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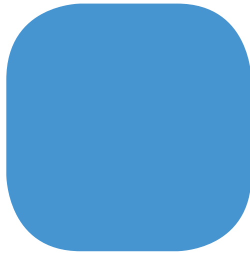

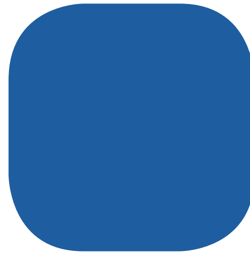
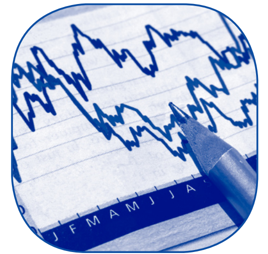

Eight key messages on the financial turmoil

November 2008

About the CEA

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies, the national insurance associations, the CEA represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. The CEA, which is based in Brussels, represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 122bn, employ one million people and invest more than €7 200bn in the economy.

Introduction

The financial crisis that originated in the US banking sector in the second half of 2007 has spread to the global economy and has had a significant impact not only on the financial sector but on the economy as a whole. This paper sets out eight key messages on the global financial crisis as it relates to the European insurance market.

The European insurance industry entered the crisis in a strong position and has shown resilience to the continuing shocks to the financial system.

Overall, European insurers have not taken significant exposure to credit risks and as a consequence have not been directly affected by the credit crunch that was at the root of the current financial crisis. However, as some of the largest institutional investors, they have suffered from the dramatic writedowns on financial assets. The insurance industry could also be adversely affected by group contagion effects, by an increase in monoline claims and directors and officers liability claims, and by a fall in the sale of insurance products due to the economic slowdown.

On average, the exposure of insurers to credit risk embedded in structured products is limited. Insurers have not been significantly affected by the related losses, with the notable exception of bond and mortgage insurers that have insured the possible loss of capital and/or interest of many securities and that are affected by a significant rise in credit defaults. In addition, the operating model of a typical insurance company means that insurers are not as exposed to liquidity risk as other financial services providers.

However, insurers are generally affected by the mark-to-market losses of their financial assets, both from low equity values in the current depressed market and from a dramatic widening of credit and liquidity spread. Nevertheless, the investment strategy of insurers has proved to be sound and, overall, the losses suffered by European insurance companies have been manageable.

As they are often part of a larger financial group, insurance companies may also be affected by problems that originate in other arms of their group. They may be required to cover the liquidity shortages or losses of other entities in the group and could face damage to their reputation.

Directors and officers (D&O) and errors & omissions (E&O) insurance lines are likely to be affected by a rise in claims, as investigations into corporate responsibility develop in the framework of the sub-prime crisis.

The business model of the insurance industry differs substantially from that of other financial services providers.

The specific characteristics of the insurance business model and the management of assets and liabilities by insurers have protected the insurance industry from the worst impacts of the financial turmoil.

The principal aim of insurers when investing in assets is to cover their commitments to policyholders. Their asset allocation is driven by the objective of matching the expected liability cash flows in terms of amount, timing and risk. Insurers therefore generally invest in products with well defined cash flows and risk profiles and largely limit the risk profile of their investments so that it is in line with their commitments to policyholders. The primary aim of insurers' investment activity is therefore to cover liabilities with appropriate and well diversified assets. The fact that insurers do not use leverage to enhance their investment returns means that they are less exposed to fluctuations in financial markets.

In contrast to other financial services providers, insurers are also characterised by the inversion of their cost/revenue cycles. In financial terms this means that insurers are primarily funded by policyholders' premiums, making them less exposed to liquidity risk and to any problems accessing credit markets. Indeed, the insurance industry could also be said to have had a stabilising effect on the financial markets as a result of its anti-cyclical investment behavior.

Solvency II will ensure insurers and supervisors have better tools to resist financial crises.

Moving to an economic risk-based solvency regime, Solvency II, will enhance risk management in insurance companies, improve their capital allocation and strengthen their ability to resist crises such as the current one. The new supervisory system will provide supervisors with the mechanisms to detect at an early stage any threats to insurers' ability to fulfill their obligations to policyholders. In light of the current financial turmoil, it is vital that there are no delays to the implementation of Solvency II.

The Solvency II regime is a three-pillar structure that defines financial, risk management and disclosure requirements using an economic risk-based approach. This means that the type and intensity of requirements and supervisory interventions are calibrated according to the true risk profile of each company and that sound internal risk management is promoted.

Pillar I will introduce a transparent valuation of assets and liabilities and define capital requirements which will explicitly reflect their inherent volatility under a predefined risk tolerance measurement. This standard method as well as internal methods to determine capital requirement will take into account all reasonably quantifiable risks. This approach, besides being a precondition for proportionate and progressive supervisory interventions, will give insurers a better understanding of the risks they bear. Furthermore, by recognising both risk mitigation (such as reinsurance, hedging, securitisation, profit sharing) and diversification effects, Solvency II provides an incentive to companies to optimise their risk management strategy.

Pillar II will require insurance companies to have in place a comprehensive risk management framework. This forms part of the Own Risk and Solvency Assessment (ORSA) that will require companies to have appropriate processes for identifying, assessing and managing their risks in a coherent framework at all levels within their organisation. In addition, Pillar II will provide supervisors with forward-looking supervisory tools and processes. The expectation is that supervisors will be able to detect any threat earlier and insurers will strengthen their ability to resist potential financial crises.

Pillar III aims to enhance disclosure requirements, creating more transparent, timely and reliable information about companies' financial situations and risks. This will trigger market discipline and provide an additional incentive for the implementation of sound risk management practices.

The financial turmoil demonstrates the need for appropriate supervision of financial institutions at group level.

Each group should have appropriate supervision comparable to that at company level. This supervision should be able to identify the consolidated exposure of the group and assess its risk profile in line with its economic reality.

The financial environment is constituted of financial groups, so supervisory and regulatory frameworks should reflect that reality. The problems encountered by several groups demonstrate the need for both risk management and supervision at group level, rather than piecemeal at company level, and support the need to include economic-based group supervision in the new Solvency II regime. Group supervision provides a tool for gaining a comprehensive understanding of the risk-profile of a group and addressing risk concentration. Appropriate group supervision also encourages enhanced risk and capital management in the whole group, facilitating the optimal allocation of capital between legal entities. As a consequence, it complements supervision at "solo" level by improving the protection of policyholders of all the legal entities of the group.

Risk management should be developed and strengthened in all financial institutions.

A risk management system capable of understanding, measuring and managing risk appropriately is crucial in any financial institution. Also vital is a clear definition of the institution's risk approach and the close integration and empowerment of risk managers in day-to-day operations so that they have the channels and authority to voice warnings on risk-taking activities that are not in line with the risk appetite of the institution.

The unfolding of the current crisis shows that in many cases risk managers had difficulty making their voices heard, even in institutions with sophisticated risk management structures. The benign economic and financial conditions that have prevailed for an unprecedented period and increasing complacency in the perception of risk at a commercial level made it difficult for risk managers to make a case for imposing risk discipline. The alignment of the incentive structure (bonuses) between operational lines and top management needs to be rebalanced through the ex-ante definition of risk appetite and risk limits on which risk managers have a direct reporting line to the board of directors.

The market-consistent valuation of assets should remain the principle that underpins financial information and prudential oversight. At the same time, it is important to avoid pro-cyclicality in accounting and prudential rules.

Market-consistent valuation promotes transparency and market discipline and ensures the accurate pricing of risks embedded in assets and liabilities. The current liquidity crunch should not be used as a reason to abandon this approach to measurement.

Mark-to-market valuation is efficient and promotes transparency and market discipline. In the light of the current crisis, it has been argued that this is true as long as the market is deep and liquid but that it can cause concern when there is a sudden drop or distress in the market. However, the crisis should not be used as a reason to abandon market-consistent valuation. When there is a lack of liquidity and depth in the relevant market, enhanced mark-to-model valuation techniques represent the best alternative for both assets and liabilities, as these techniques are based on analysis of the amount, timing and uncertainty of future cash flows. Efforts must be made to improve the use and effectiveness of these techniques. While preserving market-consistent valuation, it is important that prudential rules address the effects of pro-cyclicality in order to prevent the forced selling of assets at low prices.

If supported by appropriate disclosure, a market-consistent approach remains by far the most transparent and coherent way to show the key information about a company in financial statements.

The current market turmoil should not lead to undue constraints on insurance-linked securitisation.

Securitisation in financial services has undoubtedly played a role in spreading the financial turmoil. However, securities issued by the insurance sector differ significantly from those issued by other financial services providers due to the type of risk transferred and to the well defined and transparent environment in which insurance-linked securitisation (ILS) takes place.

Securitisation in the insurance sector allows insurers to cede insurance-related risks (eg natural or man-made catastrophes, embedded value of life portfolios) to the capital markets. ILS allows insurers to diversify their sources of protection, reduce their counterparty risk and reduce their cost of capital. ILS also offers investors the opportunity to diversify into uncorrelated, anti-cyclical risks that improve their capital/risk profile and that offer relatively high returns.

ILS differs from bank securitisation in the type of risk transferred, since the underlying risks are typically not financial (eg exchange or interest rate, credit, price) but are related to the likelihood of non-financial events. Insurance-linked securities generally also benefit from more rigorous risk-transfer tests than bank securitisations. ILS is only a risk-mitigating tool and does not prevent losses or claims from appearing, but ILS has so far withstood the financial crisis.

Better information disclosure about complex products is essential.

In order to restore confidence in complex securities and structured products, it is essential to provide investors with adequate information about the ultimate risks associated with them.

Structured products are complex products that include a variety of underlying assets and counterparties in a multilateral deal. Full transparency of the ultimate risks associated with all the components of these products, including their embedded leverage, is the only way to enable the investor to make an informed investment choice and to restore the confidence of the market after the current financial turmoil. The information provided not only needs to be complete but also understandable and concise. Appropriate harmonisation of product terminology and characteristics, as well as the enhancement of the transparency of related transactions, is crucial.

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