

“Black Swans” and insurance: Dealing with the unexpected, 10 years after 9/11



Dr Kai-Uwe Schanz of Dr Schanz, Alms & Co AG, Zurich discusses the impact of 9/11 on risk and insurance in this summary based on a comprehensive report recently published by The Geneva Association and co-edited by the author.

Since the publication of Nassim Taleb’s seminal book in 2007, the notion of the “Black Swan” has firmly established itself in commercial, economic and political thinking and acting. Of course, in the world of risk and insurance, thinking about “events that are unexpected and have an extreme impact” (Taleb) has been commonplace long before his theses were publicised and widely embraced in light of the credit crunch and financial crisis.

The long-established distinction between risk and uncertainty has drawn renewed attention following the Latin American and Russian debt crises in the 1990s, the bursting of the internet bubble in 2000, the destruction of the New York WTC Twin Towers in 2001, the demise of Enron the same year and, of course, the unprecedented credit and liquidity crisis of 2008. It is conventional wisdom that risk is quantifiable and, as such, manageable and transferable through well-proven insurance mechanisms, whereas uncertainty is characterised by the absence of any meaningful probability distribution.

On the face of it, more uncertainty and a heightened sense of vulnerability should boost the traditional value proposition of insurance. However, dealing with an environment that increasingly defies the traditional prerequisites for insurability is a major challenge for insurers which can be summarised as follows: How to remain relevant, ie continue to provide affordable cover, without compromising the commercial viability of the insurance business model?

Effects of 9/11

The terror attacks of September 11, 2001 show how the global insurance and reinsurance industry has responded to a “Black Swan” of particularly devastating proportions. The event taught insurers and reinsurers some valuable lessons as far as the perception, underwriting and pricing of risk is concerned; lessons that go far beyond the narrow realm of terrorism insurance.

Reinsurance proved effective

First of all, the global system of risk transfer and diversification through (re)insurance has proven its effectiveness. The industry (in particular European carriers) absorbed the biggest man-made loss in history which was totally unexpected in nature and size. Not a single premium dollar was set aside to cover such an event. Despite an unexpected US\$23 billion loss burden, no insurance failures worth mentioning were recorded. The business models of insurers and reinsurers were essentially validated. In particular, it became clear that it is

imperative to organise risk transfer in a truly international way. Put differently: obstacles to cross-border (re)insurance, for example limits to establishing branches or the imposition of collateral requirements, could prove costly.

Towards a more flexible business model

Also, the global (re)insurance industry’s capital base was restored amazingly quickly, not least by startup reinsurers. Their emergence, of course, limited incumbent players’ scope for recouping losses. This insight prompted established reinsurers to accelerate their moves towards a more flexible and disciplined business model based on “cycle management”, leading to a certain smoothing of pricing and capacity peaks and troughs.

Public-private partnerships formed

In response to the shock-like increase in uncertainty, public-private partnerships, combining the imposition of solidarity through compulsory insurance requirements with a balanced scheme of loss sharing aimed at aligning the interests of all major stakeholders, were set up. These partnerships have proved instrumental to the diffusion of terrorism insurance, as evidenced by sharply increasing take-up rates. However, fortunately, they have never been tested so far by another major terrorist attack. The stress resilience of such schemes remains uncertain.

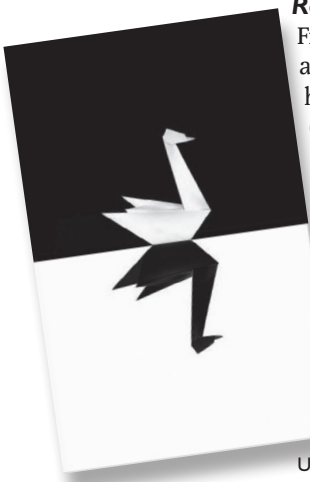
Contract certainty gained significance

One of the most noticeable effects of 9/11 was a massive improvement in contractual practices in commercial and private property underwriting. In light of the costly litigation with WTC leaseholder Larry Silverstein and some unfavourable media coverage concerning the prevalent “deal now – details later” culture, the industry has woken up to the importance of contract certainty as a cornerstone of the professional conduct of business.

Preparing for the “unthinkable”

Last but not least, insurers and, especially, reinsurers have redoubled their efforts to think and prepare for the “unthinkable”. 9/11 has – once again – highlighted the fundamental shortcomings of predictive models. “Black Swan” events are not captured by historical data. However, gratifyingly, this fact has not given rise to defeatism and paralysis in the world of risk management. Many insurers and reinsurers are now placing more emphasis on qualitative scenario analysis and planning, also addressing “innovative” forms of terrorism, such as marine piracy, aimed at disrupting vital trade lanes and large-scale cyber-attacks. The insight that traditional quantitative predictive models are only part of the story will go a long way in enhancing the insurance industry’s resilience to future “Black Swans”.

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UK edition bookcover of *The Black Swan* by Nassim Nicholas Taleb