ago, this Banana Skin stood at No. 8 when AIG’s brush with disaster exposed the risk of dabbling in exotic structured deals. Since then, it has fallen sharply as the industry absorbed the lessons, and the regulators closed in.

Paul Fohl, chief risk officer at Foyer Assurances in Luxembourg, said that “derivative and exotic products need an excellent understanding and strict procedures of control, otherwise the risks can be significant”. A reinsurer in Bermuda struck a similar note: “I think, for the most, part insurers and reinsurers are pretty smart in this area. AIG taught us all a lesson.”

Insurers do use derivatives, mainly for hedging rather than speculative purposes but, as many respondents asserted, with prudence. A US broker said “There is always a risk, but maintaining a conservative portfolio as prescribed by the NAIC should mitigate this risk”.

Regulators play an important role in this area. Many countries reported that they were not allowed to deal in derivatives; others said they were closely watched. Clive Briault, managing director, Risk and Regulation Consulting in London, said: “Hopefully this is more carefully managed and controlled post-AIG. And this will be a particular focus of supervisory attention for systemically important insurers.”

If there is a risk now, it is that insurers get tempted back into the speculative field in search of higher returns. The head of risk at a Dutch non-life company said that “It feels the industry has a short memory and the same thing could happen again, because we need to grow and increase profits for shareholders”. Davide Ferrara, partner in CSC UK thought the risk was “High, very high, especially as [insurers] turn to these for the increased ROI they are seeking in what is a very low (or even negative) yield environment in most major currencies”.



## 24. Reinsurance (21)

**‘Rates are  
ridiculously low’**

The risks in the reinsurance field come in two sorts depending on whether you are a buyer or a seller. For a while this has been a buyer’s market where the risks lie in the possibility of a change for the worse: of a shrinkage in the market and a rise in reinsurance rates. For the seller, the risks are that capacity will not shrink, and that competition will eventually drive you out of business.

Most respondents on the buy side reported that availability was strong and rates were good. The chief risk officer of a South African life company said that there was “significant reinsurance capacity, and I can’t see how the economic climate will reduce that over the next 3-5 years”. A couple of respondents went so far as to say: “Reinsurance is too cheap” (Belgium), and “the rates and terms are ridiculously low” (India).

The concern on the buy side is that a further round of natural catastrophes could shake out the market and produce a rise in rates. A respondent from New Zealand, a country very much in the recent firing line, said that “We have seen an increase in the number of major catastrophes in recent times, and I wonder what the impact will be if this trend continues on the industry and how this will impact on the availability and pricing of reinsurance”.

A shake-out could also come from a different type of catastrophe: the failure of reinsurance firms, which is why another risk – counterparty risk – features in this category. A Malaysian respondent said he was concerned about “rate softening and credit risk increase due to possibility of reinsurer default”.

From the reinsurance perspective, the risk is that things won’t change. The CFO of a Bermuda-based reinsurer said that “From a financial perspective the main concerns are the continued soft rate environment, particularly with respect to casualty and long tail lines of business, combined with low investment yields on the asset side of the balance sheet. Excess capital looking for an entree into the reinsurance markets is having a negative effect on reinsurance pricing.”

The problem of excess capacity was widely stated to be a key issue for the sector. Another Bermuda-based insurer said that “capital coming into the catastrophe market with lower return hurdles presents a real challenge to traditional reinsurers and will likely continue to do so if investment returns remain so low”.

A US broker/intermediary said that there had been “a change in focus towards reinsurance companies and capital coming from a much large hedge fund industry. I believe that in 20-30 years, hedge funds will own most of the insurance industry. In the next 2-3 years, we may see (and may have already seen) the seeds of this long term strategy sown”.



## 25. Back office (17)

The ranking of Back Office risk has been up and down in this survey over the years, probably depending on whether there had recently been any severe incidents. This year, there have not and the placing has fallen accordingly.

The concerns this time are very close to those expressed in recent years, clustering around issues of efficiency and resilience, adequacy of investment, operational risk and security. There were no marked differences in the rating of this risk by different insurance sectors.

“There is continual pressure to upgrade while in flight; it is like changing the engine on a racing car while on the Circuit”.

**Rodger Oates**

Partner

TCS, UK

Those respondents who gave it a high ranking stressed the need for constant improvement in a fast changing business and regulatory environment, and the high price of failure in lost revenue and damaged reputation. The chief risk officer of a South African composite insurer said that the back office “will be a key requirement / constraint to ensure operational efficiency both from the perspective of maintaining costs as well as providing quality service to policyholders. Both of these elements will attract significant attention by management and the regulator”.

The adequacy of industry investment in this area was an issue that concerned many respondents. Many felt that it still faced a spending squeeze, with potentially disastrous consequences if there was a sharp rise in stress. “Cost reduction pressure will cause a lack of capacity”, said a respondent from Hungary. . In New Zealand, a respondent said: “The back office may have been less of a focus in good years, with low investment in governance and process. This means a risk of inefficiency, let alone poor capacity and lack of resilience.”

Some also made the point that too many insurance companies were living off “legacy” systems having failed to make the necessary investments. An independent intermediary in the Netherlands said: “The cost of legacy is huge - but even more important is the fact that legacy systems prevent innovation”. The need for insurers to be able to meet new distribution technologies such as internet selling and smart phone apps was stressed.

Whether regulation was hindering or helping was a matter of debate. Many respondents felt that the volume of new regulation presented the biggest challenge to

**Too many  
companies living  
off ‘legacy  
systems’**

the performance of the back office. The chief financial officer of a Bermuda-based reinsurer said that “new regulatory requirements pose huge un-discussed risks to many back offices. Sidecars, collateralized vehicles and other alternative vehicles are not staffed up to deal with many risks, especially in a stressed situation. Not only are they a risk to themselves, but to the entire industry (especially ‘Bermuda Inc.’).” But the director of a Canadian composite took a more positive view: “Government regulations, if nothing else, have de-risked the back office”.



## 26. Pollution (25)

Pollution risk has always featured near the bottom of these rankings and this year does not stand out in any region or sector: just 3 per cent of respondents gave it the maximum severity rating.

The general view is that the risk is well understood and coverage is limited. The chief compliance officer of a non-life insurer in Canada said: “most companies only offer sudden and accidental coverage on a claims-made basis”. In contrast to the unpredictability of global warming, another respondent said: “we should have the expertise, technology and data to make accurate assumptions”.

But a few voiced more severe concerns, particularly about the costs of pollution and contamination in the long run. David McKibbin, chief executive of UK-based Scute Consulting, said: “It’s a huge problem. Decommissioning costs for nuclear power are significant unfunded contingent liabilities. Toxic waste disposal is underdeveloped. Water tables continue to be threatened. The insurance industry needs the ear of government as investment banking has had for 30 years”.

One US broker pointed to a higher long-run risk for insurers in India and China. “As their markets gets more mature, they’ll go through the same issues as elsewhere and mirror things like asbestos claims”, he said.



## 27. Terrorism (23)

This risk has ranked outside the top 20 in the last three surveys and this year was bottom of the pile in all regions except Middle East/Asia. It should be noted, however, that we received most responses prior to the bombings at the Boston Marathon in mid-April.

In general, respondents acknowledged the “ever-present threat” of terrorism but downplayed its impact on the insurance industry. The chief risk officer of one UK-based underwriter described the risk as “an irritant rather than existential for most companies”. Many pointed out that terrorist events are typically not included in policies, though the chief compliance officer of a non-life insurer in Canada added: “this depends on the exclusion wording and if it holds up in court. The definition of terrorism may be an issue”.

“The significant issue is not the insurance loss but how to deal with business interruption”, said William Onuwa, CRO of Canada’s RBC insurance. There were also growing concerns about the threat of ‘cyber-terrorism’, with financial intermediaries seen as a high-profile target for extremists seeking to cause economic disruption.

### **A low risk despite recent attacks**



## **CSFI PUBLICATIONS**

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