



INSURANCE

Getting the balance right

Long-term capital, risk and regulatory challenges for insurers

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FINANCIAL SERVICES



Foreword



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While the global insurance industry has been less impacted by the financial crisis, it is still facing the need to reconsider the cornerstones of its business. Capital and risk management have been challenged by volatile asset values and increasing regulatory intervention. This has resulted in an unprecedented need for the industry to refocus upon and find a balance between these key elements.

In conversations with our member firms' clients and colleagues around the world, it is clear that many institutions are now considering their strategic options as they adapt to the new landscape and increasingly regulated environment.

So when undertaking this second of a two-part global survey with the Economist Intelligence Unit, we decided to delve deeper into the themes discussed in *A glimmer of hope* – the predecessor to this report. The first report looked retrospectively at the key elements of capital and risk management and their impact on survival and growth post financial crisis. In this survey, we asked respondents of this survey to look to the future. To consider the challenges that the industry will face in the next few years - particularly capital management, the rising importance of the risk function, the increasing interdependency between these two disciplines, along with growing regulatory changes in and impact upon the industry.

As the title of this report suggests, *Getting the balance right* between these elements has become even more challenging post financial crisis and will remain a key focus for the industry. I would therefore urge you to read this timely report and, as always, my insurance colleagues and I would welcome the opportunity to discuss the key issues and conclusions as you adapt to today's challenging environment.

Acknowledgements

In June 2009, KPMG International launched *A glimmer of hope*, the first of a two-part global insurance survey series which it commissioned the Economist Intelligence Unit (EIU) to undertake on its behalf. This follow-up report analyzes the findings of the second survey undertaken in August 2009, examining how the financial crisis is changing the attitude of the global insurance industry to risk and capital management – highlighting some of the key issues that these institutions should address in response.

Our foremost thanks go to the 392 global respondents from 47 different countries who answered the survey questionnaire and the 8 executives who gave their time for interviews.

We would also like to thank members of the editorial board and our project team who have helped us carry out this research, as well as the EIU analyst team.

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Respondents by geography:

36%

Based in Asia Pacific

31%

Based in Europe

25%

Based in North America

8%

Based in the Middle East and Africa

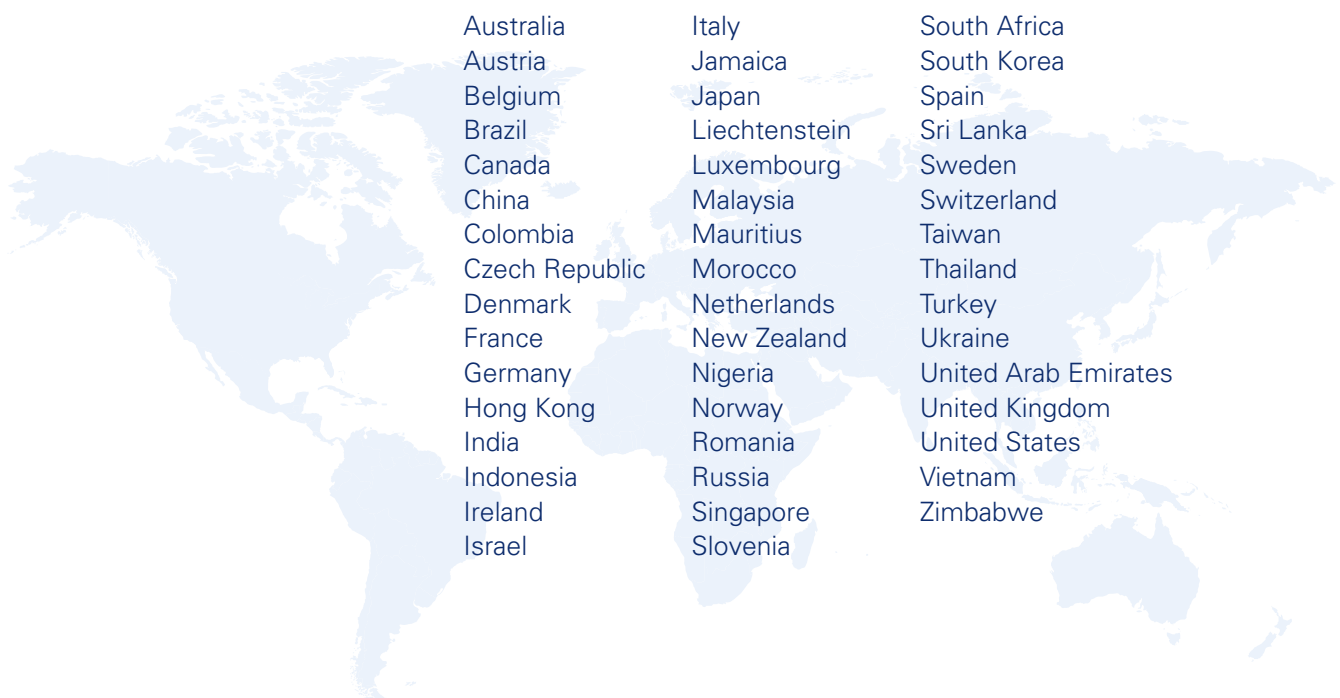
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About the survey

In August and September 2009, the Economist Intelligence Unit surveyed, on behalf of KPMG International, 392 senior executives from insurance companies around the world. The survey returned to the themes of risk and capital management reflected upon in *A glimmer of hope*¹, published in June 2009, which was the first of a two-phased global insurance thought leadership series. This second survey sought to gauge the industry's outlook around these themes, as well as their prospects around business performance, growth and regulation.

Respondents were spread globally, with 36 percent from Asia-Pacific, 31 percent from Europe, 25 percent from North America and 8 percent from the rest of the world. Approximately 65 percent of respondents represented businesses with annual revenues in excess of US\$500m. More than 60 percent of respondents were C-level or board-level executives, and the vast majority had responsibility for finance, risk or general management. Respondents were split among life insurance (46 percent), non-life insurance (47 percent) and reinsurance (7 percent) companies or divisions.

Survey respondents by country



1. *A glimmer of hope: Growth prospects in the global insurance industry and the escalation of risk and capital management*, KPMG International, June 2009.

Introduction

Respondents by sector:

46%

Life insurance

47%

Non-life insurance

7%

Reinsurance

Following the collapse of Lehman Brothers in September 2008, the ripples from the global financial crisis continue to be felt. Although there is marked variation across financial services, the insurance industry has weathered the storm relatively well – and certainly emerges from the crisis in a better shape than its close relatives, the banks.

There are numerous reasons why the insurance industry has fared relatively well: it typically has a longer-term, more conservative view of its business than banks; it has a longstanding history of managing risks; retains relatively strong balance sheets and, although there are notable exceptions, it has not strayed from its core business into more exotic, and risky, financial instruments.

While the industry should deservedly breathe a small sigh of relief, this is no time for complacency. The coming years will bring a whole host of challenges and problems. Core markets in developed countries are mature, if not saturated, while emerging markets, where there has historically been limited supply of insurance products, are likely to hold promise. Despite widespread consensus that consolidation is needed in the industry, merger and acquisition (M&A) activity is likely to be restrained as a result of a continuing dearth of capital, although again there will be exceptions to the rule.

But perhaps the biggest challenge that lies ahead will be regulatory change. In Europe insurers must consider the implementation of Solvency II, new rules governing capital adequacy, and also Market Consistent Embedded Value reporting.² The International Accounting Standards Board (IASB) has also published a discussion paper on accounting for insurance contracts (IFRS Phase II), which will move the valuation of insurance contracts to a more market-based assessment. All these regulations will impose costs on the business and could affect levels of capital and earnings volatility. But they could also bring substantial benefits to the business, if these organizations can find the necessary balance.

Insurers in North America are also bracing themselves for regulatory intervention, possibly spilling over from banks in some cases, but there remains considerable uncertainty over what form this will take. Meanwhile, rating agencies will continue to apply pressure on the industry, including their own requirements for solvency and risk management to maintain ratings.

² The concept of market consistency is that all assets and liabilities are measured in the same way that financial markets would measure assets and liabilities with similar cash flows. Many European insurers are now using market consistent economic capital models for strategic planning and resource allocation, although outside Europe this is less prevalent.

Executive summary

In general, insurers questioned for this research are reasonably confident about their company's ability to elevate risk information to board level and ensure that risk reports are relevant and appropriate for the intended audience.

Insurers point to capital as the biggest constraint on their growth prospects.

Most insurers have come through the financial crisis with reasonably strong reserves, but this does not prevent capital from being foremost in their minds when they consider possible constraints on growth. Regulatory intervention that could force insurers to hold more capital, such as Solvency II, is the number one concern, but survey respondents are also worried about the cost and availability of capital should they need to increase their buffers. Both life and non-life insurers share broadly similar concerns about this issue.

Insurers recognize that Solvency II, and similar legislation, will have a positive impact on financial stability and risk management.

Despite the recent controversy over the recommended parameters for Solvency II, respondents questioned for this survey broadly welcome the new capital regime. Just over six out of ten respondents think that the legislation will have a positive impact on their risk management, and a similar proportion expect benefits to their capital management. Interestingly a much smaller number of around one-third expect a positive impact on their profitability, perhaps reflecting concern that a higher cost of capital could push down margins.

Improvements to risk and capital management are not just about responding to regulation.

Although regulatory change is undoubtedly an issue that keeps senior insurance executives awake at night, it is not the only driver behind strengthening risk and capital management. When asked about the priorities for improving these areas, respondents point to better risk-based decision-making and improved allocation of capital as being their main areas of focus. Complying with regulatory change comes a long way down the priority list. This suggests that the primary reason to strengthen risk and capital management is to improve business performance, not just react to regulatory change.

Companies lack risk expertise, especially at the most senior level of the organization.

In general, insurers questioned for this research are reasonably confident about their company's ability to elevate risk information to board level and ensure that risk reports are relevant and appropriate for the intended audience. There are doubts, however, about the level of risk expertise at board level, which suggests that, while information about risk may be reaching the right people, the recipients lack the knowledge to respond to it, or provide the leadership that is necessary to instill a broader risk culture.

The twin drivers of regulatory change and internal pressure to improve business performance are encouraging companies to build stronger bridges between risk functions and other parts of the business.

Insurers recognize the need for better coordination between risk functions and other areas of the business.

The twin drivers of regulatory change and internal pressure to improve business performance are encouraging companies to build stronger bridges between risk functions and other parts of the business. Among the steps that insurers are taking to improve risk and capital management, the top three relate to improved coordination and collaboration. They want to build stronger links between the risk and finance function, increase the involvement of the risk function in strategic aspects of the business, and facilitate better conversations between risk and lines of business. These findings suggest a real appetite to embed risk management more deeply in their business.

Data is a key barrier to effective risk and capital management, but it is not an investment priority.

Insurers have long complained about the quality and availability of data, and forthcoming regulatory requirements will expose even greater shortcomings if nothing is done to address the problem. So far, however, insurers seem reluctant to invest in improving their data. Despite seeing data quality and availability as the biggest barrier to effective risk and capital management, it comes low down on the priority list for investment, behind process, technology, recruitment and training.

01

From October 2008, the global financial crisis swept through the economy leaving few industries or regions unaffected. Although the insurance industry did not play a central role in the crisis, it quickly became engulfed in the fall-out, with a serious effect on its business and finances. Premiums in 2008 fell in real terms for the first time since 1980 while investment income fell sharply as a result of a huge decline in global stock market values, and global downward pressure on interest rates. Shareholder capital dropped between 15 percent and 20 percent among non-life insurers; and between 30 percent and 40 percent among life insurers. Solvency is estimated to have declined among life insurers to levels last seen in 2002, while solvency ratios for non-life providers slipped back to 2004 levels.³

With the dust from the financial crisis slowly starting to settle, the situation is gradually improving after a very difficult period. Fortunately, many insurers went into the crisis with a strong capital position, helping them to withstand the storms that swept through financial markets. With stability starting to return to equity and bond markets, the industry has been able to rebuild its reserves. Unlike in the banking industry, few insurers have had to resort to recapitalizations, although there have been exceptions. Many in the industry, however, have sold assets and cut dividends to help restore them to financial health.

Despite this gradual improvement in insurers' capital position, some rating agencies remain unconvinced. In September 2009, Fitch Ratings reaffirmed its negative outlook for the industry, citing continuing uncertainties in the economy and capital markets. The fear is that, should the recovery in asset prices seen in mid-2009 prove to be temporary, insurers would need to turn to investors for capital, or in some cases, seek government support. Life insurers are particularly at risk because their performance is more closely correlated to capital markets than the non-life sector.

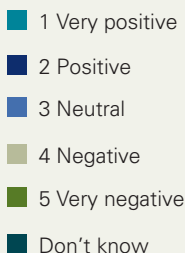
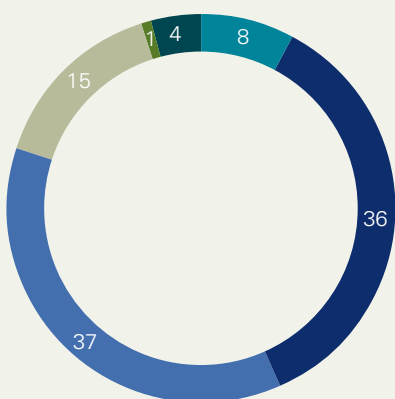
The outlook for capital

Most recent evidence points to a gradual recovery in financial markets, but this does not mean that insurers are out of the woods from a capital perspective. The risk appetite of investors is likely to remain constrained for a number of years, and in the event of a large number of insurers tapping shareholders for new capital, a reluctance to provide the necessary funds could quickly set in. In much the same way as their peers in the banking industry have done, insurers may need to look further afield for willing investors. In a recent interview with the Financial Times⁴, Tidjane Thiam, Chief Executive Elect of Prudential plc, indicated that his company may raise further capital from Asia, following a US\$750m hybrid capital issue in the region earlier this year. Others are likely to follow this lead, looking eastwards to sovereign wealth funds and other highly cash-rich investors in the Middle East and Asia. Another potential source of finance may be the private equity industry, which is likely to be on the hunt for bargains.

In general, the insurance executives questioned for this research are relatively downbeat about the outlook for their capital position. Asked to rate the outlook for their business across a number of measures,

Figure 1 – Prospects for capital position.

Looking ahead to 2012, how would you rate the prospects for your company's capital position?
(Please rate 1 to 5 where 1 is very positive and 5 is very negative)



Source: Economist Intelligence Unit survey, August 2009.

3. Swiss Re Sigma Research, November 2008.

4. "Interview with Tidjane Thiam", by Paul J Davies, *Financial Times*, September 10, 2009.

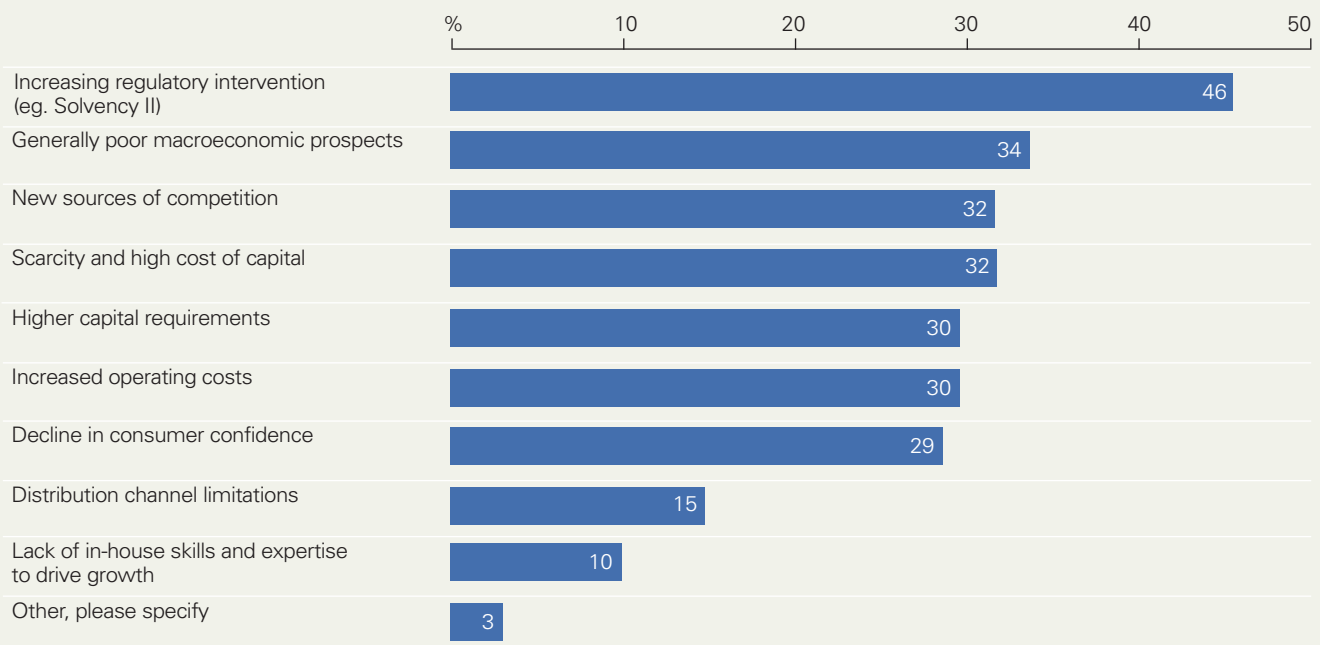
just 44 percent see their prospects for capital reserves as positive (Figure 1). And among the most significant barriers to future growth between now and 2012, three of the top six responses are directly related to capital, namely (Figure 2):

- increasing regulatory intervention (such as Solvency II)
- the scarcity and high cost of capital
- higher capital requirements

Respondents from Western Europe are particularly pessimistic, with just 36 percent viewing the outlook as positive.

Figure 2 – Barriers to growth and/or profitability.

Which of the following factors do you think are most likely to be barriers to growth and/or profitability in your business between now and 2012? (Please select up to three)



Source: Economist Intelligence Unit survey, August 2009.

KPMG Commentary

In uncertain times, capital is a critical commodity, to defend against threats and to take advantage of opportunities. In this environment, when capital is generally still pretty scarce, it is not surprising that the industry is increasing its focus on risk and capital management. A lot of the response is being labeled Solvency II, but our survey suggests that most companies see the need for this focus to ensure the business is run more effectively, in the future, with better decision making and more effective use of capital. KPMG's view is that the companies that embrace this change as a business imperative will be the real future market winners.

Case study 1

Responding to the crisis: Allstate Insurance Company⁵

Allstate cut its exposure to real-estate assets by about US\$2bn in the first half of 2009, from US\$16bn at the start of the year.

With no clear end in sight to the financial downturn, capital still tight and the threat of regulatory reform on the horizon, many US insurers are reassessing their strategies. “They’re asking themselves ‘what do we want to be?’”, says Julie Burke, Fitch’s Managing Director for the US market.

Allstate Insurance Company (Allstate) is one such example. Operating in all 50 states of the US, Allstate is parent to one of the largest US property and casualty insurers (it has significant presence in auto and homeowners’ insurance businesses), and also runs a large personal life insurance business.

While many insurers have suffered losses, Allstate’s investment mix made it particularly vulnerable, analysts say. It had heavier than average exposure to financial-sector investments, the commercial and residential mortgage markets and asset-backed securities, all of which have taken a beating in the current downturn.

Allstate’s capitalization was dented in 2008, and the company needed sizeable capital infusions to bolster its risk-based capital ratio, including the sale of some investments. By mid-2009, the capital position was notably better. In the second quarter alone, shareholders’ equity jumped US\$2.8bn from the first quarter, to US\$15.1bn. Allstate also reported US\$3.4bn in assets owned by its holding company, noting that it expected “modest” annual fixed charges of US\$680m over the coming year.

Robert Block, Vice-President of Investor Relations at Allstate, says that the company has acted on multiple fronts. One step was to increase its cash allocation. Another measure involved stress tests on various parts of its business, including an assessment of its large-scale catastrophe exposure and potential losses in its fixed-annuity business - should contract holders ask for early pay-outs (in a fortuitous move that is a step ahead of some competitors, the company had earlier sold off its variable-annuities business).

5. Interview for this survey - Robert Block, Vice-President of Investor Relations at Allstate, September 2009.

In addition, Allstate cut its exposure to real estate assets by about US\$2bn in the first half of 2009, from US\$16bn at the start of the year. “We worked to liquefy the system,” says Robert Block, adding that none of the sales were done in a ‘forced’ manner.

On the non-life side, Allstate has been affected by a general fall in new home and auto sales across the US. Meanwhile, among those customers with existing non-life coverage, the rate of churn on policies increased as the American public shopped around for better insurance rates. "People are trying to manage their personal liquidity," remarks Robert Block. Despite all this, he says, Allstate's combined underwriting margins stayed relatively consistent over the past six years or so, which he attributes to sound underwriting.

Another strategic move which analysts have acknowledged a prudent one was Allstate's decision to reduce its catastrophe risk exposure in storm-prone Florida. However, the company is not yet entirely in the clear on weather risk, Douglas Pawlowski, who covers Allstate's non-life business for Fitch Ratings, notes that the firm has suffered a series of weather-related losses recently (from Midwest storms, for instance).

The example of Allstate is symptomatic of what is happening more generally across the US industry. In a tough operating and regulatory environment, and with significant competition for growth and market share, the only way to succeed is to take a proactive approach to addressing the challenges that lie ahead.

While many insurers have suffered losses, Allstate's investment mix made it particularly vulnerable, analysts say. It had heavier than average exposure to financial-sector investments, the commercial and residential mortgage markets and asset-backed securities, all of which have taken a beating in the current downturn.

New rules for solvency

European insurers are undertaking a similar assessment of their strategic options like their US peers. However, this will be heavily influenced by the forthcoming Solvency II legislation, which was passed into law by the European Commission in April 2009, and which will be fully implemented across 27 member states in October 2012. Designed to match insurers' capital requirements more closely with the risks that they take, similar to Basel II, the capital framework for banks, Solvency II is built around three pillars:

- the first covers the calculations of minimum and solvency capital requirements
- the second sets out requirements around risk management and internal controls
- the third describes expected levels of transparency and disclosure

“Certainly, Solvency II is a cost burden but good regulation comes at a cost and it's in the industry's interest to accept that to avoid systemic failures or a loss of confidence among policy-holders”

Greg Carter
Managing Director for Insurance
in EMEA and Asia
Fitch Ratings

However, it is not the implementation date that causes consternation within the industry but instead the costs involved. According to the European Commission Solvency II Impact Assessment⁶, the cost for the industry will range between €2bn and €3bn. The rules will require insurers to build highly sophisticated internal models, which will be used to calculate their solvency requirements. Alternatively, they can use a standard formula, but few large institutions are likely to choose this option as they will probably face higher capital requirements. “Certainly, Solvency II is a cost burden but good regulation comes at a cost and it's in the industry's interest to accept that to avoid systemic failures or a loss of confidence among policyholders,” says Greg Carter, Managing Director for Insurance in EMEA and Asia at Fitch Ratings.

By ensuring a consistent approach to risk and capital management, it is hoped that Solvency II will bring substantial benefits to consumers and the industry alike. Insurers that take fewer risks are likely to be rewarded by having to hold less capital, which will mean that consumers should benefit from lower prices. “The concept of Solvency II is a sound one,” says Paul Barrett, Assistant Director for Financial Regulation at the Association of British Insurers (ABI). “With the right execution, it will be a very positive business tool for both the UK and Europe, that will help us to lead the way on a global basis.”

6. European Commission: “Executive Summary of the Impact Assessment Report accompanying Solvency II proposal,” July 2007.

KPMG Commentary

Implications for IFRS

Insurance contracts phase II is the second phase of the International Accounting Standards Board's (IASB) project to develop a common high quality standard for insurance contracts, under IFRS.

At the same time, these changes will align more closely with the measurement of available capital under Solvency II, providing a strong link between their capital models and the financial and risk metrics used in the business.

The new accounting model is likely to make significant use of current financial assumptions (such as for the discount rate) and will therefore, potentially lead to more variability in the measurement of insurance liabilities than some current accounting models. This approach aligns more closely with risk-based capital and solvency calculations, such as those proposed under Solvency II. It represents a shift away from an earnings-based approach to a balance sheet approach.

The IASB is concurrently proposing changes that would potentially require insurers to recognize more fair value gains and losses on investments in the income statement. These changes are proposed to be in place for 2012. In combination, these changes may pose a significant challenge for certain insurance companies that currently do not recognize unrealized gains and losses on their assets and liabilities in the income statement.

At the same time, these changes will align more closely with the measurement of available capital under Solvency II, providing a strong link between their capital models and the financial and risk metrics used in the business.

In general, insurers questioned for this research are reasonably confident about their company's ability to elevate risk information to board level and ensure that risk reports are relevant and appropriate for the intended audience.

Opposition and support for Solvency II

While the principles of Solvency II meet with general support in the industry, there still remains considerable uncertainty over how much capital insurers will be required to hold and the types of financial instruments that they can use. In July 2009, the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), a cross-border body of supervisors that advises the European Union on insurance regulation, published a series of consultation papers outlining their recommendations for the parameters of Solvency II. The papers created a storm of controversy, with a number of vocal opponents suggesting that the supervisors had adopted an excessively cautious stance to the quantity of capital that insurers should be required to hold, and the instruments that would be eligible.

In a letter to Alistair Darling MP, the UK Finance Minister, published in *The Times* in September 2009⁷ Stephen Haddrill, Director General of the ABI, suggested that the CEIOPS proposals would require the UK insurance industry to raise £50bn of extra capital – and would have a dramatic impact on savers' retirement income. "It is hard to see how such a massive recapitalization could be achieved," he wrote. The ABI is also concerned that the rules could restrict the use of certain financial instruments as capital. For example, many in the industry currently rely on hybrid capital as one source of reserves, but Solvency II could limit the use of hybrids, forcing insurers to hold equity instead. This would greatly shrink the pool of available investors, the ABI believes.

Paul Barrett (ABI) likens the current proposals to an automotive manufacturer producing a car with only safety in mind. "You could limit the car's top speed to 20mph and you could build it with huge crumple zones and make it 70ft long, but it would be totally impractical, hugely expensive and it wouldn't be economically efficient," he says. "Similarly, if you look at the losses that would arise out of the current proposals for Solvency II, it just doesn't make sense."

He adds that the highly cautious stance adopted by CEIOPS reflects concern among supervisors to prevent a further crisis. "Supervisors have been very scared by the collapses of banks. All they are worried about in a very narrow sense is they don't want to be blamed for anything else going wrong. They're therefore trying to push every button they can to reduce the risk of an institution failing."

7. "Insurers warn new rules may force them to raise £50bn," Catherine Boyle, *The Times*, London, September 2, 2009.

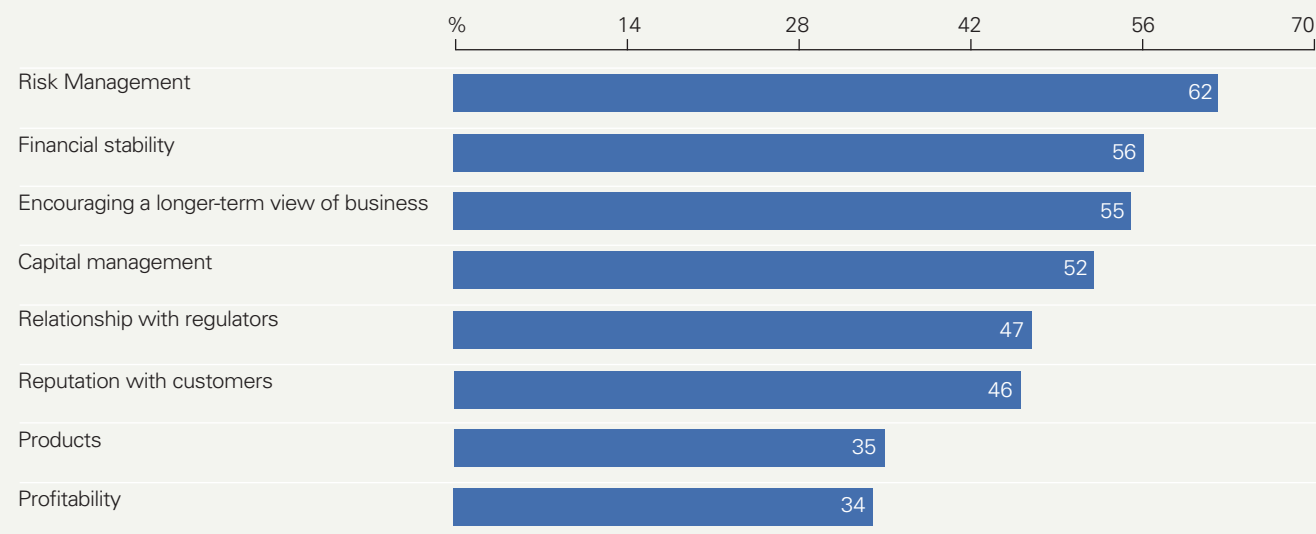
In addition to mandating levels of capital and the instruments used, Solvency II aims to improve overall discipline in risk and capital management, and standardize transparency and disclosure across the industry. Here, the majority of respondents questioned for our survey agree that Solvency II will have a positive impact. Just over six in ten say that it will be beneficial for their capital management, and a similar number see it as a positive development for their risk management. There is also strong agreement that it will prove to be a benefit for overall financial stability (Figure 3).

“Solvency II is a move from a rather simplistic ratio-based model to a risk-based system. That clearly has benefits of capturing more of the risks that companies face,” says Chris Waterman, a Managing Director in Insurance at Fitch Ratings. “Anything that will improve the transparency and management’s awareness of those risks and improve transparency as to how those risks are measured has got to be a helpful thing.” Respondents are less convinced, in figure 3, however, that the legislation will prove beneficial for products and profitability.

Figure 3 – Impact of new legislation.

What impact do you expect new legislation such as Solvency II or new economic guidelines to have on different areas of your business over the next three years?

(Please rate 1 to 5 where 1 is very positive and 5 is very negative - percent who say positive)



Source: Economist Intelligence Unit survey, August 2009.

There may be several reasons for this: first, they may assume that they will need to hold higher levels of capital, which could reduce their financial flexibility and push up costs in what is likely to remain a very soft market. Secondly, they may come to realize that products once considered profitable could in fact, turn out to have very low margins once their performance is subjected to more rigorous analysis.

Although Solvency II only affects European insurers, supervisors from other regions of the world are watching developments closely.

The international implications

Although Solvency II only affects European insurers, supervisors from other regions of the world are watching developments closely. "There's a great deal of work going on to create or maintain, as level a playing field as possible," says Greg Carter (Fitch Ratings). American state regulators are studying the legislation, although Greg Carter does not expect that they will follow closely the European route. He adds that there is a much greater desire in Asia to mirror the rules – both to attract capital from the EU market and to play in European or multinational business.

Over the coming months, regulators and the industry will be engaged in forthright discussions over the parameters of Solvency II. Eventually, it is likely that an equilibrium will be found that satisfies both parties as much as possible. "The more engagement and debate that happens at this time, the better," says Robert Lang, Head of Insurance for Europe at HSBC. "What we ultimately want as companies participating in this process, is certainty and clarity regarding what is going to be required and why, so that we can be prepared in time and achieve the objectives."

02



Strengthening risk and capital management

Forward-thinking insurers recognize that, by strengthening their risk and capital management, and improving coordination between the two functions, they can create improved performance across pricing, compensation and a whole host of other areas.

32%

of respondents say complying with regulatory change is a priority for improving risk and capital management

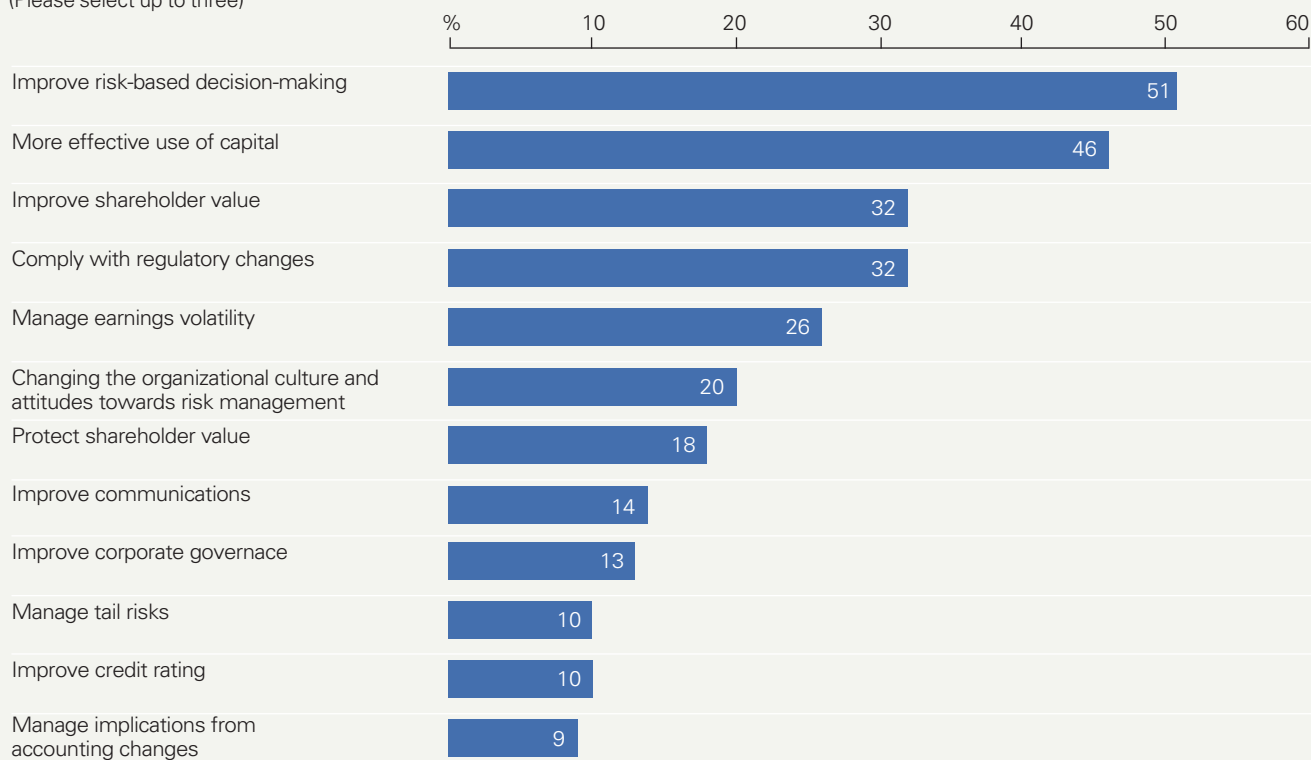
While regulators and rating agencies undoubtedly represent a powerful driver for improving risk and capital management around the world, internal drivers to step up business performance are also crucial. Forward-thinking insurers recognize that, by strengthening their risk and capital management, and improving coordination between the two functions, they can create improved performance across pricing, compensation and a whole host of other areas. “Solvency II will outline the path, but my company has the ambition to get ahead of the curve and adopt those principles sooner because they will lead to better risk management, better understanding of the business and better overall performance,” says Robert Lang (HSBC).

Respondents to this survey concur with that sentiment. When seeking to improve their risk and capital management, it is primarily the ‘pull’ of better business performance that drives them, not the ‘push’ of regulatory change. Asked about their priorities in this area, respondents point to improved risk-based decision-making and more effective use of capital as the main areas of focus (Figure 4). There is then a significant drop to compliance with regulatory change, which is cited by only 32 percent of respondents. This is encouraging, as it suggests that insurers are making these changes to improve their business rather than as a box-ticking response to regulatory intervention.

Regulation such as Solvency II, and the requirements of some rating agencies, is discouraging this box-ticking approach by asking insurers

Figure 4 – Priorities for improving risk and capital management.

Between now and 2012, which of the following do you expect to be your main priorities for improving risk and capital management? (Please select up to three)



Source: Economist Intelligence Unit survey, August 2009.

to demonstrate that they use internal models as part of their business practice. “If insurers are forced to use models in their business, the rationale of regulators is that they will have to think more carefully about them,” says Dr Andreas Tsanakas, Senior Lecturer in Actuarial Science at Cass Business School. “Management has to consider the models credible, if they are prepared to make decisions based on them.”

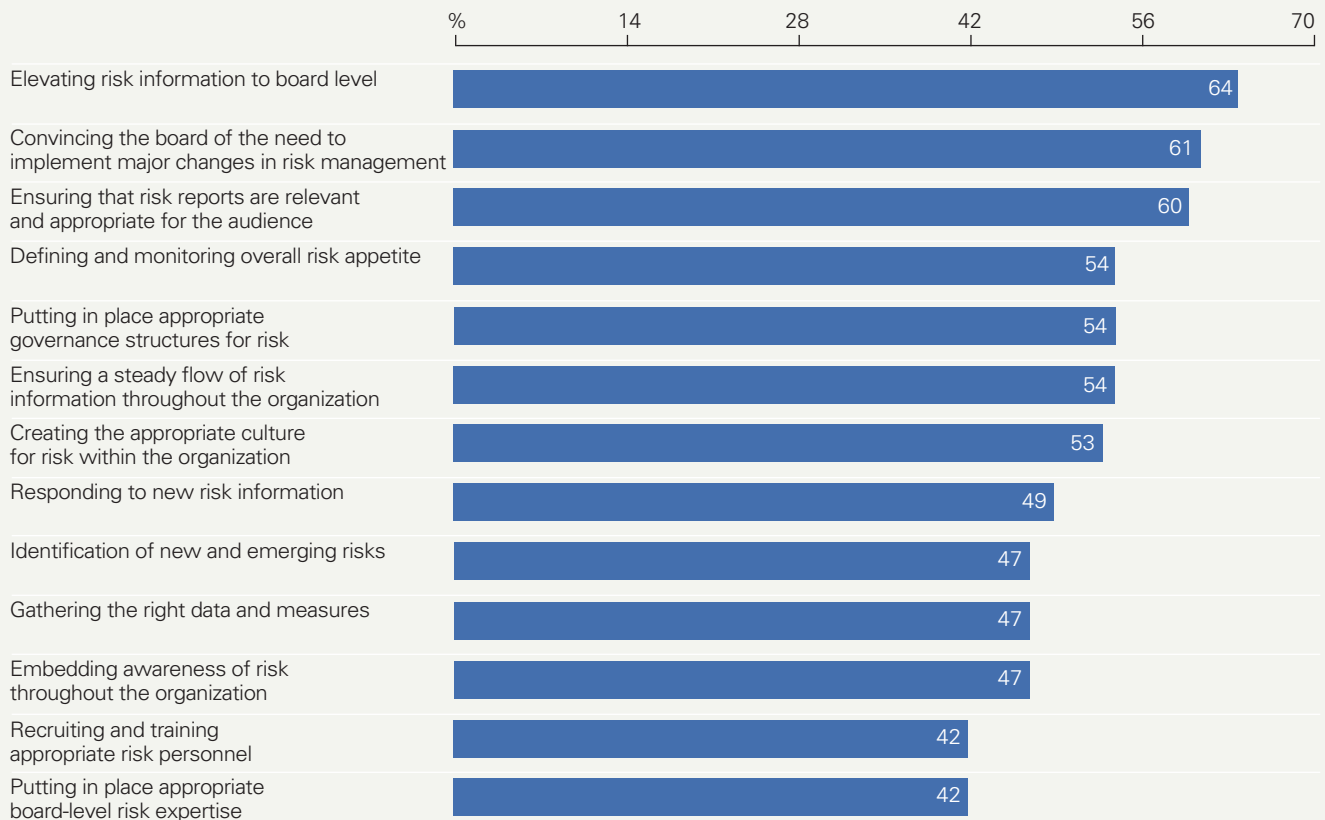
Risk expertise

However, this raises an important question about the level of expertise required to interpret complex models and make strategic business decisions based on this assessment. Some in the industry are concerned that, while the actuarial capabilities to create and update the models are in reasonably good supply, there may not be appropriate risk expertise at the top of insurance companies to make the best use of these important tools.

This survey reveals a perception that there may be gaps in the risk expertise of senior management. Just 42 percent of respondents think that their organization is effective at putting in place appropriate board-level expertise. Meanwhile, 37 percent of companies say that they intend to strengthen risk representation at board level in order to improve their management of risk. At a time when the industry is shifting to a much more model-based, statistical view of the business, there is clearly a need to focus on risk expertise at a senior level; some in the industry appear to be responding to that challenge.

Figure 5 – Effectiveness of risk and capital management.

How would you rate the current effectiveness of your organization in the following aspects of risk and capital management?
(Please rate 1 to 5 where 1 is very positive and 5 is very negative - percent who say effective)



Source: Economist Intelligence Unit survey, August 2009.

Another related concern is that insurers, particularly if they do not have the right expertise at the top of the organization, may come to over-rely on models and regard them as unquestionable.

67%

of respondents say their Chief Risk Officers (CRO) are board members

Communicating with the board

There is however, greater confidence in the framework by which information about risk reaches the board. Just over six out of ten think that their company is effective at elevating risk information to the board, and 60 percent rate themselves as effective at ensuring that risk reports are relevant and appropriate to their audience (Figure 5). But good processes for reporting to the board are insufficient on their own. Without the ability to interpret and act upon this information, boards are essentially operating in a vacuum.

Bart Patrick, Head of Insurance at SAS, the business intelligence software company, believes that the risk function has a vital role in making risk information palatable for the board. "It is the responsibility of the risk function to present this information in a way that the board can understand," he says. "Just giving the board a bunch of numbers on a spreadsheet is not helpful."

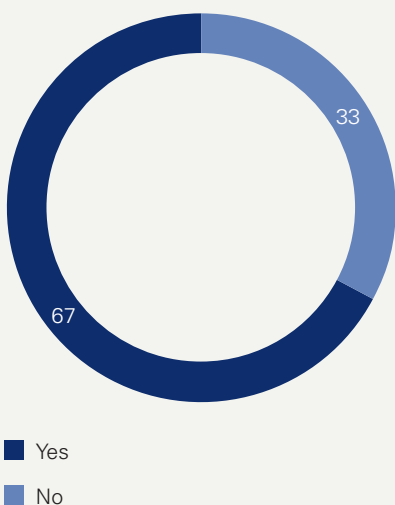
Another related concern is that insurers, particularly if they do not have a strong embedded risk management culture, including the right expertise at the top of the organization, may come to over-rely on models and regard them as unquestionably correct and universally applicable. "In such cases, you could say that the use of models may discourage dissent within corporations because a model viewed in this way represents a single basic narrative that affects the entire business," says Dr Andreas Tsanakas (Cass Business School). "The problem is that if you're wrong, you're wrong about everything."

Dr Andreas Tsanakas advises that any model should be complemented with rigorous stress testing and other sources of information. "Modeling won't give you all the answers but it's part of the process of thinking about risk in a structured way," he says. "It's an information tool for management, and they should combine it with other sources of information before they make strategic decisions."

Risk governance and the Chief Risk Officer

As a result of the financial crisis there has been a renewed focus on the importance of risk governance in financial institutions. There is now a clear consensus about the need for clear ownership of risk at the top of the organization. "When we go through the rating process, we're looking at where risks are owned within an organization," says Greg Carter (Fitch Ratings). "Often, you will find it's not the Chief Risk Officer but a specific board member who is given ownership of a particular risk. Either way, that ownership needs to be at a very senior level."

Figure 6 – Is your Chief Risk Officer (or equivalent) a board member?



Source: Economist Intelligence Unit survey, August 2009.

In the wake of the financial crisis, there have been growing calls for financial institutions to put in place a risk committee to provide oversight and advice to the board on risk management. In July 2009, for example, the Walker Review on Corporate Governance in the UK recommended the establishment of board-level independent risk committees, separate from the audit committee, that should report on risk positions and participate in enterprise-wide risk management oversight.¹⁰ Some commentators have expressed concern, however, about the availability of suitably qualified non-executives to fill risk committees.

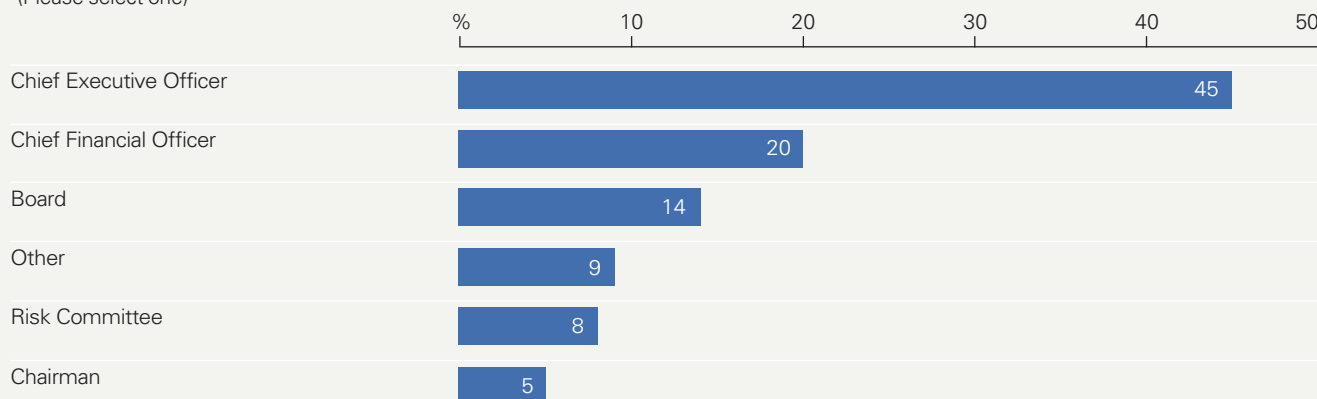
Another key recommendation of the Walker Review, and indeed from the vast majority of corporate governance experts worldwide, is the establishment of an independent Chief Risk Officer (CRO) position that reports to the board. The CRO role which first emerged in the banking industry and has since become equally prevalent in insurance, is becoming an increasingly prominent member of the executive team. “Given the regulatory focus on risk management, the CRO is clearly a very important role,” says Greg Carter (Fitch Ratings). “The issue for the risk officer is to be as independent as possible and not to be a line function within a business unit that has commercial pressures on that role.”

Among our survey respondents, the CRO is a board position at two-thirds of companies (Figure 6). He or she reports to the Chief Executive Officer at 45 percent of companies and to the Chief Financial Officer at 20 percent of companies. The fact that, at the majority of companies, the CRO either sits on or reports to the board is an encouraging finding, and is a clear indication that the role has become well established (Figure 7). “Speaking as a Chief Executive, I would always foresee a CRO as my direct report and that person would always be a key contributor to the daily running of my business and its strategic considerations,” says Robert Lang (HSBC).

10. HM Treasury consultation document, London, UK, July 16, 2009.

Figure 7 – To whom does the Chief Risk Officer (or equivalent) in your organization report?

(Please select one)



Source: Economist Intelligence Unit survey, August 2009.

KPMG Commentary

We are seeing an increasing trend in the Chief Financial Risk Officer (CFRO) function on the board being split into a CFO and a CRO function. The risk function is therefore becoming a recognized full seat on the board. This trend is driven by an increasing awareness of the importance and an appreciation of the risk function, as well as a recognition of it having to be balanced against other functions at the highest level in the insurance organization. Our survey results support this trend, with almost half of the respondents' CRO's reporting to the CEO.

The need for coherent data

The emphasis of Solvency II on models is posing a series of important challenges for many insurers around data. Increasingly they recognize the need for significant investment to improve their data capabilities, and to ensure that their data are reliable and up to date.

While the cost and complexity of data may be off-putting, it is inadvisable for insurers to shy away from making the necessary investments.

Respondents clearly recognize this as a problem. When asked about the most significant barriers to effective risk and capital management, respondents point to data quality and availability as the most serious issue. And yet, asked about their main priorities for investment in risk and capital management, data comes a long way down the list after process, technology, training and recruitment. How can this anomaly be explained? One reason may be the sheer cost of investing in accurate data, while another may be the complexity of the undertaking. Many insurers have hundreds, if not thousands of legacy systems which make it very difficult to extract the data they need and present it in a consistent format.

Keeping data relevant is also a challenge. "Let's say you're a non-life insurer, with exposure to damage caused by hurricanes. You may then find that, because of climate change, the potential damage has increased dramatically and a lot of your past data are becoming less relevant," says Dr Andreas Tsanakas (Cass Business School). Similar problems will affect a life insurer, given the enormous uncertainties around longevity trends. Again, past experience is not a reliable guide to the future.

While the cost and complexity of data may be off-putting, it is inadvisable for insurers to shy away from making the necessary investments. "It all starts from the data," says Bart Patrick (SAS). "If insurers are to use these models in their business as the regulators will expect them to, they need to get this right as a fundamental priority."

KPMG Commentary

IT challenges for insurance companies

The preparation for integrated finance and risk reporting and economic capital reporting, generally calls for large investments in new technology and modifications of existing systems. Insurers are faced by tight delivery deadlines, budgetary constraints and an already overloaded IT agenda. This means they generally opt to invest their IT budget in add-on reporting environments and dedicated finance and risk tools, without changing the existing operational legacy systems.

The real challenge for insurers lies in the data from the many legacy systems.

Typically, in order to meet the increasing demand for fast information, timelines have been stretched and processing power increased. This ad-hoc strategy is unlikely to be sufficient to satisfy the much more stringent Solvency II requirements. Furthermore, increasingly complex actuarial models and faster close cycles require an exponentially increasing amount of processing power, driving the need for innovative estimation techniques such as replicating portfolios to address the risk and capital management challenges of the future.

The real challenge for insurers lies in the data from the many legacy systems. They often sit at the very heart of their finance and risk administration, containing client information, insurance policies, historic loss data, general ledgers, etc. The set of available 'off the shelf' software packages for the insurance industry to replace these legacy systems is still relatively small, and the cost and risk of replacement is significant. Many companies are looking at solutions that enable them to extract from and manage data outside these core systems.

Regardless of which IT strategy is followed, insurers would be wise to consider these strategic options from an integral point of view, so they are not only able to serve their current information needs, but also new finance, risk and capital reporting requirements, such as Solvency II and IFRS II.

Coordination and culture

Clear ownership and leadership of risk is essential in order to embed a broader culture of risk in the organization. So too is the need to ensure that there is clear communication and coordination between the various risk functions. Solvency II and IFRS Phase II emphasize the need for closer collaboration between risk management, capital management, the finance function and performance management than may have been the case in the past.

Bart Patrick (SAS) emphasizes the importance of good communication between the risk function and finance function, particularly in terms of the way that information is reported to the board. “There is a tie in between risk capital calculation and financial management,” he continues. “If you bring those two things together it is easier to make it understandable to the board. They can look across business lines and immediately see what the revenues are, what this risk exposure is, and the amount of risk capital that is required.” He cautions however, that there is some way to go before the required coordination between risk and finance is in place. “There is huge variation across the industry, but I would say that this remains a pretty steep learning curve.”

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Bart Patrick
Head of Insurance
SAS

KPMG Commentary

Finance and risk

Creating an integrated reporting framework is one of the key challenges for insurers. Such a framework should contain the common policies and standards for the processes, systems, tasks and responsibilities for providing both financial and risk information to all of the insurers' stakeholders. The demand for an improved framework comes from both internal and external stakeholders often receiving inconsistent messages from the risk and finance departments.

An 'Integrated Reporting Framework' program requiring significant investments over an extended period of time, must first understand the finance and risk systems in the long run.

Delivering seamlessly integrated financial and non-financial information through a traditional silo structure of overloaded reporting functions, inflexible processes and legacy systems can be challenging and ineffective. However, the benefit of a fully integrated reporting framework, is more consistent, reliable and enables timely messages to stakeholders. This in turn offers additional perspectives on the insurer's current and future performance and risk metrics.

Developing a comprehensive transformation program to deliver an integrated reporting environment, is a challenge for many insurers. As pragmatic IT solutions (e.g. stand-alone data portals) make way for more robustly integrated IT architectures (e.g. one common data warehouse solution for multiple applications), insurers are running into numerous implementation challenges: properly allocating complex data management tasks and controls between the different functions; and assigning clear responsibilities for data quality. Furthermore, the deeply routed language and cultural barriers between the finance and risk functions often prove difficult to break down as well.

Before embarking on a large transformation program, it is important to first consider all the stakeholder requirements and expectations, to understand the wider impact it can have on the organization. An 'Integrated Reporting Framework' program requiring significant investments over an extended period of time, must first understand the finance and risk systems in the long run. Taking small steps in clearly defined implementation phases will help keep the focus on the expected benefits while containing the implementation risks to a minimum.

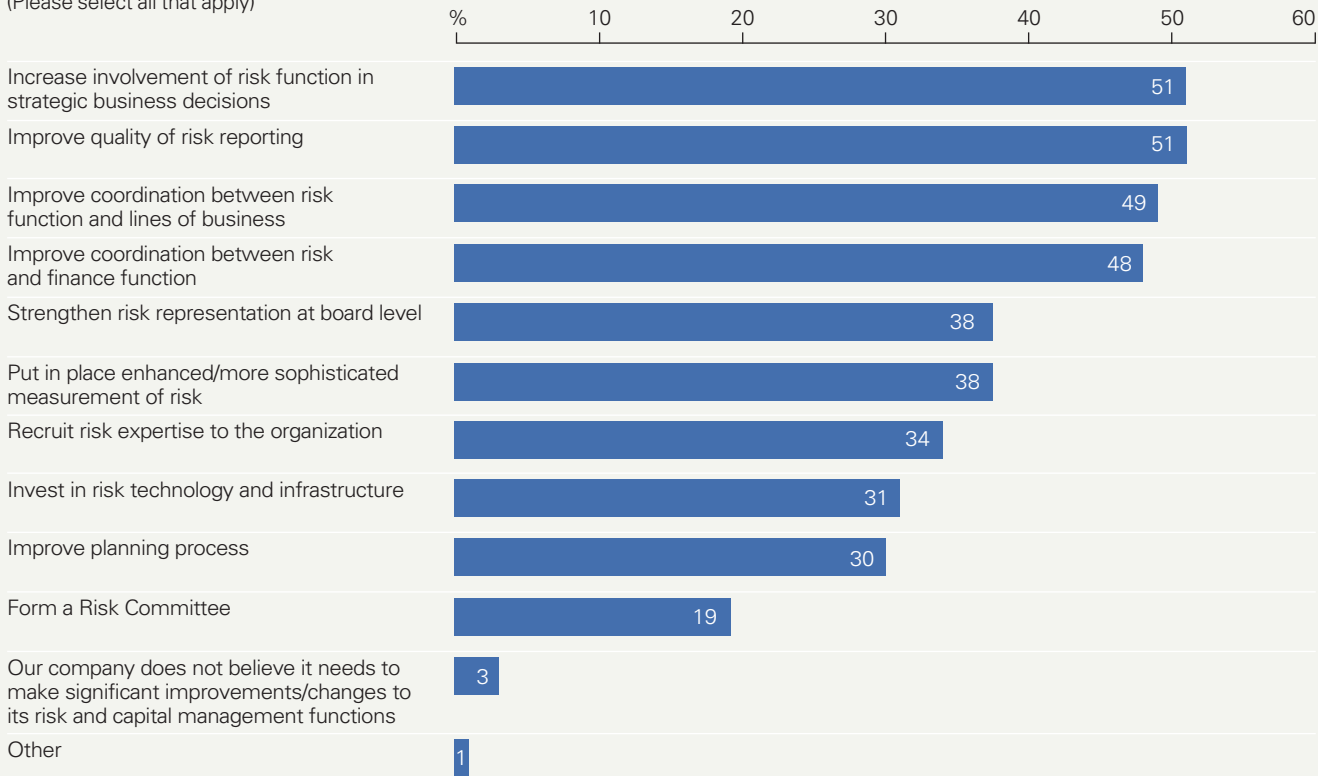
49%

of respondents seek to improve communication between risk and the lines of business

It is clear from the survey that this kind of coordination is something that does not come naturally to many insurers. Only half of respondents say that they are effective at creating an appropriate culture of risk in the organization, and 47 percent say that they are effective at embedding it. When asked about the steps they intended to take to improve risk and capital management, coordination between risk and other areas of the business figures prominently (**Figure 8**). For example, 48 percent say that they hope to improve coordination between risk and the finance function, and 49 percent seeks to improve communication between risk and the lines of business.

Figure 8 – Steps to improve risk management.

Between now and 2012, which of the following steps does your company expect to take to improve its management of risk?
(Please select all that apply)



Source: Economist Intelligence Unit survey, August 2009.

Good risk management, like any other function or discipline in the organization, depends on good overall management.

The fact that these issues are on executives' minds suggests that there is some way to go before these lines of communication are optimized. Part of the issue could be territorial, with professionals from each discipline worried about losing responsibility for certain activities. But there are also likely to be cultural differences, with each function using different methods and terminology. In simple terms, this means that there is no 'single version of the truth' and that boards may well receive reports that are inconsistent and based on different calculations.

There are, however, encouraging signs of a risk culture becoming more deeply embedded in many organizations. Dr Andreas Tsanakas (Cass Business School) cites as an example the increasingly widespread use of more technical statistical language in risk practitioners' day-to-day conversations. "People are becoming more trained in the language and concepts of statistics," he says. "For example, today you hear Finance Directors and Risk practitioners talking about concepts such as tail dependence and tail correlation, and I don't think you would have done three years ago. These terms enter the consciousness of the market and I do think there is a benefit to that."

The organizational challenges facing insurers as they seek to strengthen risk and capital management raises an important point. Good risk management, like any other function or discipline in the organization, depends on good overall management. "Some of the core problems in risk management are organizational, not behavioral or technical," says Dr Andreas Tsanakas (Cass Business School). "A lot of it is about improving management structures and infusing risk culture in the organization. It's challenging but that's what it's all about."

KPMG Commentary

Ultimately, we believe the issue for insurers is effective and sustainable implementation of risk and capital management, against a background where there is a perceived gap around two of the fundamental elements, skilled resources and data. Solvency II should help in this regard because it cannot be ignored, and will effectively force boards to commit the funds to address these issues properly. Provided the regulators listen to the industry, and arrive at a solution which is economically viable, there is a real chance that regulators and management will find their interests aligned around a solution that at the same time protects the consumer and adds shareholder value.

Conclusion

Risk and capital management functions in insurers are facing significant challenges. Executives in these disciplines must deal with the financial crisis and its fall-out, which have pushed concerns about risk to the forefront and caused available capital to ebb away. They must confront a wave of regulation designed to match capital more closely to risks and increase consistency of financial reporting to find the right balance. And perhaps most importantly, they face continual demands from management and shareholders for improved performance in a highly competitive environment.

Huge management challenges lie ahead. The implementation of new regulation will require significant investments in data, technology, infrastructure and people. There remains uncertainty over the potential impact of new rules on earnings volatility and required capital reserves. Governance must be strengthened to ensure rigorous oversight and questioning of management's risk assumptions. And major organizational barriers must be eroded in order to ensure that risk and capital management share a common purpose and are fully embedded in the organization.

But as executives have been reminded time and again during the current crisis, every challenge has its opportunities. Forthcoming regulation, such as Solvency II and IFRS Phase II, may be costly and a headache to implement but, provided agreement can be reached on required capital levels and eligible instruments, it should enable insurers to strengthen risk and capital management and set the standard for transparency and disclosure. In an environment where growth is likely to be constrained for some years, this is an opportunity that is too good to miss.

KPMG Thought leadership



A glimmer of hope:

Risk and capital management in insurance, June 2009

This initial survey report is the first of a two-part series produced by KPMG International in cooperation with the Economist Intelligence Unit. It examines how the financial crisis is changing the attitude of the global insurance industry to risk and capital management, highlighting some key issues including preventing further losses and positioning their businesses for future growth. The survey's findings reflect the sentiment of the 315 senior insurance executives across 49 countries who answered the survey.



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