

Business models of the future: Learning from the crisis



Dr Kai-Uwe Schanz, Principal Partner of Dr Schanz, Alms & Company AG, Zurich, examines the strategic implications of the financial troubles that affected the insurance industry late last year.

In the wake of the global credit crunch, only a handful of insurers came under life-threatening stress. AIG, once the world's most highly valued insurance company, was almost brought to its knees by credit default swap transactions engineered by its financial products division. In general, the business models of those insurance and reinsurance companies that were hardest hit by the credit crisis share three fundamental traits.

First, these organisations ventured into the coverage of financial and credit risks rather than sticking to their knitting, ie the management and absorption of hazard and underwriting risk. In light of last year's financial market dislocation, it is tempting to just discard any strategy aimed at extending the traditional business model. A more differentiated and balanced approach would probably focus on the massive weaknesses in enterprise risk management (ERM) displayed by a number of companies. It was shocking to observe how a relatively small part of the organisation brought a supposedly rock-solid, world-leading company like AIG to the brink of collapse.

Second, the capital management strategies of these organisations were short-term oriented – the main focus was to maximise immediate returns through share buybacks and an excessive use of leverage. Capital buffers to be relied upon during “rainy days” were wantonly run down to win plaudits from financial analysts and “activist” shareholders. Financial flexibility was reduced to critical levels, which became painfully clear after equity and debt markets virtually shut down in the second half of 2008.

Third, aggressive asset management strategies were pursued in order to boost returns. Investment portfolios were loaded with securities whose exposure to liquidity risks was grossly underestimated. Alternative assets (eg hedge funds) and structured products all of a sudden turned out to be illiquid, forcing massive unrealised losses upon companies' balance sheets and requiring capital measures at highly unfavourable terms just to compensate for mark-to-market losses. Obviously, fair value accounting, an inherently problematic notion in the context of insurance, played a pernicious role in exacerbating pro-cyclical behaviour. However, the root cause of these calamities should be spotted in inadequate ERM practices which failed to anticipate stress scenarios for market and credit risks.

Back to the roots?

The lessons to be drawn from the crisis seem obvious. First, insurers and reinsurers should focus on what they historically did best – assessing, managing, absorbing and transferring underwriting risk. Another beauty of concentrating on these core activities is that they provide a “natural” hedge against financial market dislocations: insurance liabilities are long-term in nature and largely independent from policyholder behaviour. Matching these


liabilities with long-term assets effectively shields the insurance industry from short-term financial market turmoil. This is in stark contrast to the banks – they always face the Damocles sword of a run and could be forced into crippling fire sales of assets to maintain liquidity.

Second, the industry's asset management strategies should be guided by prudence and conservatism. The imperative of asset-liability management as described above should determine investment decisions rather than the lure of higher investment returns the risks of which were frequently misjudged.

Third, capital management strategies should adopt a more medium-term oriented, less aggressive approach. The colossal threats to financial flexibility towards the end of 2008 demonstrate that the excessive pursuit of capital efficiency could well jeopardise an organisation's survival in times of market stress. Also, investors' awareness of that risk has grown significantly.

Don't throw the baby out with the bath water!

The recommendations above seem to be natural. Just embracing the “virtues of the past”, however, would not offer a sustainable answer to one of the insurance and reinsurance industry's most long-standing flaws – its inability to generate consistent shareholder returns commensurate with risk. More often than not, returns have not just proven highly volatile but also fell short of the cost of capital. Corporate leaders in insurance and reinsurance were, rightly, looking for ways of improving this uninspiring performance record. They were doing so in order to maintain investors' long-term support of an industry which is among the most capital-intensive ones in the world. These innovative efforts included an extension of traditional business models.

Post-crisis, it has now become clear that companies were generally not successful in their endeavours to introduce return-enhancing innovation. However, an innovative mindset which includes the willingness to regularly challenge existing business models will be of paramount importance for the long-term viability of the industry. What needs to improve dramatically, though, are the safety mechanisms accompanying innovation – arguably the most important challenge ahead of ERM. 

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