



International Association for the  
Study of Insurance Economics

## Insurance and Finance

Research on Finance Issues in Insurance

# Geneva Association Information Newsletter

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## **The Geneva Association**

The International Association for the Study of Insurance Economics, or by its short name “The Geneva Association”, is a unique world organisation formed by a maximum of 80 chief executive officers from the most important insurance companies in the world (Europe, North and South America, Asia, Africa and Australia). Our main goal is to research the growing importance of worldwide insurance activities in all sectors of the economy. We try to identify fundamental trends and strategic issues where insurance plays a substantial role or which influence the insurance sector. In parallel, we develop and encourage various initiatives concerning the evolution – in economic and cultural terms – of risk management and the notion of uncertainty in the modern economy.

The Geneva Association also acts as a forum for its members, providing a worldwide unique platform for the top insurance CEOs. We organise the framework for our members in order that they may exchange ideas and discuss key strategic issues, especially at the General Assembly where once per year over 50 of the top insurance CEOs gather. The Geneva Association serves as a catalyst for progress in this unprecedented period of fundamental change in the insurance industry and its growing importance for the further development of the modern economy. It is a non-profit organisation.

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The research programme on insurance and finance comprises academic and professional research activities in the fields of finance where they are relevant to the insurance and risk management sector.

The programme is dedicated to making an original contribution to the progress of insurance through different initiatives in the field of insurance finance. It engages in: highlighting issues of key importance, promoting studies of the function of finance in insurance, discussing the relevance of financial concepts and instruments to the industry, detecting new and promising theoretical developments, and diffusing knowledge and the results of research world-wide.

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### **The Geneva Association Newsletter – Insurance and Finance, No. 3, April 2008**

#### **Newsletter for Finance Directors and Researchers in Insurance**

This Newsletter for Finance Directors, senior financial managers in insurance companies and researchers in the field of finance is published by The Geneva Association as an information and liaison bulletin to promote knowledge and understanding of financial issues in insurance. It also fosters contacts between finance experts at insurance companies and at universities and other institutions with an interest in insurance. Any suggestions concerning the content or layout of the newsletter are welcome. Please notify us if you are interested in receiving this publication regularly.

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**I. EDITORIAL: ON CRISES AND REGULATION**

By Patrick M. Liedtke\*

Certainly, an insurance and finance newsletter and its editorial written in the midst of what some high-level commentators, including luminaries such as Alan Greenspan (especially when they are located in the US), consider to be the worst financial crisis since the Second World War, have to deal with the unfolding of the extraordinary events over the past months. In this issue of The Geneva Association's Information Newsletter on Insurance and Finance, we publish two contributions on this subject: Dave Bradford's "*The Crisis in the Subprime Mortgage Market and Its Impact on D&O and E&O Insurers*" and Daniel M. Hofmann's "*A Risk Management Approach to Financial Crisis Prevention*". They provide thought-provoking information on two specific elements of the current crisis. In this editorial I would like to focus on the relationship between financial crises and the way they influence the development of new regulation in insurance.

On a global and ongoing level, the insurance industry continues to face two historic efforts by international regulatory bodies to change the major frameworks under which it operates: IFRS and Solvency 2. These projects have *per se* little to do with the current crisis and were certainly not triggered by it as they go back many years. However, they are closely related in that they address some of the key issues that make the current disaster in some parts of the financial system so acute: firstly, the content, transparency and reliability of information that is passed on to the market by financial institutions (largely the domain of IFRS reforms); and secondly, the way in which adequate capital levels are measured and set for financial institutions to safeguard their operations in adverse market conditions (for the insurance industry this is the Solvency 2 project).

Most experts, especially those based in Europe where the centre for both reforms currently lies, agree on the serious impact that these two reforms will have on the insurance sector worldwide. Nevertheless, many managers, in particular those operating in medium-sized and smaller companies and those in emerging markets, still tend to underestimate the extent of the current reforms and their relevance on business strategy and the daily operational routines.

IFRS, the international financial reporting standards set by the IASB (International Accounting Standards Board) in London, address the fundamental issue for any business, namely: How do we communicate with financial markets? This question has gained even more relevance due to the unfolding of the current credit crisis in the financial markets that has one of its roots in the problems of newer accounting mechanisms and a lack of transparency in financial markets. The mark-to-market approach that is the tool of choice of the IASB has serious shortcomings when its crucial underlying assumption is violated. This happens when the pricing function in markets, which is meant to be an adequate reflection of the true value of an asset (or a liability in those rare cases where such markets exist), breaks down. Behavioural economists know a great deal about the limits of assuming rational behaviour in market participants. They have made great advancements in the past years analysing and explaining some of the most obvious shortcomings of the supposedly rational *homo economicus*. At this stage of the current financial crisis it seems to be a gross oversight and huge negligence to have built an accounting and information system tied so closely to the notion that markets are always the expression of rationality. The Geneva Association has pointed out in its research and the work of many collaborating experts some fundamental problems of the universal and indiscriminatory use of mark-to-market valuation (or the fair value approach as it was referred to earlier). We never thought that some of our concerns would find such a quick validation.

This is not to say that mark-to-market is generally bad. The mark-to-market approach is probably the best of all the limited and imperfect systems we can currently implement to account for the successes and failures of economic endeavours and then transmit that information to the markets (and other parties). However, knowing where its shortcomings lie should entice us to adapt the approach in some serious ways. It makes no sense to use market information when information asymmetries go beyond a certain level. It makes no sense when markets are dominated by certain classes of actors that face specific constraints which others don't, such as a need for fire sales for example. It makes no sense when markets fail to ensure the necessary liquidity to make enough trades that send useful information

to its participants. It makes no sense when only marginal operations start to influence market pricing because certain barriers exist that preclude a wider exchange to take place.

It is important to realise that the mark-to-market concept works in most markets most of the time – that's why it is a useful tool most of the time but not always. We need to do better than the systems we have and even than those we are currently devising for the future. The question is: Is that too tall an order for the IASB?

The other big regulatory project, Solvency 2, wrestles with the basic issue of: How do we understand insurance operations and in which way do we determine the capital necessary to run insurance businesses? The scope and impact of Solvency 2 is enormous: Although at this point in time, Europe seems to be at the centre of the attention, triggered by the legal adoption of the new solvency system in the future, this regime change will have a major impact not just in Europe but internationally over time. Many emerging markets (among them China, India) are planning to adopt Solvency 2 (or close derivatives thereof) if they prove workable. Furthermore, if the agreed IASB and FASB convergence project gets both EU and SEC approval, it will also give a push to Solvency 2 (or something comparable) in the US, if by then international financial markets will not have already exercised enough pressure on American firms to come up with solvency figures modelled on the European benchmark. Solvency 2 will also have international impact over time in emerging and less developed markets. It will be the only risk-based capital system in insurance designed to be consistent with the Basel 2 framework. The Basel Committee of Central Bank Governors and the Ministers of Finance of the G-10 have stated that they wish to have a more standardised regulatory architecture globally and across all financial services sectors.

In this way, the current crisis, which is primarily playing out in the mortgage and banking world and affecting to a much lesser extent the insurance sector, is going to have a very wide impact on future regulation. Solutions made for short-term focussed and liquidity-vulnerable parts of the financial sector will be influencing also new regulatory initiatives affecting insurance. And this, even though they come from outside the insurance realm and despite most insurance business being longer-term and more concerned with solvency questions than liquidity issues.

Reformers will have to be careful not to apply the wrong set of rules to markets that operate completely differently only because one would like to treat all financial services the same.

At the same time, one has to just observe the political discourse in Washington, London, Brussels and other parts of the world to realise that the real challenges are only partially of a theoretical or technical nature. Much, as is usually the case with far-reaching reforms, rests in the political realm. The insurance industry will have to project its full weight into those political discussions, making use of the intelligence of their global think-tank, The Geneva Association, as well as that of the various national and transnational trade bodies with their lobbying powers. As the current credit crisis demonstrates, every system has its weakness and we are not going to devise a perfect solution, neither for financial services in general nor for insurance in particular. However, we should not falter in our efforts to try and ameliorate current standards to closer reflect business reality, provide better information to all stakeholders and guarantee a high level of financial stability. A few important remarks have to be made in this respect:

- Since no system is going to be totally failure-free, we should make better efforts to understand where potential weaknesses lie and how to deal with them. The next financial crisis will certainly come and we should have the right strategies and tools to manage it with bearable cost.
- Knowing that there is a limit to how safe a system can be, we have to make a conscious decision as to how we are going to balance out the efficiency of a system with its “accident” rate (taking into consideration both, frequency and severity of adverse events). A thorough discussion about the tolerated “risk level” of our financial systems is key to a sound and efficient design process for regulatory and supervisory norms.
- Insurance plays an important role for a modern economy, fulfilling unique functions in managing risks for groups of people (and entities) over time. (See some of the very extensive and fundamental work of The Geneva Association on this issue.) When devising new rules, the vital interest of any society to manage risks efficiently has to be borne in mind, allowing in consequence

the insurance industry as *the* key risk manager and partner to operate in an efficient way. The same holds true for other industries that are involved in similar essential functions too.

- As any car driver knows only too well, speed can kill. Reform processes also have speed limits. Not only do they require enough time to be devised and properly formulated. The pace of change that an industry and the players operating in it can withstand without sacrificing too much efficiency or – what would be much worse – control over their operations is limited too. We have to make sure, together with insurance regulators, policymakers and other parties concerned, that we tackle the right projects at the right time and in such a way that their pace of change contributes to sound operations rather than creating undesired disruptions. Again, this is a question of balance, the one between the desire and need for change and the ability to cope with it.

If the above points are observed, the insurance industry and its partners and customers can look forward towards new regulatory frameworks that will enhance its value proposition in a modern service economy; a modern service economy that needs efficient risk identification, management and transfer mechanisms to grow and prosper. The Geneva Association is set to continue making a strong intellectual contribution to this laudable aim.

**About the author:** *The author is Editor of the Insurance and Finance Newsletter and Secretary General and Managing Director of The Geneva Association*

## II. THE CRISIS IN THE SUBPRIME MORTGAGE MARKET AND ITS IMPACT ON D&O AND E&O INSURERS

*By Dave Bradford\**

### Executive summary

One year after the first subprime-related writedowns were reported, the potential impact of the crisis on D&O and E&O insurers is coming into focus. More than USD250 billion in writedowns from companies across the globe have sparked dozens of securities class action suits, the principal source of losses to public company D&O insurers. These suits, along with related defense costs, are expected to produce USD3.6 billion in insured losses, spread across accident years 2007 and 2008. Though losses to E&O insurers are more difficult to quantify, current indications are that they will be significant, but not catastrophic. Most of the exposure is concentrated in a small number of insurers of financial institution D&O and E&O. According to market share estimates derived from Advisen's Program Benchmarking database, the top ten writers of financial institution D&O are responsible for 77 percent of the written premium, with the top three accounting for nearly 50 percent. Writers of financial institution E&O show a similar concentration of market share. Thus far, mounting D&O and E&O losses have had little impact on rate levels, which have been falling steadily since 2004. However, there are indications that underwriters are now pushing for higher premiums for financial sector insureds.

### The subprime mortgage crisis

An unprecedented wave of defaults by subprime borrowers with adjustable rate mortgages sparked the present crisis in the global financial markets. Subprime mortgages are loans made to borrowers with weak credit scores. Most of these mortgages, which were structured with very low initial monthly payments, were originated in 2005 and 2006 when lenders significantly relaxed underwriting standards. When falling real estate prices made it difficult for subprime homeowners to refinance before higher monthly payments kicked in, many defaulted.

Defaults in U.S. mortgages reached record levels in the second quarter of 2007, forcing a large number of subprime mortgage lenders to shut down or file for bankruptcy. The fallout spread quickly throughout the financial markets. Securities backed by subprime mortgages – typically collateralized debt obligations (CDOs) – plummeted in value, leading to losses for investors, including commercial banks, pension funds, mutual funds, residential real estate REITs, insurance companies and hedge funds. In a few cases, highly leveraged hedge funds were forced to close when they couldn't meet margin calls.

As of February 8, 2008 131 financial institutions had reported USD257 billion in writedowns, and the total continues to grow. In addition to losses stemming from CDOs and other mortgage-backed securities, companies also were forced to write down investments in mortgage lenders, hedge funds, bond insurers and other companies deeply – and sometimes fatally – wounded by the subprime mortgage crisis. Although subprime mortgage defaults were largely a U.S. phenomenon, the financial impact has been global. Nearly 60 percent of the companies reporting writedowns are non-U.S.

### **Liability of D&O and E&O insurers**

As of February 8, 2008, 191 lawsuits related to the meltdown of the subprime mortgage market had been filed. Almost every party involved in the loan origination and securitization machine that financed the housing boom of the recent past is a target for lawsuits. Securities class actions and other suits alleging securities law violations comprise the largest category of subprime-related lawsuits.

Most of the suits have been filed against U.S. companies, but it is likely that there will be an up-tick in suits filed against non-U.S. companies that have taken large losses from mortgage-backed CDOs. Shareholders in non-U.S. jurisdictions with “loser pays” rules and lacking mechanisms for U.S.-style securities class action suits will be slower to file lawsuits, but it seems inevitable that those suits will develop over time.

In addition to the lawsuits filed thus far, there have been dozens of investigations launched by regulatory agencies and law enforcement officials around the world. These include probes by the U.S. Securities and Exchange Commission, the U.S. Federal Bureau of Investigation, and attorneys general in six U.S. states, as well as regulatory authorities in at least seven other countries.

The financial impact of these lawsuits on insurers is likely to be painful, but not devastating. The types of insurance coverages most likely to come into play include directors and officers liability policies; errors and omissions policies covering financial institutions, real estate appraisers, auditors and lawyers; fiduciary liability policies; partnership liability policies; and credit risk insurance policies.

Loss projections for E&O are difficult since information on prior suits and settlements is sparse. However, the number of lawsuits that potentially may trigger coverage under E&O policies still appears to be in a manageable range, and indications are that many hedge funds and larger financial institutions did not purchase coverage or have very large self-insured retentions. In addition, it is likely that many suits will invoke coverage limitations and policy exclusions. At this point it appears that E&O insurers will be harmed by subprime-related claims, but not dangerously wounded.

More than one-third of the suits filed to-date may trigger coverage under D&O policies. Advisen forecasts D&O losses from securities class action suits – the single most significant source of losses to public company D&O insurers – of USD3.6 billion, which will be spread over accident years 2007 and 2008. This projection is based on an analysis of a range of scenarios taking into account historical securities class action dismissal and settlement patterns and the profile of financial institution D&O retentions and policy limits. This is expected to produce approximately an additional 30 loss ratio points for 2007 and 2008 combined. One saving grace for insurers may be that many large banks have eliminated corporate reimbursement and entity coverage (so-called side B&C coverages) leaving only coverage for derivative suits and other non-indemnifiable situations as well as suits with the entity in bankruptcy (so-called side A coverage).

Subprime-related losses will not be evenly distributed across the D&O and E&O markets. Advisen’s Program Benchmark database contains policy information for nearly USD420 million worth of financial institution D&O premium written in 2006-2008. From that database, it was determined the top ten writers of financial institution D&O account for 77 percent of the total market, while the top three write nearly 50 percent of the total premium volume. Financial institution E&O writers show a similar concentration of risk, with the top ten writers accounting for 80 percent of the total premium written, and the top three having more than 50 percent market share.

### **Impact on D&O and E&O pricing**

Advisen monitors and reports on premium trends in North America, both on behalf of the Risk and Insurance Management Society and for the ADVx™ premium index in Advisen.com. We anticipated

increases in D&O renewal premiums in reaction to the subprime crisis, but we had not detected any meaningful activity. In fact, the average renewal premium has been falling faster in D&O than in any other line tracked, and the pace of deterioration showed signs of accelerating in the fourth quarter.

To confirm the findings from the empirical data collected for ADVx™, Advisen conducted a survey of 110 financial institution insurance buyers the week of January 28, 2008. The results of the survey support the trends seen in the program data: there has been little pricing impact from the subprime meltdown on either financial institution D&O or E&O premiums. Just short of 90 percent of survey respondents reported that their D&O programs had renewed at the same or lower premiums, and 91 percent of all participants reported stable or lower E&O premiums. However, indications are that underwriters are beginning to take action. Of those companies reporting premium increases, the majority of those increases occurred in the fourth quarter of 2007 and the first quarter of 2008. This trend suggests that more and more companies in the financial sector can expect to see underwriters demanding higher premiums with the next round of renewals.

### **Analysis and conclusions**

The impact of subprime-related losses to the commercial insurance market so far has been absorbed and offset by favorable experience in other lines of business. Subprime losses will fall largely on D&O and E&O underwriters, but even within these narrow sectors, underwriting results are still expected to be within the range of acceptable year-to-year fluctuation.

One event that could lead to a further round of writedowns, and potentially a surge in lawsuits, is the collapse of bond insurers that guarantee the principal and interest of some bonds backed by subprime mortgages. Fitch estimates that the largest bond insurers collectively are exposed to about USD100 billion in CDOs that were backed by subprime mortgage collateral. Even if the insurers don't fail, rating downgrades will impact the value of insured bonds.

The spread of mortgage defaults beyond the subprime market also could trigger a new round of writedowns and lawsuits. The crisis in the subprime mortgage market may be a harbinger of deeper problems with adjustable rate mortgages in the current economic environment, and quite possibly may extend to the standard mortgage market. This situation could be exacerbated by what many economists see as a looming recession in the U.S. economy.

Economic forces exerting downward pressure on D&O and E&O premiums are overwhelming efforts by underwriters to make pricing corrections, even in the narrow domain of financial institutions. Nonetheless, the results of Advisen's survey of financial institution insurance buyers suggest that the situation may be changing: underwriters are pushing for higher rates, and are succeeding in achieving them on a small but growing number of renewals. However, it is likely that the pricing impact will be limited to the financial sector, and will not stem the downward trend in rate levels in the broader D&O and E&O market.

***\*About the author:*** Dave Bradford is a co-founder of Advisen and leads the Research and Editorial team. He is Advisen's senior insurance industry analyst and editor-in-chief of Advisen's various publications. Prior to founding Advisen in 2000, Dave spent twenty years in underwriting, marketing and strategy development roles in the reinsurance industry. Most recently he was a senior vice president with Swiss Re and led the Global & National Division of Swiss Re America. Prior to Swiss Re, Dave was a senior vice president with Reliance Reinsurance Corp. He began his career as an actuarial analyst with Allstate's Assumed Reinsurance Division.

***About the report:*** Primary research for this report was conducted using the Advisen.com information and analysis platform and its underlying databases, including the Program Benchmark database of 1.1 million insurance programs and the MSCAd database of nearly 10,000 large loss events. "The Crisis in the Subprime Mortgage Market and Global Credit Markets: The Impact on D&O and E&O Insurers" is available to Advisen subscribers for USD200, and to non-subscribers for USD500 by calling Advisen at 212.897.4800, or emailing support@advisen.com in the US, or +44 (0)20 7929 6929 or london@advisen.com in the UK.

### III. A RISK MANAGEMENT APPROACH TO FINANCIAL CRISIS PREVENTION

by Daniel M. Hofmann\*

The credit crisis shows that financial innovation and the emergence of large complex financial institutions (LCFI) – to pick two salient characteristics of today's market landscape – have made our world potentially much riskier. But the wheel of innovation cannot be turned back, and risks are a fact of life. What should be done to avoid a repeat of the past?

The wrong answer is to call for more regulation. Regulation has unintended consequences – for which the Sarbanes-Oxley Act provides a primary illustration. And regulation cannot prevent crisis, as illustrated by the U.S. savings and loan disaster, which occurred despite decades of tight supervision.

But there is always room to improve the resilience of our financial system. To do so, we should adhere to three principles of good risk management. We must first know our risks and, second, collect the necessary information to assess and price them properly. And, third, we must ensure that incentives allocate responsible behavior and accountability to market participants.

Alas, all three principles were violated in the run-up to the current crisis.

Obviously, the risks of financial instruments are difficult to understand if they were designed to be opaque. But that should not have absolved buyers from conducting due diligence that went beyond a simple rate check. Underappreciated was also the fact that complexity in itself is a big risk. While the probability of one small thing going wrong is always negligible, the non-linear feedback mechanisms in complex interconnected markets ensure that even small risks can have large systemic impact. We must cope with the paradox that the financial system is very efficient and stable for most of the time, but prone to excessive instability once thrown out of balance.

Stress testing may help explore limits and lead to a better understanding of risk. But the value-at-risk (VaR) models used in banking appear to have created a false sense of security. The objection relates not only to the assumption that the future is an extension of the past or that correlations are stationary and underlying distributions always well behaved, but also to the time horizons in VaR-models (usually limited to days), which, by the 100 to 2000-year standards applied for extreme events in the insurance industry, appear short.

A couple of years ago and under the impression of another severe financial crisis, Myron Scholes called for "new methodologies" and said that "planning for crises is more important than VaR analysis." Today, planning is even more imperative after a crisis for which market participants were ill prepared.

Turning to the second point of good risk management, we can accept that risk assessment was encumbered in the presence of off-balance sheet vehicles that may have been created primarily to obfuscate the true ownership of risk. Hence, international financial reporting standards must be built on consolidated accounts, and regulators should apply consolidated supervision of entities under their jurisdiction. This is no small feat.

Even more difficult will be the work toward an agreement on rules for better and timelier information sharing among national supervisors. Cross-border activities are a characteristic of our modern financial institutions. It should not happen that a problem in a small segment of one national market creates collateral damage in some distant other market.

Finally to the most important issue – incentives. Much has been said about incentives created by bonus systems that royally compensate for seemingly profitable trades but do not hold individuals accountable for loss-making activities. Similarly, questions were raised about the incentives leading to rating decisions. And it is not difficult to find evidence that securitization weakens the screening incentives of banks and mortgage institutions.

Correcting incentive structures will go a long way toward instilling more accountability. It will also strengthen the market's ability to identify and better value the risk of even fairly complex transactions.

Incentives are also set by regulatory and monetary authorities. One should hope that Basel II reduces some of the incentives that encouraged regulatory arbitrage and the use of off-balance sheet constructions. But the challenge remains that regulation should enhance and not stifle the activities of properly incentivized market participants.

The credit crisis provides a good reason to reconsider monetary policy. While price stability is clearly a necessary condition for financial market stability, the central banks' dominant focus on consumer prices while neglecting real and financial asset prices may have been too narrow. The economic costs of bursting market bubbles can be as large as the cost of recessions generated by central banks forced to curb excessive inflation. Monetary policy makers are challenged to come up with models that better reflect the pro-cyclical nature of modern financial markets. There is much work to be done and little time to be lost if the next crisis should find our markets better prepared and more resilient.

*\*About the author: the author is Group Chief Economist of Zurich Financial Services.*

#### IV. CREATION OF THE CHIEF INVESTMENT OFFICERS NETWORK IN INSURANCE

The Geneva Association is embarking upon a new initiative, the creation of a platform for Chief Investment Officers in insurance. The aim of this initiative is to facilitate the exchange of experiences on key issues facing insurance asset management and to establish a more effective dialogue with government policymakers, regulators, rating agencies and other external stakeholders of the insurance industry. The target groups are the Chief Investment Officers and top asset managers from the largest international insurance and bancassurance groups as represented in The Geneva Association.

##### Mission:

The Chief Investment Officers Network (CION) strives to create more knowledge and better understanding about issues that confront the role and function of insurance asset management and the formulation and implementation of investment strategies. It serves as a platform for the interchange of information, expertise and best practice approaches. Issues of common concern are identified (without the objective to develop a single policy position and to influence external stakeholders through the provision of credible research and high-level meetings and seminars). In addition, there is the intention of informing government policymakers and wider public opinion of the key role that institutional investors play within the modern economy.

##### Topic Structure:

The CION follows a topic-orientated approach through its activities. Possible topics fall into three different groups:

- a) Topics that address high-level technical and organisational issues in asset management. This would include: different styles of effectively running an asset management operation; measuring the contribution and value to the parent group; and how to deal with internal constraints arising from wider corporate policies within the group, such as ALM, capital management and internal performance measurement and reporting.
- b) Topics that entail an exchange of views with external organisations whose policies impact on the asset management efficiency and decision-making. This would include identifying and assessing the impact of regulatory authorities, rating agencies, accounting standards setters, and tax authorities, and through balanced discussion with these organisations to find ways of reducing these external constraints, where they are costly or unnecessary;
- c) Topics that deal with the wider economic role of the asset management sector. This would include assessing its influence on the structure and development of capital markets in advanced and emerging countries, on innovative ways for financing for the private and public sectors, and on global economic growth and stability.

Initial List of Topics:

- Regulatory Interface: how asset allocation decisions are currently affected by the regulatory and governance environments and which constraints create the highest concern and how to establish an effective dialogue with regulators and standard setters.
- Rating agency Interface: how rating agencies currently impact on investment policy decisions, and the key area of concern and how to set up an effective dialogue with the rating agencies.
- Differing views on investment policy decisions: the different treatment of asset allocation decisions from the regulatory, rating, tax and economic point of view. How best to deal with or trade-off conflicting treatments.
- Can regulatory or rating agency treatment of investments influence the financial markets (e.g. liquidity, products, capital provider, emerging markets, etc)?
- Corporate governance structures and insurance asset management.
- Integrated Risk Model: are there any 'state of the art' integrated risk models and what are their value to asset management?; is there a case for developing a more standardised model?
- Investment Risks: how to deal with investment risks not fully captured in internal or external frameworks (inflation risk, convexity risk, options and guarantees embedded in insurance liabilities).
- Economic Value Creation: how to measure the economic value creation and performance of an asset management organization within a global insurance group/financial services group (benchmarking, performance measurement, economic value creation, expectations of stakeholders, etc).
- Financial Market perceptions: how do financial analysts currently assess the performance of an asset management business within a wider insurance or financial services group? Is performance properly reflected in their valuation models? What type of business model is most favored by financial analysts and investors?
- Policy issues in investing in alternative asset classes: private equity, hedge funds, commodities and risk securitizations.
- Investment in insurance-linked securities (ILS) for asset management companies within insurance and reinsurance groups: risk concentration or improved overall portfolio diversification?
- IFRS and US GAAP treatment of investment holdings and their current and potential future impact on asset allocation decisions.
- Special government/public projects (e.g. carbon disclosure et. al.) and their impact on insurance asset management.

Other possible topics:

- Optimal incentive and remuneration structure for portfolio managers.
- Effective Operational risk management in an asset management organization.
- SOX relevant investment processes.
- Current tax issues in asset management and possible solutions.
- Models for setting credit and market risk limits.
- Asset allocation models and how they should interface with internal ALM/ Economic Capital models.

The inaugural meeting of the CION will take place on 27 June 2008 in Zurich, hosted by Swiss Re. The organization team consists of Benjamin Meuli and Guido Fürer for Swiss Re and of Gerry Dickinson and Patrick M. Liedtke for The Geneva Association. The outline above is subject to the discussions of the assembled CIOs and will be amended according to the specific needs articulated during the meeting.

## V. THE 4<sup>th</sup> INTERNATIONAL INSURANCE AND FINANCE SEMINAR OF THE GENEVA ASSOCIATION

### 5.1. Programme of the 4<sup>th</sup> International Insurance and Finance Seminar of The Geneva Association (6–7 December 2007, hosted by Prudential)

**Venue: Prudential's Head Office, Governor's House, Laurence Pountney Hill, London**

#### **Day 1, Thursday, 6<sup>th</sup> December**

8.30-9.00 Registration and coffee

9.00-9.15 Welcome and opening remarks:

*Patrick M. Liedtke, Secretary General and Managing Director, Geneva Association*

*Philip Broadley, Group Finance Director, Prudential plc*

*Gerry Dickinson, Vice Secretary and Head of Insurance and Finance, Geneva Association, and*

*Professor Emeritus, Cass Business School, London*

#### **Session 1: Current Developments in Insurance Risk Securitization Markets**

9.15-10.15 Introductory Remarks by Chairman: Max Taylor, Deputy Chairman, Aon (UK) and former Chairman of Lloyd's of London

Speaker Panel:

Morton Lane, President, Lane Financial

Ed Giera, Managing Director, JP Morgan (Europe)

Simon Harris, Managing Director, Insurance Rating (Europe), Moody's Rating

10.15-10.45 Questions to the Panel and discussion

10.45-11.15 Break for tea or coffee and informal networking

#### **Session 2: Insurance Linked Securities: Investor, Legal and Rating Agency Perspectives**

11.15-12.15 Introductory Remarks by Chairman: Mel Carvill, Head of Strategy, Finance and Risk Management, Assicurazioni Generali SpA

Speaker Panel:

Urs Ramseier, Head of Insurance Linked Securities, Horizon21

Nigel Montgomery, Partner, Sidley Austin LLP, International Law Firm

Rob Jones, Managing Director, S&P Insurance Rating (Europe)

12.15-12.45 Questions to the speakers panel and discussion

12.45-14.00 Buffet Lunch

#### **Session 3: IFRS and Solvency 2: the Current Challenges**

14.00-15.00 Introductory remarks by chairman: Philip Broadley, Group Finance Director, Prudential plc

Speaker Panel:

Tim Harris, Chief Accountant, Aviva

Mark Swallow, Chief Financial Officer Swiss Re (Europe)

Alex Finn, Partner, Capital Markets Group, Price Waterhouse Coopers.

15.00-15.30 Questions to the Panel and discussion

15.30-16.00 Break for tea or coffee and informal networking

#### **Session 4: Solvency 2 and the 2<sup>nd</sup> Generation of International Risk-based Solvency Systems**

16.00-17.00 Introductory remarks by chairman: Denis Duverne, Member of the AXA Management Board and Executive Director in charge of Finance, Control and Strategy, and Chairman, CFO Forum.

Speaker Panel:

Thomas Steffen, Chairman, Committee of European Insurance and Pensions Supervisors (CEIOPS) and Director of Insurance Supervision, BaFIN, Germany

Tom Wilson, Chief Risk Officer, ING and Chairman, Chief Risk Officers Forum  
Gideon Pell, Chief Risk Officer, New York Life Insurance Company, and Chairman, the Solvency Committees of GNAIE and ACLI

17.00-17.45 Questions to the Panel and discussion

19.30-21.15 Dinner at Tower Room, 7<sup>th</sup> Floor,  
London Underwriting Centre, 3 Minster Court, Mincing Lane, EC3R 7DD.

## **Day 2, Friday, December 7th**

### **Session 5: Asset Liability Management in Insurance: the Current Challenges**

9.00-10.00 Introductory remarks by Chairman: Dieter Wemmer, Chief Financial Officer and Member of Group Executive Committee, Zurich FS

Speaker Panel:

Michael Bös, Head of Asset-Liability Management, Munich Re Group

Anthony Bice, Director, Oliver Wyman

John Roe, Head of UK Insurance ALM Advisory, RBS Global Banking and Markets

10.00-10.30 Questions to speaker panel and discussion

10.30-11.00 Break for tea or coffee and informal networking

### **Session 6: IFRS Developments and Financial Statement Presentation for Insurance Companies**

11.00 -12.00 Introductory remarks by chairman: Jerry de St Paer, Senior Vice President, AIG, and Chairman of the Group of North American Enterprises (GNAIE)

Speaker Panel:

Peter Clark, Senior Project Manager, Insurance, International Accounting Standards Board

Ralph Hebgren, Senior Analyst, Insurance Research, Keefe, Bruyette & Woods

Maurizio Lualdi, Senior Investment Adviser (Insurance), Capital Global Investors

12.00-12.30 Questions to the Panel and discussion

12.30- 13.30 Buffet Lunch

### **Session 7: Asset Management: Key Issues in Outsourcing Policy**

13.30- 14.30 Introductory remarks by Chairman: Luke Savage, Director of Finance, Risk and Operations, Lloyds of London

Speaker Panel:

Martin Senn, Chief Investment Officer and Member of Group Executive Committee, Zurich FS

Guido Fürer, Head of Global Asset and Risk Management, Swiss Re Group.

Robert Goodman, Managing Director and Co-Head, Global Insurance Asset Management, Deutsche Bank

Edouard Stirling, Senior Vice President, State Street Bank (Europe)

14.30-15.00 Questions to speaker panel and discussion

15.00-15.15 Concluding Comments:

Gerry Dickinson

Patrick M. Liedtke

## **5.2. Summary of Discussion Sessions at the Seminar**

By **Dr. Kai-Uwe Schanz**, Special Advisor & Chairman of The Geneva Association's CCO Network, and Principal Partner, Dr. Schanz, Alms & Company, Zurich - with contributions from **Derek Atkins** (Institute of Financial Services), **Professor Gerry Dickinson**, Vice Secretary General, Head of Insurance and Finance, The Geneva Association, and Professor Emeritus, Cass Business School, London, and **Heinrich H. Wiemer**, Head of Insurance Research, Bank Vontobel, Zurich.

## At a glance

- Continuing the tradition of previous seminars the 4<sup>th</sup> International Insurance and Finance Seminar was of outstanding quality. The event featured senior panel speakers from the insurance industry, the financial community, regulatory authorities and rating agencies. Plenum discussions benefited from the contributions of high-calibre attendees.
- The seminar systematically addressed current finance issues on the insurance industry's strategic agenda: the securitization of insurance liabilities, the dynamic development of the regulatory and financial reporting landscape and the evolving economics of asset liability management.
- The growth of insurance-linked securities is expected to continue – notwithstanding the current liquidity and credit crisis. Pressure on regulatory capital, rising catastrophe exposures and investor expectations will continue to act as powerful drivers.
- Solvency 2 and IFRS offer the unique opportunity of establishing a consistent framework which is based on an economic view and addresses the current “cacophony” caused by different standards of internal, regulatory and rating agency capital.
- Asset management is a key contributor to the insurance industry's profitability. Driven by cost pressure and risk considerations outsourced insurance assets are experiencing strong growth. The dynamic and increasingly complex relationship between insurance liabilities and assets, however, may slow this trend and favour in-house solutions.
- Presentation slides will be available on [www.genevaassociation.org](http://www.genevaassociation.org) or <http://ga.e-doc.info>.

## The fourth annual seminar in a row

The International Insurance and Finance Seminar is an annual meeting linked to The Geneva Association's Financial Directors' Network. The seminar brings together selected finance executives from the international insurance sector and executives from the wider financial community and government with a close interest in insurance.

Building on the success of the previous events in 2004 (hosted by Prudential), 2005 (hosted by Aviva) and 2006 (hosted by Lloyd's of London) the fourth Geneva Association Insurance and Finance Seminar 2007 returned to its “roots” and again benefited from the hospitality of Prudential. About 100 senior participants from the insurance and wider financial community gained a first-hand insight into current finance topics of strategic relevance and impact. The seminar topics were chosen by Professor Gerry Dickinson, Vice Secretary General and Head of Insurance and Finance at The Geneva Association, and Patrick Liedtke, Secretary General and Managing Director of The Geneva Association. They also invited the chairmen and speakers who kindly agreed to help. Based on these topics the conference saw a lively interaction between the speakers and the plenum. In total, ten insurance CFOs, CROs and CIOs addressed the event, contributing to the remarkable level of this fourth Insurance and Finance Seminar.

## Seven discussion topics

The following seven themes were examined during the seminar:

1. Current Developments in Insurance Risk Securitisation Markets
2. Insurance Linked Securities: Investor, Legal and Rating Agency Perspectives
3. IFRS and Solvency 2: the Current Challenges
4. Solvency 2 and the 2nd Generation of International Risk-based Solvency Systems
5. Asset Liability Management in Insurance: the Current Challenges
6. IFRS Developments and Financial Statement Presentation for Insurance Companies
7. Asset Management: Key Issues in Outsourcing Policy

## Session 1: Current Developments in Insurance Risk Securitisation Markets

Session chairman **Max Taylor, Deputy Chairman, Aon (UK)**, expressed his opinion that Insurance Linked Securities (ILS) are on course to become a mainstream tool for catastrophe cover. Progress has been relatively slow but the market is now taking shape.

**Morton Lane, President, Lane Financial**, provided an overview of the current state of the ILS market. In his view the reinsurance and the securitisation markets are converging. The market is growing rapidly with USD 6 billion of new Cat bonds issued in 2007 alone. The pace of growth has been sustained even though traditional reinsurance passed the pricing peak in 2007. Using the example of Swiss Re as the ILS market leader he explained how insurance companies can make use of ILS both to enhance their own capital efficiency and to offer such services to third parties. Morton Lane expressed his conviction that ILS will experience sustained growth and see an accelerating pace of product innovation. He cautioned, however, that a true breakthrough depends on insurers being able to make more money by writing a risk and passing it on to the securitisation market than by retaining it.

**Ed Giera, Managing Director, JP Morgan (Europe)**, discussed the use of the ILS concept in the area of annuity risk products. His starting point was the observation that populations are living longer, while actuarial forecasts have consistently underestimated the longevity risk. Consequently, life insurers have had to look for more capital to cope with it. So far, life insurance has not proven susceptible to capital markets-based forms of risk transfer, except for some extreme mortality (pioneered by Swiss Re). In future, Solvency 2 will introduce an explicit capital charge for longevity risk encouraging life insurers to seek risk transfer via ILS. Ed Giera foresees a crucial role for investment banks as an intermediary between specialist pension insurers and the capital markets in terms of slicing and distributing market, inflation and longevity risks.

**Simon Harris, Managing Director, Insurance Rating (Europe), Moody's**, shared his views on the ILS market. He reminded seminar participants that banks are the main users of securitisation. In comparison the use of securitisation by insurers is rare. He outlined that, fundamentally, ILS can be used by insurers for two purposes: for capital management, e.g. by optimizing regulatory capital requirements through securitising embedded value or for risk transfer, e.g. via securitising natural catastrophe risks. Simon Harris also mentioned Solvency 2 as a driver of ILS growth as it encourages risk mitigation as a substitute for increased capitalisation. In addition, insurers are increasingly using ILS to 'accelerate' their balance sheet for capital efficiency purposes. As main hurdles to ILS growth he identified the lack of homogenous data, the complexity and cost of ILS as well as investor conservatism. Nevertheless, even in light of the current credit crisis, hedge funds have not been frightened off buying Cat bonds as diversification is more attractive than ever.

In the **subsequent discussion** the question of the ILS markets' resilience to a shock-like liquidity crunch was raised – and as such the reliability of the insurance protection they offer. Another discussion point was as to whether it makes sense for longevity-exposed institutional investors to invest in hedge funds that buy longevity bonds.

## **Session 2: Insurance Linked Securities: Investor, Legal and Rating Agency Perspectives**

The second session was chaired by **Mel Carvill, Head of Strategy, Finance and Risk Management, Assicurazioni Generali SpA**. Kicking off the panel presentations **Urs Ramseier, Head of ILS, Horizon 21**, provided an overview of ILS from an alternative asset manager's perspective. He stressed that Horizon 21, as a major buyer of ILS, is interested in 'pure' insurance risk as opposed to a mix of insurance, financial, market, credit and other risks embedded in insurance company shares. Urs Ramseier also pointed out that the life ILS market (mortality and longevity) is growing faster than the non-life area. He confirmed the views expressed in session 1 suggesting that ILS is set to be increasingly used as a capital management/ROE enhancement tool – beyond risk transfer. From an investor's perspective he demonstrated that the ILS market has provided a better return to investors than the equity markets over the last five years. He concluded that, while raising capital through the ILS market is cheaper than raising capital on the equity market, ILS is still too expensive. The cost of ILS will have to fall before the market can really take off.

**Nigel Montgomery, Partner, Sidley Austin LLP**, elaborated on the potential of ILS in the area of run-off. As previous speakers he mentioned Solvency 2 as a major driving force as it is likely to promote greater consideration of run-off and the capital tied up in it. Nigel Montgomery summarised the various options for managing a run-off: (1) Consolidate your company's run-off business to be handled by a specialist or internal team, (2) sell all or part of it to a specialist run-off provider, (3) buy Adverse Development Reinsurance and also pass over the claims handling, (4) set up a Scheme of Arrangement and (5) securitise your run-off business. The securitisation of run-off aims to shift the risk

of adverse development onto the capital market. Issuers would benefit from a release of capital for additional underwriting, an improved ROE and a better rating evaluation. Investors in run-off based securities should be attracted by uncorrelated risk, relatively short risk exposure and the progressive, rather than single hit nature of any adverse development.

**Rob Jones, Managing Director, S&P Insurance Rating**, identified two main drivers of ILS from the rating agency's perspective: Insurers are eager to issue ILS because insurance is a capital intensive industry, there is pressure on regulatory capital, and catastrophe exposure is rising. Investors are interested in ILS to diversify their portfolios. He mentioned three issuer motivations: capital raising (e.g. securitising embedded values), risk transfer (e.g. Cat bonds, extreme mortality bonds, longevity bonds) and reserve funding (e.g. Triple X for US life insurers). Rob Jones also discussed the key elements of S&P's ILS rating methodology (insurance, structural and legal aspects). He finally addressed the issue of capital relief based on ILS structures. S&P, so far, has pursued an ad hoc approach, except for Cat bonds, but are now considering a globally consistent, principles-based approach as part of its new economic capital model analysis (to be introduced in 2008).

Among the topics raised in the **subsequent discussion** was the lack of liquid secondary markets as well as the question as to whether ILS makes sense for those insurance companies that successfully manage the underwriting cycle.

### **Session 3: IFRS and Solvency 2: the Current Challenges**

Session chairman **Philip Broadley, Group Finance Director, Prudential**, called for the aims of IFRS and Solvency 2 to be aligned. He acknowledged, however, the difficulties arising from the fact that IFRS deals with financial statements for all industries in more than 100 countries whereas Solvency 2 focuses on insurer solvency in 27 countries. Therefore, the interests of the two projects do not necessarily coincide.

**Tim Harris, Chief Accountant, Aviva**, reminded the audience of the major opportunity presented by the nascent status of both IFRS and Solvency 2. There is a chance of establishing a coherent framework, based on an economic approach. But major differences do still exist. For example, IFRS requires insurers to split their reporting between insurance and investment contract liabilities whereas Solvency 2 applies to all contracts issued by an insurer. Further, the two draft frameworks differ in respect of the valuation of insurance liabilities. Tim Harris also called for a maximum alignment between IFRS and Solvency 2, based on the economics of insurance business and taking into account the recent advances in economic capital management. Ultimately, a coherent framework for internal management, financial reporting and regulatory reporting should be established.

**Mark Swallow, CFO, Swiss Re (Europe)**, highlighted the fundamental differences between IFRS and Solvency 2 in terms of geographical scope and key stakeholders. Reaching a consensus proves challenging in both areas given the global character of IFRS and the multitude of insurance accounting standards around the world on the one hand and the intricacies of the EU political process in the context of Solvency 2 on the other. Further, Mark Swallow addressed key technical challenges pertaining to IFRS (e.g. the way risk margins work) and Solvency 2 (e.g. the standard formula which should not be used as a benchmark for internal models). He concluded by discussing major opportunities associated with IFRS and Solvency 2, especially the potential to improve the perception of our industry by effectively addressing concerns about its transparency, complexity and performance.

**Alex Finn, Partner, Capital Markets Group, PwC**, expressed his opinion that the existing bases of financial reporting and solvency regulation are inadequate. The results of a PwC survey conducted among professional firms, actuarial firms, industry groups and standard setters indicate that there is potentially a way forward, with major challenges to be overcome, though. For example: There is a worldwide criticism about the use of theoretical market values with a clear preference for entity-specific approaches. Also, except for the U.S., there seems to be broad support of the three IFRS building blocks (future cash flows, time value of money and margins). Alex Finn concluded by looking towards the future of financial reporting in insurance: He emphasized that we should expect to be faced with "unknown unknowns" whereas we know "unknowns" such as the treatment of investment contracts and the cash flows to be included in the valuation and also benefit from a few "known knowns" such as prospective best estimate cash flow valuation methodologies. Against this backdrop he warned against "digging up the road over and over again".

The **subsequent discussion** centred on the challenge to make insurance accounts understandable. Ultimately, our investors need to be able to compare an investment in an insurance company with one in any other industry.

#### **Session 4: Solvency 2 and the 2<sup>nd</sup> Generation of International Risk-based Solvency Systems**

Session chairman **Denis Duverne, CFO, AXA Group**, emphasised that Solvency 2 will be a modern, risk-based, economically well grounded framework which also takes into account the evolution of the industry (such as the emergence of multi-national groups) and its risk management practices (such as sophisticated risk modelling techniques).

**Thomas Steffen, Chairman, Committee of European Insurance and Pension Supervisors (CEIOPS) and Director of Insurance Supervision, BaFIN, Germany**, recognised the significant progress made under Solvency 2 so far, such as the agreement on a risk-based framework and the consensus reached in difficult areas such as technical provisions and qualitative requirements. He also acknowledged the various Quantitative Impact Studies as a key source of insights and lessons for the regulatory authorities. As far as the effective use of internal models is concerned Thomas Steffen highlighted some key success factors as derived from the lessons from Basel 2 such as senior management commitment and data quality. He also discussed the question as to whether Solvency 2 could be regarded as the second generation of risk-based solvency systems, building on the EU's Basel 2 and the U.S. system of risk-based capital (RBC). In this context, the three distinguishing features of Solvency 2 are its total economic balance sheet approach, market-consistent valuation and the freedom to use internal models. Thomas Steffen concluded by gauging the possible impact of Solvency 2 on competition. He expressed his conviction that Solvency 2 will benefit the economy in general and consumers in particular because of its risk-based approach, focus on governance, risk management, risk controls, transparency and disclosure as well as its supervisory implications (complementing the traditional focus on consumer protection by the objective of maintaining financial stability).

**Tom Wilson, CRO, ING and Chairman of CRO Forum**, emphasised the CRO Forum's support of Solvency 2, especially the market consistent valuation of assets and liabilities, the Solvency Capital Requirement (SCR) that takes into account diversification effects and risk mitigation techniques, the allowance of internal models and the Minimum Capital Requirement (MCR) being a threshold below which a company must not fall. However, the CROs believe that further work is required, for example on the potentially inappropriate treatment of equity risk in the Solvency Capital Requirement (SCR) and the currently inadequate recognition of geographic diversification. Tom Wilson also discussed the strategic and management implications of Solvency 2. Capital requirements under Solvency 2 are expected to be higher than under Solvency 1. However, as most insurers already pursue an economic approach and have to meet rating agency requirements the impact of Solvency 2 in this area will be limited. As far as the business mix is concerned riskier products may come under pressure, e.g. life products and NatCat protection. The CROs also believe that Solvency 2 will not trigger a wave of industry consolidation. In terms of management implications Tom Wilson highlighted the additional workload from internal modelling and risk controls, increasing incentives for active balance-sheet and capital management, the need to more accurately price and design financial guarantees and the growing importance of financial engineering skills as a complement to traditional actuarial skills.

**Gideon Pell, CRO, New York Life**, offered a U.S. perspective on risk-based solvency. He started by introducing the North American industry associations looking at solvency: The American Council of Life Insurers (ACLI) and the Group of North American Insurance Enterprises (GNAIE). They are monitoring the EU Solvency 2 project, the U.S. NAIC's Risk Based Capital regime and the IAIS's Global Standards. He stressed the significant common ground between these three frameworks: They are principles-based, capital requirements are tied to risk, sophisticated internal models are allowed and the risk management approach is holistic. On the other hand, significant differences remain: For example, Solvency 2 is based on a market consistent valuation whereas the NAIC framework uses book value. Solvency 2 adopts a holistic aggregate view whilst the NAIC regime is based on a product level view. Solvency 2 allows for all models to be stochastic whereas in the U.S. only interest and equity risk models may be stochastic. Gideon Pell concluded by stating that both Solvency 2 and NAIC risk-based capital are aligned with high-level IAIS guidance. The U.S. perspective is that Solvency 2

risk margins would need further validation and calibration. The various differences notwithstanding the U.S. industry wishes to work with its European counterparts on a global convergence of solvency standards.

In the **subsequent discussion** the impact of the sub-prime crisis on the insurance market was raised (D&O claims due to bad lending decisions, mortgage indemnity claims because of falling house prices and the prospect of a recession hitting insurance growth).

### **Session 5: Asset Liability Management in Insurance: the Current Challenges**

Session chairman **Dieter Wemmer, CFO, Zurich Financial Services**, pointed to the confusion caused by differing regulatory, internal (economic) and rating capital requirements. Solvency 2 is now addressing this issue by driving a level playing field across Europe which is likely to create a competitive advantage for European insurers relative to US players. He cautioned against an excessive reliance on models citing the bankers' models which failed to anticipate an unprecedented liquidity crunch.

**Anthony Bice, Director, Oliver Wyman**, stated that insurers are looking more closely at their asset liability management (ALM) as part of an overall reassessment of the three main areas of insurance value creation: liability management, strategic balance-sheet management and asset management. In the new competitive environment insurers face conflicting requirements between minimizing risk and maximizing opportunity in the area of investment management. He also highlighted the link between company size and risk appetite: Smaller insurers are likely to focus on minimising ALM risk. Larger insurers are expected to be more willing to create value by seeking exposure of net assets to selected markets (e.g. by investing in liquid markets). The largest insurers may even endeavour to create value by seeking exposure of net assets to market opportunities, basically acting like hedge funds. Anthony Bice also outlined the contribution of dynamic hedging to reducing economic capital requirements and earnings volatility. He finally mentioned that, whilst hedging is key to ALM, it must be realised that the longest available bond is 16 years, i.e. shorter than many insurance liabilities.

**John Roe, Head of UK Insurance ALM Advisory, RBS**, pointed to the wide chasm between the large insurers who use economic capital as the key capital metric and the smaller insurers who aim for the much lower required regulatory capital. In terms of modelling methodology similarly large differences exist between those using advanced stochastic approaches and those who content themselves with prudent deterministic methodologies. In view of Solvency 2 the smaller players will come under pressure which may drive consolidation in Europe. As regards models, John Roe cautioned not to over-rely on them in the context of extreme tail events, an issue effectively highlighted by the recent credit crisis. In general, he felt that models should be used only to support intuition.

The **subsequent discussion** focused on the insurance industry's risk appetite. It was recommended that insurers should only keep those risks on their balance sheet that they are being paid for. The fundamental question to ask is 'What sort of company are we trying to be in relation to the expectations of the stakeholders?' Most recently, companies are moving away from major market positions and become more risk averse in their ALM. It was also claimed that shareholders don't want insurers to become hedge funds as insurance is high risk in its core underwriting aspects which doesn't need to become high risk in its investments too.

### **Session 6: IFRS Developments and Financial Statement Presentation for Insurance Companies**

Session 6 was chaired by **Jerry de St. Paer, Senior Vice President, AIG**, and Chairman of the Group of North American Enterprises (GNAIE). Kicking off the panel contributions **Peter Clark, Senior Project Manager, Insurance, International Accounting Standards Board (IASB)** started by summarising feedback he received on the basic model of IFRS, i.e. the three building blocks of estimates of future cash flow, time value of money and a margin. So far, the IASB has received 120 comments on its consultation. The initial view is that there is fair support for the overall direction but some reservations on Day 1 profit, risk margins, service margins, entity specific expenses, non-life discounting (mainly from the US and Bermuda) and performance reporting, particularly insurance premiums, revenue, and deposits. He emphasised that the aim is for an Exposure Document to be finalised in 2009 and for IFRS to be implemented in 2012.

**Ralph Hebgen, Senior Analyst, Keefe, Bruyette & Woods** presented the expectations of a sell-side analyst vis-à-vis IFRS. Analysts need to understand the covered company's business and be able to explain it to their clients. In particular, they need to see how the products generate profits and cash and to keep the drivers of profit and outgo separate. They also need access to proper segmental information. If they had this information, analysts and their clients would gain more confidence in their forecasts. Ralph Hebgen has made it very clear what analysts do not need: surprise announcements, off-balance sheet liabilities and the proverbial black box, e.g. aggregate consolidation items, aggregate claims and benefits and aggregate investment income. He also voiced certain reservations about a convergence between IFRS and MCEV. Investors are obviously allured by the deceptive simplicity of IFRS-based earnings. In Hebgen's view a differentiated approach may be superior to outright convergence: An enhanced IFRS to capture the short-term earnings dynamics and a more transparent MCEV to capture the long-term earnings dynamics, properly taking into account the complexity of insurance business.

**Maurizio Lualdi, Senior Insurance Investment Advisor, Capital Global Investors**, started by demonstrating that, over the past 20 years, the European insurance industry has not been successful in creating shareholder value (relative to the market as a whole). He referred to a recent survey according to which a lack of transparency and simplicity is to blame for the sector's underperformance. Maurizio Lualdi also explained that the insurance sector's actual performance in terms of earnings growth and volatility has not been considerably worse than other relevant sectors' record. But he mentioned a massive gap between company predictions and actual performance as a major factor affecting investors' appetite for insurance stock. Against this backdrop, he called for improved disclosure standards in insurance, a key imperative for an industry where most investors do not understand how companies make money. More transparency is urgently needed to better understand key profit drivers such as asset development, margins and risk underwriting, for example by using cash as a basis for analysing asset development and margins in the life insurance industry. In general, he urged the industry to clearly separate financial from risk reporting in order to improve the visibility of earnings – an approach successfully adopted by the banks. He concluded by reminding the audience that 90% of all investors are not insurance and reinsurance experts. Why should they take the pain of obtaining a PhD in insurance in order to fully understand a sector which represents a mere 5% of global market capitalisation?

The **subsequent discussion** centred on one specific example given by Maurizio Lualdi: Ferrari does not have to explain how the car is made to attract investors. Investors have confidence in the results based on clear and transparent earnings metrics.

## **Session 7: Asset Management: Key Issues in Outsourcing Policy**

**Luke Savage, Director of Finance, Risk and Operations, Lloyd's of London**, was chairman of the final session. Kicking off the panel discussions **Martin Senn, Chief Investment Officer, Zurich Financial Services**, shared Zurich's experience with outsourcing its asset management function. He identified four key benefits arising from this fundamental decision: (1) the ability to focus on core activities, (2) access to the best talent in the market, (3) increased flexibility and (4) reduced operational risk. The in-house investment management department assumes overall responsibility for the Zurich's assets, develops and implements the investment strategy and supports the investment portfolio and relevant systems. After carefully reviewing the entire investment value chain, ZFS has decided to outsource security selection and trade execution whereas asset manager selection and tactical asset allocation remain insourced. Martin Senn concluded by emphasising that Zurich's core activity is insurance. This clear focus, in conjunction with cost efficiencies, has driven the decision in favour of outsourcing.

**Guido Fuerer, Head of Global Asset Management, Swiss Re**, presented a different perspective. Swiss Re has decided to insource most of its investment management which, together with risk underwriting, it considers a core area of value creation. Guido Fuerer stressed the complexities associated with asset management for insurers: Depending on whether internal, rating or regulatory capital models are used the asset composition may have different effects on an insurer's capital. Further, there is a dynamic and complex relationship between an insurer's assets and its liabilities. And, finally, there are specific local insurance and investment regulations to be taken into account. Swiss Re has been doing asset management for 140 years and feels confident about both its investment

expertise and the necessary scale. On the other hand, Swiss Re considers outsourcing where it believes it makes sense, for example in respect of those assets which back economic net worth (as opposed to assets backing liabilities). He mentioned alternative assets as an example for outsourcing but stressed that even in this area the selection process is kept in-house.

**Robert Goodman, Managing Director and Co-Head, Global Insurance Asset Management, Deutsche Bank** reminded the audience that, in the long run, growth in tangible book value per share matters most for the development of the share price. The levers of tangible book value are: (1) underwriting performance, (2) the investment of float, (3) the investment of surplus, (4) capital management and (5) domicile (for tax). Robert Goodman demonstrated the importance of investment income which, on average, has contributed around 60% to pre-tax income over recent years. In this context, he views outsourcing is an opportunity to set and realise value enhancement targets. This potential, he believes, is reflected in the significant growth of outsourced insurance assets (35% CAGR since 2004; a rate expected to be sustained over the medium-term). The three key drivers behind this momentum: (1) cost and complexity reduction, (2) risk management and (3) enterprise value enhancement. Looking ahead, Robert Goodman expects an increased recognition that (1) consistent risk-adjusted investment returns lead to a valuation premium, (2) fragmented corporate investment activities are associated with significant risks and (3) ALM sophistication will increase, driven by Solvency 2 and resulting in the focus of asset management shifting to strategic selection of cheapest beta and best alpha.

**Edouard Stirling, Senior Vice President, State Street Bank (Europe)** highlighted the dynamic external environment asset managers have to cope with, characterised, for example, by globalisation, an accelerating pace of product innovation, an increased regulatory burden and changing customer needs. Edouard Stirling stressed that good governance is a necessary condition for asset managers to deliver (appropriate goals, benchmarks, rewards etc.). Any organisation pondering an outsourcing strategy needs to be aware that a loss of control would be inevitable. Its decision-makers also need to realise that they would become a manager of managers, with a completely different skill set required for such a role. Finally, a company should have a clear idea of why it is outsourcing. In Edouard Stirling's view, short-term cost cutting is not a valid reason. On the other hand, the advantages of outsourcing are evident, mainly access to specialisation, scale, global reach, flexibility, lower total costs and a shift from fixed to variable costs. He concluded by stating that, in principle, all parts of the value chain can be outsourced, even though such an approach is considered to be high risk. Outsourcing selected parts, particularly trade execution is more common.

The **subsequent discussion** focused on the new co-ordination issues which now arise between the asset management function and the increased complexity of asset-liability management systems. This is requiring greater co-ordination between the CIO and the CRO. Asset management is a growing area of business in many insurance companies, and as these businesses go global outsourcing becomes an increasingly important option for them.

**Patrick M. Liedtke and Gerry Dickinson** wound up the Seminar and thanked all participants for attending and making it such a success.

### First Announcement

## 5th INTERNATIONAL INSURANCE AND FINANCE SEMINAR OF THE GENEVA ASSOCIATION

The 5<sup>th</sup> International Insurance and Finance Seminar of The Geneva Association will take place in early December in London and is going to be hosted by Aviva. Exact dates will be communicated in the coming weeks through our website. Please note that it is an invitation-only event and that attendance is limited. Should you be interested in further information on this conference, please contact The Geneva Association Secretariat: [info@genevaassociation.org](mailto:info@genevaassociation.org)

**VI. LATEST ISSUES OF THE “ETUDES ET DOSSIERS” WORKING PAPERS SERIES**

- **No. 344 / April 2008**  
**24<sup>th</sup> GENEVA ASSOCIATION PROGRES CONFERENCE ON**  
**“TOWARDS A GLOBAL ARCHITECTURE FOR INSURANCE REGULATIONS AND**  
**SUPERVISION”**  
Geneva, 3 – 4 April 2008
- **No. 343 / April 2008**  
**8<sup>th</sup> CEO INSURANCE SUMMIT IN ASIA ON**  
**“ACHIEVING REGIONAL SYNERGIES AND PARTNERSHIPS TO BOOST COMPETITIVENESS”**  
Jakarta, 30 January - 1 February 2008
- **No. 342 / February 2008**  
**KIDI INTERNATIONAL CONFERENCE 2007 ON**  
**“NEW RISK MANAGEMENT ENVIRONMENT AND STRATEGY”**  
Seoul, 6 September 2007  
&  
**MONTEPASCHI VITA ANNUAL FORUM 2007 ON**  
**“INSURERS AND BANKS: COMPLEMENTARITY AND COMPETITION”**  
Rome, 12 October 2007
- **No. 341 / February 2008**  
**5<sup>th</sup> CHIEF COMMUNICATIONS OFFICERS MEETING OF THE GENEVA ASSOCIATION**  
Munich, 13-14 December 2007  
&  
**10<sup>th</sup> MEETING OF THE GENEVA ASSOCIATION’S AMSTERDAM CIRCLE OF CHIEF**  
**ECONOMISTS**  
Amsterdam, 7-8 February 2008
- **No. 340 / February 2008**  
**4<sup>th</sup> INTERNATIONAL INSURANCE AND FINANCE SEMINAR OF THE GENEVA**  
**ASSOCIATION**  
London, 6-7 December 2007
- **No. 339 / January 2008**  
**BARRIERS TO GLOBAL INSURANCE BUSINESS OPERATIONS: THE SITUATION IN BRAZIL,**  
**CHINA, INDIA, MEXICO AND RUSSIA**  
Research Report
- **No. 338 / January 2008**  
**3<sup>rd</sup> CHIEF RISK OFFICER ASSEMBLY ON**  
**“KEY DRIVERS OF A NEW RISK CULTURE”**  
Rüschlikon, 26–27 November 2007  
&  
**5<sup>th</sup> ANNUAL ROUND TABLE OF CHIEF RISK OFFICERS**  
Edinburgh, 21-22 May 2007
- **No. 337 / December 2007**  
**THE INSURANCE INDUSTRY AND ENTERPRISE RISK MANAGEMENT: FROM COMPLIANCE**  
**TO VALUE CREATION**  
Milan, 21 November 2007  
&  
**UNINSURED INDUSTRIAL RISKS. THE LIMITS OF CURRENT INSURANCE SOLUTIONS**  
**AND THEIR CAUSES** – Ongoing Research Project



## The Geneva Reports

### The Geneva Association publishes study on regulation in new series

The Geneva Association has created a new series, “The Geneva Reports—Risk and Insurance Research”.

The purpose of this new series is to tackle issues of strategic importance to the insurance industry that warrant special attention and particular analysis. It is published at irregular intervals and available both in printed and electronic versions.

The first issue of the Geneva Reports is a study on the regulation of insurance entitled *Regulation and intervention in the insurance industry—fundamental issues*. It will be available at the end of April 2008.

While a very substantial body of literature concerned with the regulation of banking has developed over recent years, dealing with both its fundamental motivation and specific forms and applications of such regulation, a similar intellectual effort concerned with insurance regulation is lacking to a considerable extent. It is the aim of this study to work towards closing this gap.

The study can be downloaded for free from The Geneva Association website ([www.genevaassociation.org](http://www.genevaassociation.org)). Hard copies can be ordered from The Geneva Association secretariat or through the website.



## First Call for Papers

### LONGEVITY FOUR:

#### Fourth International Longevity Risk and Capital Markets Solutions Conference

On 25th September 2008 in Amsterdam

#### Submission Instructions

We are inviting academics to submit papers in all areas relating to longevity risk and capital markets solutions. All papers will be submitted electronically to [emma.brophy.1@city.ac.uk](mailto:emma.brophy.1@city.ac.uk). The decisions about submissions will be communicated to authors directly when the formal programme for the conference will be announced. Jointly authored papers should be submitted by the person who will present the paper, if it is accepted.

#### Scientific Committee

Submitted papers will be reviewed by a Scientific Committee comprising: Theo Nijman (Tilburg University and Netspar), Richard MacMinn (Illinois State University), Jennifer Wang (National Chengchi University, Taiwan), David Blake (Cass Business School and Pensions Institute) and Anja De Waegenaere (Tilburg University and Netspar).

#### Special Issue of IME

**Insurance: Mathematics & Economics** will publish a **Special Issue** of the best papers presented at the conference. The guest editors for this special issue will be David Blake (Cass Business School and Pensions Institute), Anja De Waegenaere (Tilburg University and Netspar) and Theo Nijman (Tilburg University and Netspar).



## International Association for the Study of Insurance Economics

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### VII. CONFERENCES ORGANISED AND/OR SPONSORED BY THE GENEVA ASSOCIATION

## 2008

### April

- |       |            |  |
|-------|------------|--|
| 3-4   | Geneva     | <b>24<sup>th</sup> PROGRES Seminar</b> on Insurance Regulation and Supervision   |
| 3-4   | Hartford   | <b>Insurance, Intellectual Property &amp; Innovation</b> , organised by the Insurance Law Center and the Intellectual Property and Entrepreneurship Law Clinic at the University of Connecticut and The Geneva Association |
| 20-22 | Copenhagen | <b>6<sup>th</sup> ART of CROs meeting</b> , co-organised by Tryg Vesta   |

### May

- |       |          |  |
|-------|----------|--|
| 28-31 | Hamilton | <b>35<sup>th</sup> General Assembly of The Geneva Association</b> (members only) |
|-------|----------|--|

### June

- |       |        |  |
|-------|--------|--|
| 26-27 | Zurich | <b>1<sup>st</sup> Meeting of Chief Investment Officers in Insurance</b> , hosted by Swiss Re |
|-------|--------|--|

### July

- |       |        |   |
|-------|--------|---|
| 13-16 | Taiwan | <b>The Geneva Association / IIS Research Awards Partnership</b> |
|-------|--------|---|

### September

- |       |          |   |
|-------|----------|---|
| 15-17 | Toulouse | <b>35<sup>th</sup> Seminar of the European Group of Risk and Insurance Economists</b>   |
| 18-19 | Munich   | <b>M.O.R.E. 22 – Conference on Management of Risks in the Economy</b>   |
| 29-30 | Zurich   | <b>5<sup>th</sup> Liability Regimes Conference</b> , a joint initiative by Swiss Re, Zurich Financial Services and The Geneva Association |

### October

- |      |      |   |
|------|------|---|
| 8-10 | Rome | <b>Montepaschi Vita Annual Forum</b> , organised by AXA/Montepaschi Vita and The Geneva Association |
|------|------|---|

### November

- |       |        |   |
|-------|--------|---|
| 6-7   | London | <b>5<sup>th</sup> Health &amp; Ageing Conference on Long-Term Care – Risk Profiles, Future Determinants and Financing</b> , jointly organised with BUPA |
| 20-21 | Munich | <b>4<sup>th</sup> CRO Assembly</b> , jointly organised with Munich Re   |

### December

- |            |        |  |
|------------|--------|--|
| <i>tba</i> | London | <b>5<sup>th</sup> International Insurance and Finance Seminar</b> of The Geneva Association                                |
| 11-12      | Rome   | <b>6<sup>th</sup> Meeting of The Geneva Association's Chief Communications Officers</b> , hosted by Assicurazioni Generali |