Insurance industry and crisis: *future prospects*

On the occasion of the traditional New Year's annual meeting, held at the Cologne Chocolate Museum, which brings together customers, brokers and various German institutions and associations, Professor Fred Wagner from Leipzig University presented the following lecture on the Sovereign Debt Crisis and Insurance.

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The insurance industry is in a transition and it is in times of change. Crisis has become the norm. German insurers are dealing permanently with crisis and their consequences since 2001. Their business model has proven to be robust, beginning with the stock exchange crisis, the banking crisis until the sovereign debt crisis. The latter – with its low interest rates, a sharp rise in volatility of the investment markets and the negative rating environment – has proven to be the most aggressive challenge to the insurance industry yet, even though the most recent European Insurance and Occupational Pensions Authority (EIOPA) financial stability report shows slight signs of relief. Apart from the life insurance, premiums and profitability have stabilized. Nevertheless, a declining level of solvency and liquidity are distinct warning signs.

ILLUSTRATION STOCK

Background and causes of the crisis

Let me briefly look at the causes of the current crisis. In the public debate in Germany, the terms «sovereign debt crisis», «debt crisis», «euro crisis», «banking crisis» and «financial crisis» are being used. Most often the terms «debt», «financial» and «euro crisis» occur. They show the broad scope of the problem, and yet they are very unspecific at the same time. The fact is: Europe's crisis is as of today less a sovereign debt crisis as a regulative one. For the apparent deficits in the balances of the Member States, no fiscal union had been agreed upon, in which the stronger members support the weaker ones, automatically. In the common destiny of a single currency however, the tried and true recipe of currency devaluations in times of declining competitiveness of a Member State is no longer an option which can be used.

Moreover a toxic cocktail has developed from the massive deregulation of the financial markets, their almost complete digitalization and interconnectedness, quantitative easing and the actual rising government debt ratio: This cocktail will keep us busy as a society, but particularly the insurance industry for years.

Government debt as a deep social problem

Behind this development over the past ten to fifteen years, however, lies a deeper social problem: Germany recorded, for example, 1.6 trillion euros in debt taken in between the years 1950 and 2008. Almost as much interest – 1.5 trillion euros – has been paid in the same period for this debt. Short-term liquidity profits have thus created long-term problems. Now, Germany has of course a special responsibility to finance the Reunification. Nevertheless sovereign debts do not incur accidently:

- They arise because citizens require higher or – during times of structural changes – undue benefits of their state and want, at the best case, to reduce their tax rate.

- They arise because politicians – aiming for the next election – delay necessary structural adjustments and do not promulgate unpopular truths. Since the 1970s, for example, the problems that come up now in the field of the pension provisions for us, have been foreseeable.

Trust and customer

But what does the just described mean for the individual? Through the necessary fiscal consolidation, the efficiency of the state is reduced and there is a lack of social resources to finance the pensions. So you could find the presumption that a higher demand for private pension products exists. In theory the endowment products – those which build up capital – in particular should be booming.

We all know: that is not the case.

This shows: The insurance industry is much less free from this crisis as we would like to believe. During the crisis, customers have become more sceptical. They are being certainly more informed with the help of the Internet – but not necessarily better informed. They are more price-sensitive, more willing to change, more uncertain. They are looking for security, but want to maintain flexibility at the same time.

THE INSURANCE INDUSTRY COULD AND SHOULD MORE ACTIVELY CHAIR THE DEBATES ABOUT HOW WE MAKE PROVISIONS FOR OUR PENSIONS, HOW WE ADAPT TO GLOBAL CHANGES AND TO THE STRUCTURAL BREAKS

The just described pressure towards consolidation, the change in life circumstances and the significant uncertainty, this all requires a broad social «Rethinking». Here lies an opportunity for the insurance industry. As one of the most important intermediaries for our society, our industry could and should – regardless of the politics of the day – more actively chair the debates about how we make provisions for our pensions, how we adapt to global changes and to the structural breaks. Here is the chance to build lost confidence.

2013: A European year of transition

Overall, we will probably in 2013 end on a fairway that we feel as downright quiet after the turmoil of recent years. The combination of the ESM (European Stability Mechanism) and the bond purchase program of the ECB (European Central Bank) should calm the markets (initially). European governments are now required to develop future-proof mechanisms for European economic and fiscal integration, implement the necessary reforms of national structures and to reduce the public debt ratios.

How stable the current European financial architecture is judged by the markets, will show itself soon at the example of Spain and Cyprus. Certainly of interest is also the outcome of the Italian elections. Here Europe's third largest economic power after Germany and France elects it´s new government. It will be interesting to know the development of the political situation in Italy and whether the Italian reform zeal is waning. The reaction of the financial markets can be imagined. Surely not only Italian government bonds, but also the bonds of all European countries in crisis would be affected. Insurers with high engagement particularly in Spain and Italy have to face a reduction in their credit ratings and thus reduced competitiveness.

Solvency II

Of direct interest to the insurance industry are the advances in Solvency II. As you know, the Commission has postponed the launch also because of the on-going crisis. Meanwhile, it must be emanated from a step-by-step-introduction between 2014 and 2017.

The results of the recent Quantitative Impact Studies are – according to the current schedule – to be expected in spring, and they will demonstrate whether the current rules are really suitable to represent the individual risk situation of the individual companies, accurately and assessable. Still critical are the models for the development of the interest rates. In particular, the capital buffer for the long-term guarantees of life- and health insurers are in focus. According to current proposals, the risk capital requirement varies radically depending on short-term interest rates, and they assign the risk and investment managers with great challenges.

Viewing the sovereign debt problems, it must be stated that the planned regulation sets disincentives by favouring government bonds at the risk capitalization. Major asset classes such as Corporate Bonds, Covered Bonds, Real Estate and Stock Company Shares will be, also by comparison, «more expensive» and therefore less attractive. If you look at the role of the insurance industry as a long-term, stabilizing capital provider for the overall economy, this is difficult to understand.

2013: A transitional year also nationally

Also nationally – this means for us here in Germany – we are going to experience a transitional year in 2013 – a year of the federal election traditionally lacks the tranquillity for wide legislative initiatives. Instead we will be dealing during the election campaign – in addition to the national debt and the future organization of the banking system – with other important issues directly related to the insurance industry. These include the demographic development and the reorganization in the areas of pensions and long-term care, as well as climate change.

Economically all experts start with the assumption of only a slight growth in Germany in 2013. The already 2012 experienced restrained approach of German industry and services, due to the sovereign debt crisis, will certainly continue in 2013.

Significance sovereign debt crisis for capital management

In front of the outlined background, the challenges for capital managers are growing. The easy money policy, which is useful – if not necessary – for the banks, but also for the indebted states, is difficult for insurers. Viewing the guaranteed interests, especially in the personal insurance the challenges are particularly great. Recent analysis and the example of Japan show, that life insurers are likely being able to cope with low interest rates for decades, but it generates unsatisfactory results for their equity investors.

In addition, the high level of volatility, the widening of credit spreads (Euro periphery countries, bank debts) and systemic risks put the asset management to the test. Additionally, the (exaggerated) rating pressure on government bonds and all downstream asset classes continues and the markets are pricing significantly lower ratings in some cases.

Many, especially (South) European, placements can therefore not be considered any more. Surely

the diversification benefits for standard systems are not yet fully exploited, but their modelling remains difficult. As consequence of this investment emergency, new asset classes (such as infrastructure, renewable energy and power grids) and new issuers (especially from the emerging markets) must be found and they must be integrated. However, this significantly increases the complexity both organization wise and capacity wise, in particular also in the mapping of the models.

Leeway in actuarial practice

But if the capital market is weakening in the foreseeable future as yield bringers due to the crisis, it means nothing other than that the insurance practice once more comes into the focus of earnings. This field holds options for action and opportunities for individual insurers.

If we look at the insurance industry as a whole, the effort must be directed towards the product design (keyword: decreased guarantees), the product mix of new business (keyword: lower risk capital absorption by disability insurance, investment funds-linked products), the risk assessment in underwriting, the costs and – where possible – the prices. Own capital resources can be strengthened, for example, through a reduction of the participation in current-profits, through retained earnings and by means of hybrid capital.

2012: A landmark year for the insurance industry

If you look, especially in the field of industrial insurance, just back at 2012 and forward to the upcoming time, it can be stated: There is movement in your market.

There are several signs of change. Now the outspoken plans of Swiss Re, to act as a primary industrial insurer, show once more: competition is picking up. The race for lucrative new areas of growth has begun. The internationalization is increasing, as is the long scolded willingness for innovation. Not at least, the soft cycle approaches it's end – at least in some areas.

The overdue increases in premiums for company car fleets were the first in a round of price hikes for the entire market. A more selective selection of customers in the liability and property insurance market hints at a hardening of settings.

Insurance industry: Competition and internationalization

Let us briefly remain at the plans of the Reinsurers. Their request for new segments is understandable in the context of the crisis and the slower growth of the Reinsurance market compared to the direct insurance market. But the lead of the established industrial insurers in the areas of customer and broker relationship, in the structures for issuing and managing policies, in the field of international insurance programs as well as in the claims handling will not be caught up overnight.

THERE ARE SIGNS OF CHANGE IN THE INDUSTRIAL INSURANCE MARKET. THE INTERNATIONALIZATION IS INCREASING, AS IS THE LONG SCOLDED WILLINGNESS FOR INNOVATION

The relative independence of MAPFRE from unaffiliated reinsurers is an important competitive factor[1].

Also, the direct insurers will give themselves a run for the money in the next phase. We are surely all aware of ACE´s announcement, to become significantly more active in Germany. At the same time, we are experiencing how for example HDI-Gerling and Allianz increasingly turn to emerging markets. In this context, it is also especially relevant for your company how the new competitors in Latin America perform and how they put pressure on MAPFRE as the market leader over there[2].

Industrial Insurance: Innovation

In a market with more competition and with a market interest rate that is not sufficient to compensate for inflation or for losses in the actuarial result, speed, innovation and new growth areas are the key words that promise future success.

The accusation, that the industrial insurance in its entirety is not enough innovative, is certainly

beside the point – but it has a core of truth. If you think about it, it is very quickly becoming clear: Innovation in the industrial insurance is more evolutionary than revolutionary. By an individual adjustment of the coverage clauses, step-by-step-responses to new customer requirements and changing risk landscape new covers are being developed.

But it is also clear: It is complex, often not only in the dialogue, but in the trialogue between customers, direct insurers and reinsurance companies, to build up risk transfer to new areas. Especially when

- There is no loss history
- Great casualties and catastrophic risks are threatening

MORE INVESTMENT IN KNOW-HOW AND RESEARCH ON THE INSURERS' SIDE ARE SURELY A KEY TO SUCCESS, TO EXPAND THE BOUNDARIES OF INSURABILITY

[1] Cf. Moody's (10/2012): Credit Opinion: MAPFRE GLOBAL RISKS, p. 4.

[2] Cf. Engelhardt, R. (2012): MAPFRE stärkt Marktführerschaft in Zentralamerika, in: Versicherungswirtschaft, no. 15 (Aug.), 2012.

- Direct- and Re-Insurers are increasingly competing with each other
- Global linkages become more and more complex

More investments in know-how and research on the insurers' side are surely a key to success, to expand the boundaries of insurability. Among other reasons, this explains that insurers now increasingly offer policies to protect against intangible risks, such as violations of intellectual property rights, hackers, loss of use, or violation of privacy laws.

End

Maybe we do have to deal also with an «expectations» problem. Everyone has probably experienced by himself during everyday life: The computerization and globalization has greatly accelerated our life. That is also the reality of our customers. Processes, which a decade ago were still very lengthy run, start today at your fingertips. This trend changes people's expectations. Everything must be readily available, if possible.

This expectation does not stop at insurers. You will have to endure this apparent anachronism. And you should act fast – maybe faster than a few years ago. But insurers also do well keep the long-term value for the customers and partners, which insurance even – or especially – provides through their deliberateness.

With acceleration and deceleration, we have two navigation triggers, which can both be success factors if they are used with the view to the target and with the view towards differentiation. Times of change such as the present, lend themselves to examine our own positions and to find new ones, prove best practices and to discover new things.

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