Redefining the Industry: Regulation, Risk & Global Strategy!

What a challenge the IIS[1] put to the some 400 delegates from some 35 countries, including 11 from Australia, and 6 only from France: for the academics and executives attending their 43rd annual seminar in Berlin July 8 – 11, 2007 the task was nothing short of "reinventing" themselves and their industry, while grasping cultural differences and finding ways to cover emerging countries (micro-insurance) and integrating Islam compatible solutions (takaful – see box below). Takaful have know a 20 years experience and thus have resisted the test of time in the Middle East and other parts of Asia and are now ready to extend their offering to the large Islamic populations established in the Western World. However, Chakib Abouzaïd, C.E.O. of Takaful Re from Dubaï, concluded his presentation with this comment: *"Takaful is about solidarity and mutuality and not about religion. It is a commitment to values. Without commitment, there is neither credibility nor future for Takaful industry."*

TAKAFUL: The Islamic Insurance

Conventional insurance involves elements of uncertainty *(gharar)*, gambling *(maisir)* and interest *(riba)*, which are unacceptable under Islamic law. Muslims around the world have for generations grown-up with the mind set that insurance is forbidden as contrary to the *sharia*. However, in 1985, the Islamic Fiqh Academy ruled that insurance is acceptable to Islam if it operates through mutual self-help and cooperation, an important social tenet of Islam. *Takaful,* which derives its name from an Arabic word meaning "guaranteeing each other", offers insurance that operates on a mutual model. Policyholders (or participants) pay contributions *(tabarru)* into a fund where the group voluntarily shares risk collectively so that participants who suffer insured losses can receive compensation from the fund. Any surplus in the fund that is not retained as reserves; must be either returned to participants or paid as a charitable contribution *(zakat)*. *Zakat* is one of the five pillars, or obligation of the Islamic faith.

While it is possible to operate a takaful on a purely mutual basis, most recently formed companies operate as commercial entities that aim to make profits by operating the fund. The fund manager is also responsible for providing solvency capital. If a deficit arises in the fund, then it is made good by an interest-free loan *(qard hassan)*, usually from the operator. This loan is repaid from any future surpluses, but if these prove insufficient, then any losses fall on the operator.

There are two principal ways in which the operator is remunerated for the services and risk bearing provided:

- *Al Mudharaba* model: The operator receives a defined proportion of the profits of the takaful fund,
- *Al Wakala* model: The operator receives a defined fee from member contributions, or *tubarru*, and from the takaful fund itself.
- The current trend is to combine both models:
    - *Wakala* for underwriting,
    - *Mudharaba* for investment

The past twenty years have seen takaful operations opening in Islamic countries as well as countries having large Muslim communities. There is no doubt a tremendous opportunity for takaful in those Western countries that have large Muslim communities, but significant investment is required to compete with the conventional industry, and regulatory changes would be necessary, as seen in the Malaysian market, to allow takaful to compete on equal terms.

Many of the challenges facing takaful operators are strategic as this formative market tries to establish itself. There is still little infrastructure for this new business. Whereas skills and resources can be borrowed from conventional markets, human resources from traditional mutuals and reinsurance covers from traditional reinsurers setting up special shops, there remains a need for a significant investment required to create the business: establishing the Shari'ah board, training staff, creating brand awareness among potential customers, and implementing the appropriate technology. But this is the price to pay to market protection and savings products to the world's 1.6 billion Muslims!

Source: Emphasis 2007/2; p 2/5 – Tillinghast – Towers Perrin

[1] International Insurance Society – The society is nearly 50 years old and comprises 23 global members, 110 corporate members and 550 individual members covering 90countries and its mission statement stands as: "*To facilitate the worldwide transfer of ideas and innovations and to foster the development of personal networks across national and international insurance markets through a joint efforts of executives and academics."*

As far as micro-insurance is concerned, global players are taking an interest, not last among them the AIG group is expanding his business far beyond its original Ugandan laboratory. In the last 12 months, they have started an ambitious program with already 17 new partnership with local microfinance institutions in Latin America (Mexico, Brazil), in Asia (India, Indonesia, Pakistan). Already more than 3 million are insured with annual individual premium in the 5/10 US$ range, but this is only a beginning the development plan calls for 20/25 million insured by the end of 2008, 50/100 million in 5 years and up to 500 million before 2020. AIG is even planning to enter directly the micro finance business in carefully targeted markets. However, it was enlightening to hear on micro-insurance for low income population directly from a West Africa experience.

We reproduce here only the conclusion of the very interesting presentation by M. Nelson Kuria, managing director of the Co-operative Insurance Company (CIC) of Kenya. He summarizes key factors for success in the micro-insurance markets:

- Insurance packages for co-operative and microfinance institutions in general has proven profitable over the year, hence sustainable, save for micro-health, which has required a recent reengineering,
- Innovative and competitive products have become known throughout the co-operative movement and micro finance institutions in Kenya and this is rapidly increasing among other communal groups, like churches,
- The pilot micro-insurance packages should be offered to other MFIs across the country. By targeting a homogenous segment, the inherent product risk will be spread over a wider group, thus enabling CIC to provide attractively priced products,
- Partnership with strategic partners are crucial in the distribution of micro-insurance policies to low income families, a market that has been neglected so far by traditional commercial insurers,
- Support from and collaboration with technical partners and donor agencies would enhance local operators capacity in designing and pricing the micro-insurance products that would be relevant and affordable for low income households,
- This in turn will enable low income persons to access financial services with a higher overall protection against life, health and property risks, hence enabling them to benefit from a specific income generating opportunity.

If this was not enough, there is also the need to develop and implement an ERM strategy that Solvency 2 calls for, at least for European Union based companies. Although the deadline has been pushed to 2012 to allow all countries to be "on board", this remains a very important project when combined with the implementation of the new International Accounting Standard. These developments will change the appraoch to sustainability and solvency of both the national control boards and the quotation agencies.

Finally, all this is taking place at a time of accelerated globalisation with growing market in the East that require immediate attention even tough the return may be still far away in the future and when the soft market is clearly around the corner: will the new models, the return request from the financial markets on which the industry now depends for its capital (see Paris Re IPO) bring sense at last and limit the trend to a soft landing rather than the crash experienced in the past? It is yet impossible to provide an answer but clearly the exchanges during the IIS seminars tend to provide insight for the heavy burdened industry new generation CEO.

Jacques AIGRIN, C.E.O. of Swiss Re, launched the first C.E.O. panel, a traditional feature in all IIS Seminar with strong words for his fellow executives: *"The risk landscape has been changing quite dramatically in recent years and some key developments stand out: Event driven risks are increasing in size, the interdependency of risks is growing, and stakeholder expectation remain high. At the same time numerous regulatory, legislative and accounting initiatives on insurance and financial services have emerged. These trends demand continuous and close attention. In a world where risks are increasing in financial size and complexity, Swiss Re's strong balance sheet, risks taking capacity and innovative solutions continue to be critical success factors.*

A modern regulatory framework is also a key condition for ensuring that reinsurers provide capital efficiently. For this reason, regulators, rating agencies, and accounting standards need to pursue the same economic and risk-based view of a reinsurer's financial strength. Harmonisation and mutual recognition of regulatory bodies are essential factors in making the market more efficient. We have seen encouraging progression the area with the Solvency II project in Europe. We expect that the EU directive will enhance the risk culture in the industry, and lead to a more rational and transparent marketplace.

Reinsurance will continue to expand into wider forms of capital market solutions. Swiss Re is at the forefront of this long-term transformation process. We are proud to have driven the development of the insurance-linked bond market and related instruments for both property and life exposures. Going forward, the industry, regulators and rating agencies need to work together to unlock the full potential of capital market solutions."

Patrick Thiele, President and C.E.O. of PartnerRe expressed his own views on risk sharing pretty much the same position when, prior to stressing the merging movement of capital and insurance markets, he remarked in three points:

- Risk-averse society wants to off-load risk:
    - *It is illustrated as insurance premiums grow faster than the GDP*
- Capital markets remain focused on return, illustrated by:
    - *Limited application of risk technology,*
    - *Low credit spread (not enough reflection of risk factor),*
    - *Growth in non-diversified vehicles (no spreading of risk).*
- Insurance is primary adapter of risk management tools and technology:
    - Very sophisticated application of insurance risk,
    - Driven by illiquid, long tail nature of exposures

Of course the key to an end to cycles is probably as usual "underwriting discipline". However, after analysing how the cycles in the insurance industry seem always linked with last years good result, Leonard Battifarano, Senior Vice President AIU (AIG Group) had this piece of advice to his colleagues stop looking in the rear mirror and adjusting your prices on the past and look ahead to what might happen, especially when so many elements of the risk context are ever changing. And he summarized in a simple phrase, which all risk-management professionals would applaud: *"Underwrite the exposure, not last year's loss history!"*

Well, one might say that this is precisely the intention behind the new Solvency 2 directive that was released during the Seminar (on July 10 precisely). If it would be too early to comment the text in detail, it is surely interesting to take Karel van Hulle, Head of Unit, Insurance and pensions, DG Market of the European Commission at his word when he professes that "Solvency II is about offering a modern, innovative and liberal regime for the prudential supervision of insurers, based on sound economic principles" and further quote the four objectives pursued by the proposed directive:

- Deepen the single market,
- Enhance policy holder protection,
- Improve international competitiveness of E.U. insurers, and
- Further better regulation.

In his conclusion he remarked that Solvency II (see box below) is "all about improving risk management and rewarding already existing good practice" and that "updating risk management processes and practices into a company takes time" before offering a "warning" advice to the practitioners in the room:

- Insurers need to start preparing now, if they do not want to be caught out when Solvency II comes into force (in 2012),
- The future will belong to those who prepare for it now!

For his part, Helmut Perlet, Chief Financial officer of the ALLIANZ Group, see some key issues and implications of Solvency II for his company:

- Risk based calculations will create an incentive for more integrated risk management *(but large players have already developed sophisticated models for capital allocation)*,
- Convergence issues:
    - to Basel II in Europe;
    - of supervisory approaches in the different member states,
    - with IAS/IFRS
- Market consistent valuation of assets and liabilities,
- Group Supervision: who will be in charge?
- Increased transparency concerning supervisory practice and the business model of insurance companies.

Helmut Perlet sees some crucial factors on which the success of Solvency II will depend:

- Ensure that groups are supervised in line with their risk profile: *Clearly defined lead supervisor concept with separation of roles and responsibilities; allowance for diversification*;
- Level playing field independent of group location: *Harmonisation of supervisory standards & practices across member states*;
- Foster risk management best practices: *Incentives to implement full internal models (more accurate than standard models)*;
- Avoid regulatory arbitrage: *Supervision of sectors not covered by Solvency II have to be upgraded (i.e. pension funds)*;
- Ensure efficient reporting: *The starting point for public disclosure has to be the future IFRS standard.*

CBR versus SOLVENCY II

Although the Risk Based Capital (RBC) standards in the USA and the E.U.'s proposed Solvency II share the common gaol of protecting policyholders and strengthening insurers through sound regulation, in many ways they differ substantially. While Solvency II calls for a global, enterprise-wide risk-management appraoch, taking into account the company's risk profile (principle of proportionality), RBC focuses solely on capital adequacy.

For Solvency II, the commission has chosen a top-down, holistic appraoch with three supporting pillars:

- **Pillar 1:** Capital adequacy through capital requirements on two tiers, a Solvency Capital Requirement (SCR), and a Minimum Capital Requirement (MCR).
- **Pillar 2:** Risk management requirements with capital adjustments to the SCR in case of deficiencies.
- **Pillar 3:** Disclosure requirements to reinforce market discipline.

In Solvency II, risk management and disclosure requirements are equally important as capital adequacy. A fundamental difference between the two regulations is that Solvency II is based on economic fair-value concepts, while the RBC calculations are based on best estimates modelling rather than prudent statutory values.

The Solvency II top-down appraoch is designed to lead to a coherent system, which will bring together quantitative and qualitative risk management. This unified measurement appraoch makes risks more transparent for management, further integrates risk and performance management.

The RBC bottom-up appraoch had the advantage of allowing for a quick implementation. In addition, the flexibility of using different time horizons enables long-term risks to be modelled more accurately than under Solvency II.

Source: Insurance Insights 2007; p 54/64 - KPMG

For his part, Jerry M. de St. Paer, Executive Chairman of GNAIE[2] stressed that as his members are significant participants in the European and world-wide insurance markets they care about Solvency II; their major concern encompassing the convergence between the new proposed E.U. regime and the IFRS proposals really echoes one of Allianz' remark: a

[2] GNAIE = Group of North American Insurance Enterprises is an industry organisation of US, Bermudian and Canadian based international insurance companies.

"level regulatory playing fields"; in other terms, will Solvency II treatment of capital requirements for E.U. and non E.U. based companies create de facto competitive imbalance?

Whereas Solvency II and RBC frameworks differ in their appraoch to establishing risk-sensitive capital requirements, developments in the RBC for interest-rate risk and market risk indicate that the thinking around risk quantification is reaching greater alignment on both sides of the Atlantic.

As a matter of fact, a meeting of minds may be accelerated by major rating agencies which are now including Enterprise-wide Risk Management (ERM) criteria in their quality assessments and which are starting to take internal models into account. In his address to the IIS Seminar delegates, Rodney Clark, Director Insurance Ratings – Standard & Poor's, stressed that *"risk management is at the heart of what Standard & Poor's does: we assess insurers' risks and how risks are managed. Previously, only qualitative credit was given to risk management practices and models; ultimately, we may give some quantitative recognition to risk models, but only where models are robust and underlying risk management framework is sound."* – See box below –

Clearly, holistic risk management or ERM tops the agenda of every insurance and reinsurance CEO, indeed every board of directors, as it encompasses much more than underwriting rules or investment choices, and even the traditional ALM (Asset Liability Management) to effectively strive to attain the best risk/return blend, the efficient frontier that fulfil the shareholders risk appetite.

However, if this global appraoch has become a priority in the wake of the recent surge in corporate governance issues and catastrophic events, it will become a permanent fixture of the industry if the regulators and the rating agency take as critical look into it as the Solvency II intentions and the rating agency new appraoch as the views express during the seminar seem to imply.

Enterprise-wide Risk Management: a rating agency perspective

Once a firm's enterprise-wide risks are identified and objectives are set, an ERM program should:

- Develop and maintain systems to periodically measure the capital needed to support the retained risks of the company;
- Reflect the risk capital in:
    - ✓ Strategic decision making,
    - ✓ Product design and pricing,
    - ✓ Strategic and tactical investment selection, and
    - ✓ Financial performance evaluation.

The product of a fully realized ERM program is the optimisation of the enterprise risk adjusted return. ERM quality evaluation is based on the risk profile of the company; therefore, the importance of the ERM in the company rating is based on its capacity to absorb losses and the complexity of its risk portfolio. As a rule of thumb:

- For an insurer with TIGHT capital and COMPLEX risks, ERM is **very important**,
- For an insurer with EXCESS capital and ORDINARY risks, ERM is **not so important**.

To summarize, the appraoch Standard & Poor's suggest the Greek Temple appraoch, the foundation is the risk management culture that must be embedded in the entire organisation, the three pillars are the risk control processes, the emerging risks management, the risk and economic models and the fronton is Strategic risk management.

Clearly the objective is to optimize risk-adjusted returns, i.e. capital allocation, and what the rating agency will be looking for is how the economic capital model supports strategic risk management through:

- A consistent view across all risks *(to make decisions about optimising risk-adjusted returns)*,
- The capability to assess trade-offs between different risk types,
- The assessment of risk adjusted returns,
- Capital budgeting, and
- Strategic investment allocation.

Source: IIS Seminar in Berlin on July 10, 200 – Rodney Clark, Director Insurance Ratings – Standard & Poor's

A discussion on risk management can take many different directions but one aspect has seen a recent attention namely the risks to reputation. Reputation is clearly identified as the main asset of many organisations, and the insurance industry is no exception. Indeed, reputation may even be more critical as insurance and reinsurance products are suppose to bring a financial protection and rests on the trust that the insured has that the insurer will make good on his promises. Sometimes, they hope for a security that is not even reasonably attainable. More and more insurers recognise that their reputation is probably their greatest asset and they are focusing on brand management to address the perennial issue of earning trust and developing and maintaining consumer trust.

In recent years, crippling events such as the collapse of several renowned insurer and worldwide corporate scandals have soured the reputation of the industry and the fallout from these types of events has led to increase regulation and, to say the least, inflated scrutiny from control bodies, government, boards and the public alike. Recent catastrophes have also served to frame the public image of the industry as a whole. Flood victims in France, never compensated fast enough, even when they had not purchased any cover. The AZF explosion in Toulouse on September 22, 2001 resulted in delays in assessing and repairing all the damages for lack of assessors and workforce. More recently, the media focused on high profile unsettled cases following Hurricane Katrina, even though 92% of the polled victims felt fairly treated by their insurer.

This negative depiction of the insurance industry is rather typical. The perception by the public of a quasi-governmental nature, with mandated covers like homeowners and motor insurance, for examples, only serves to disenfranchise the consumers and to sustain a somewhat callous and imperialistic image of the industry. While insurers successfully launch campaigns boasting individual “solutions” such as security, retirement planning, protection against loss, etc., most of the time they fail to highlight successes and critical socio-economic contributions such as claimed paid in highly publicised natural disasters and critical implementation which supports the construction of a dam, skyscraper or transportation infrastructure, not to mention making possible such world event at the Olympic games or gigantic concerts!

It is critical that the perception of the industry be changed. But would a universal campaign to illustrate its integral value to the underlying functionality of the world and future developments be enough? I have a feeling changing the public perception will require much more than mere advertising: a sustained effort of information on risks, a clear engagement in a permanent dialogue with all stakeholders and clear signals of corporate social responsibility (CSR) where it matters to the public.

Although not all in the CEO panel agreed with him, Geoff Riddel, Global Corporate Business, Zurich Financial Services, took this point to heart and was adamant with this advice to his colleagues: *“Now is the time to build relationship with everyone out there and to boost your know-how” and further “If you want to be a long term winner, your business must be run from a high moral ground in enlightened self-interest of being seen as contributing to society. Given the fact that business today is in the hands of the powerful consumers, CSR is the sure-fire way to win consumer confidence and the trust of the community.”*

Our industry is one of people: human resources are a very important asset, but establishing and maintaining key leadership and a capable and loyal employee base has always been a challenge. It is even more so in the rapidly growing markets like China and India where training and retaining indigenous resources is the only solution, especially when local cultural differences must be integrated in the business model. However, the problem may become acute even in the mature markets with the pappy-boomers nearing retirement. The good news, says Susan Ring, C.E.O. Of the UNUM UK based “disability specialist”, is that they do not wish to retire soon. But she added this warning: *“If we do not know how to put to good use the productivity of our new older workforce we might have roaming bands of bored, annoyed, grumpy, unemployed and sexually active elders, leading to public displays of affection, social upheaval, and overall mayhem. It would not be pretty!”*

Here below are reproduced the "NINE" commandments to be a winner proposed by M. Jonathan Harris of Mc Kinsey; they may well be the table against which to evaluate the industry progress at the IIS 44th annual Seminar in Taipei in July 2008.

Nine trends shaping the future corporate landscape	
Macro-Economic trends	
1 Shifting centres of economic activity	Asian (ex-Japan) and European GDP's converge by 2025
2 Overburdened public sector	Squeeze from spending on pensions and healthcare
3 New consumers	1 billion new household with $ 5,000 income in 10 years
Social & Environment trends	
4 Social life in a technological world	Rapid increases in connectivity
5 Turbulent tides of talent	Highly qualified individuals in developing markets
6 Social cost of the free market	Rising pressure for corporate responsibility (e.g. climate change)
7 Limited resources, unlimited demands	Rapidly increasing consumption of minerals and fossil fuels
Business trends	
8 New global industry structures	Unprecedented scale of largest corporations
9 New economics of knowledge	Increasing collaboration and new sources of knowledge that create value

For this IIS Seminar, the annual meeting points of minds and might in the Insurance and Reinsurance Industry worldwide; I will not borrow my conclusion from a political figure, even if it is tempting to quote the German secretary of state warning to the insurers not to condone a "herd behaviour", but rather from our guide during the city visit on Sunday. Quoting Mark Twain when he visited Berlin in the late Nineteenth century, and coming from the newly established city of Chicago he remarked how "new a city Berlin seemed". The guide went on to stress that there were always cranes active in Berlin, buildings being destroyed to give way to large avenue or simply new buildings, even artificial forests reconstituted after being felled for heat at the end of the war. His conclusion might well be the best advice for the insurance and reinsurance industry today: *"We Berliners are constantly reinventing our city!"*

Pr. Jean-Paul LOUISOT
Berlin, July 12, 2007