



Position Paper

Insurers Learn Lessons from Credit Crisis

5 February 2009



Colophon

The Dutch Association of Insurers (*Verbond van Verzekeraars*) uses position papers to express its views, policies and arguments on concrete issues and current developments on the cutting edge of politics, society and the insurance industry.

Readers are authorised to use (parts of) the text of the position paper, provided the source is mentioned.

This position paper is also available on the website of the Dutch Association of Insurers (*Verbond van Verzekeraars*): www.verzekeraars.nl via the button, 'Publicaties/Downloads/Position papers'.

More detailed information on the content of this position paper, 'Insurers Learn Lessons from the Credit Crisis' is available from:

Mr M.N.J. Heeneman / P.J.A.H. Koopman

telephone: 070 - 333 86 93 / 070 - 3338698

email: m.heeneman@verzekeraars.nl / p.koopman@verzekeraars.nl

This is a publication of the
Verbond van Verzekeraars
Bordewijklaan 2
PO Box 93450
2509 AL The Hague

The credit crisis has dealt a heavy blow to the Dutch financial sector. The government has thus far managed successfully to guarantee the stability of the financial system with the use of instruments such as credit guarantees, support measures, takeovers of American mortgage loan portfolios and, in a single instance, nationalisation. All that notwithstanding, the storm showed no signs of offering a lull by the beginning of 2009. The shrinking credit markets and falling demand have thrown local economies in several countries into a recession. The stock exchange figures for the bank and insurance sectors are under ongoing pressure and the pension funds have stood by helplessly as their financial buffers evaporated into thin air. This has resulted in grave uncertainties in the indexing of many pension schemes. An extremely favourable solvability position (see Figure 13 BCG) at the start of the crisis has partly ensured that the security the insurance sector offers consumers, remains as yet uncompromised. According to a survey conducted by the *Centrum voor Verzekeringsstatistiek* (Centre for Insurance Statistics) (Figure 1), the consumer has not yet lost faith in the solidity of the insurers. The crisis has however had a major impact on the insurance sector. It is very hard, at this stage, to accurately predict future developments, especially in view of current interest rate developments. Given all of the above, the insurers believe it is their responsibility to draw a number of important lessons from the crisis. The foremost wish is the desire to render the sector more resistant to future financial shocks.

The *Verbond van Verzekeraars* (Dutch Association of Insurers) has formulated a number of recommendations for signalling risks that could culminate in crises in market situations, for supervision, for risk management in the financial institutions, and for guarantees of solid capital positions in the operating entities (*werkmaatschappijen*). The credit crisis demands a thorough review of the relationship between return and risk. Looking back, it is now clear that, in striving for higher returns, not enough adequate attention was paid to the underlying risks over the entire value chain. This explains why the bankruptcy of Icesave could cause such havoc, and why the exposure of the financial sector, including the insurers, to complex credit derivatives turned out to be rather irresponsible in certain instances.

The purpose of this position paper is to contribute to the discussion on the future of the financial system by proposing a number of concrete recommendations. To that end, the authors made use of, among other things, the expertise of the Boston Consulting Group (BCG). BCG has conducted an analysis to determine how the financial crisis actually affects the insurance sector, the role that the sector itself played in the crisis, and the measures that could be implemented to render the sector more resilient in the future. The survey is included as an attachment to this document. The *Verbond van Verzekeraars* shares the analysis and recommendations and will use the insights gained from the report as basic principles in the current political discussions at both national and European level.

Characteristics of insurance

It is important, at the outset, to recognise a number of characteristic differences between the various financial sectors in the Dutch economic system. This means that the lessons that the insurers will learn from the credit crisis will not necessarily be identical to the conclusions that may be drawn by the banks and pension funds.

The difference between the operations of the insurers and the banks is mainly characterised by the fact that insurers enter into long-term obligations through life and pension insurance policies, and consequently must ensure that they have at all times adequate capital coverage. Partially based on the high solvability requirements, life and non-life insurers tend to pursue rather conservative investment policies. If the solvability buffer of any given insurer proves to be inadequate, it is to be expected that the supervisors takes the necessary steps to protect the interests of the policy holders.

In the case of the banking sector, faltering confidence in the stock markets could easily transfer to the bank's customers. Rapidly falling stock exchange prices could, as in the case of Fortis, even result in a bank run, which could quickly lead to liquidity problems for the applicable bank. This is not a realistic scenario for insurers: after all, insurers do not have cash machines.

It is partially thanks to the fact that insurers are not exposed to sudden liquidity problems that there is no need for a deposit guarantee system for this sector. Whereas the government provides a safety net for banks and small savers in the case of a financial collapse, the guarantee system for the insurers

resides in the high solvability buffers and the very nature of the industry. That notwithstanding, there is no denying that the insurers are heavily affected by the credit crisis as well.

There are also significant differences between pension funds and insurers. Pension funds have 'buttons to push' whenever a compelling situation arises: they can decide not to index, charge the customer a higher premium or even reduce the benefits. For those reasons, pension funds are authorised to invest greater capital amounts in high-risk assets, such as equity shares. Insurers, on the other hand, have contractual obligations towards their clients and therefore need to provide higher levels of security. An example of this is the fact that, once a pension scheme has been linked to an index, the insurer will be bound to fulfil the related obligations.

Recommendations

The core business of the insurance company is and remains the provision of financial security in a society that is stricken with high risks. As in the case of most other players in the financial sector, the credit crisis is also a completely new experience for the insurers. It has unfortunately transpired that the economic models that have thus far been used to predict economic shocks have failed in this case. The 'perfect storm' that we are currently witnessing and that also triggered the corrosion in the value of equity, bonds, real estate, raw materials, and interest rate levels, has confronted governments, as well as all the different financial sectors with a major challenge. The havoc wreaked to the real economy is substantial. The central task ahead is to implement effective measures that will not only render the sector more crisis-resistant, but also ensure that future financial crises will unleash less catastrophic consequences.

When developing its view on the credit crisis, the *Verbond van Verzekeraars* made use of, among other things, the expertise of the Boston Consulting Group (BCG). BCG has issued four recommendations, all of which have been adopted and are presented by the industry in order to contribute to the social discussion about the credit crisis.

1) *More focus on 'bubble management'*

Almost every grave financial crisis in human history was preceded by an economic 'bubble'; a period of powerful growth and high returns. For that reason, it is essential to implement measures, both before and during the emergence of the bubble, to prevent it from 'bursting'. This could be done by, for example, creating more robust financial buffers or by hedging the prevalent risks. The 'bubble' phenomenon is evident wherever the subsidiaries of a company are undergoing rapid growth and are generating extremely high returns. In many instances this is a sign that a risk has not been identified and assessed (correctly). Vigilance with regard to that aspect, and not only with respect to poorly faring subsidiaries – as is currently mostly the case – is therefore imperative. Where necessary, the accounting principles need to be adapted to enable more crisis-resistant asset management in the sector.

2) *Supervision: Intervention where needed*

The supervising authority (DNB) should not only issue warnings when signalling escalating risk scenarios, but should also be in a position to implement active intervention measures for the entire sector. Even where the rules of the game have been spelt out clearly in advance, it is still important for the referee to be able to intervene at all times to secure fair play. After all, it is rarely possible for individual players to display behaviour that deviates strongly from the behaviour of their competitors, as this could put them in an unfavourable competitive position. It is important these intervention measures are done in a coordinated fashion and at international level; which would demand improved mutual harmonisation of the European supervisors and the associated legal intervention authorisations. The Association definitely supports a (more coherent) European approach to the issue of supervision; however, this must always be linked to national implementation and authorisation. There are more than 400 insurers in the Netherlands that are embedded in national legislation and surrounded by national stakeholders. This demands a very high level of knowledge of the local situation.

3) *More focus on risk management*

Risk management must be secured more tightly in the governance structure of the enterprise as such. The Executive Board must be charged with collective responsibility for risk management. The General Management of the company must be more aware than is the case today of the balance between risk and return. To that end, the risk models that are currently being used should become more transparent, more easily explained and, if possible, also simpler. All current risk models should be 'retro-tested' for feasibility. More attention should be given to the kinds of risks that are not inherent in the models with the use of scenario analysis instruments. The complicating factor in all this is the fact that the current developments were indeed incorporated in most of the existing risk models; however only in the form of an event that occurs once every 150 years. It is undoubtedly hard to manage that type of theoretical risk; that notwithstanding, it is important for those types of scenarios to be assigned a role in the company's long-term strategies.

4) *Guaranteed capital positions for Dutch operating entities (werkmaatschappijen)*

The same principle used in the shipping industry, namely the use of risk-reducing compartmentalisation, should also be applied to contain the risks inherent in capital management. For example, it is important in that regard for local subsidiaries to remain independently capitalised in order to increase the overall financial resilience of the insurance sector as a whole. Obviously, additional capital could also be invested in the areas within the group where the most value is generated.

Conclusion

The credit crisis also asks for critical reassessment of a number of 'adjoining' areas, such as supervision, accountancy standards, reward systems and possible market disruptions caused by government intervention. The *Verbond van Verzekeraars* has the following views with respect to the aforementioned issues:

- *Supervision*

The European Commission has set up a new framework for the supervision of the insurance sector titled Solvency II, which the sector believes should be implemented without delay. Solvency II bases supervision more on the concept of 'exposure to risk' and therefore offers more security and a more intelligent system than the old regime. Solvency II also entails the consolidation of the supervision of groups operating in more than one country. In addition, it is also desirable for DNB to increase the depth and frequency of its reports.

Furthermore, the sector would also have to determine whether it is possible to gather more or better management information from the members of the Association on, for example, investments. This can be done by the *Centrum voor Verzekeringsstatistiek*.

- *Accountancy standards, IFRS*

The international accountancy standards (IFRS), as compiled by the International Accounting Standards Board, are aimed at creating greater uniformity, transparency and harmonisation in financial reporting. The regulations apply to the assessment of the investor's assets as well as liabilities. The discussion about the influence of the IFRS on the financial crisis is focused on the assessment of the assets at current market value. This assessment method provides a sound overview of the assets and obligations at any given time, but could reinforce a rising and falling economic cycle. If all market values should fall dramatically at the same time, this phenomenon could also seriously compromise solvability. It could force insurers to sell high-risk assets in a relatively illiquid market environment and thereby further consolidate the corrosion. In other words: assessment in a dried-up market could act as an accelerator of the crisis precisely when the market is direly in need of a brake on the system. The same problem arises in the assessment of obligations that are influenced by fluctuations in long-term interest rates. The Association believes it is absolutely essential to bear these undesirable effects in mind in the framework of the application of the principle of assessment at current market value. According to the IFRS it is not currently permissible to build up buffers during good times to use during bad times. These issues

demand international consultation between the supervisors, the regulators (IASB) and the insurance sector.

- *Remuneration policy*

Although, in the view of BCG, the Dutch remuneration policy played a subservient role in the credit crisis, the insurance sector, in dialogue with DNB, will scrutinise the reward policy and test its effect on the stability and solidity of the sector. In addition, the Association also wishes to remove all possible conflicts of interest in the distribution of financial products. The latter aspect is covered in new legislation that came into effect on 1 January 2009.

- *Rating agencies*

The crisis also demands reflection on the role and influence of rating agencies. As is well known by now, excessive valuations were assigned to an extensive number of complex financial products (such as CDOs), because not all the risks were discounted in the ratings. Once the actual values were revealed, the holders of complex financial products were forced to write off substantial amounts of capital. Effectively there was absolutely no supervision of the operation of the rating agencies. That vacuum must be filled as soon as possible through the extension of the field of operation and powers of the supervising authorities.

- *Transparency*

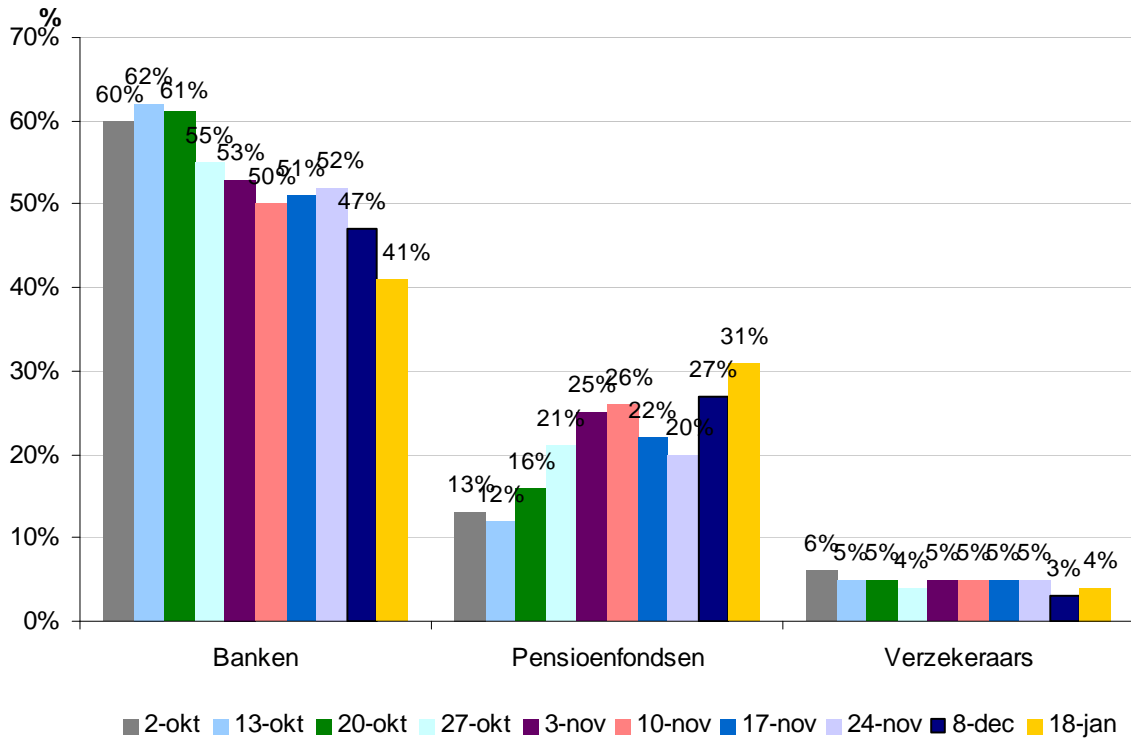
Insurers must pay more attention, in their contacts with their clients, to the relationship between the risks and returns inherent in the purchased product. In addition, it is also desirable for the client to obtain more insight in the risk profile of the provider. The developments in the field of unit linked life insurance have revealed that transparency must be the guiding principle in the communication with the customer. It is important for the consumer to be well informed and advised and to be able to understand the nature of the products he is purchasing. This is the reason why the De Ruiter models and so called product guides were introduced and why turnover and sales related remunerations (e.g. bonuses) were eliminated for pension and unit linked life insurance. Further improvements are being implemented when possible, thereby consulting consumer organisations. It is however important to keep in mind that security and guarantees always come at a price.

- *Level playing field*

Although, for the time being, no one is under the impression that the government interventions have resulted in market disruptions, it is nevertheless extremely important for DNB, AFM and the NMa to continue to keep a critical eye on related developments and to ensure that the (hopefully) rapid reduction of government participation is effected in a proper manner.

The insurance sector wishes to present these recommendations to contribute to the public debate on a future financial system in which the concepts of sustainability, balance, solidity and transparency assume central roles.

Figure 1. "Which financials were hit the hardest by the credit crisis"



[FIGURE 1]: Banks, Pension Funds, Insurers, Oct, Nov, Dec, Jan)

Figure 13 from BGC

