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With the benefit of hindsight

Achieving effective risk management is the overriding goal, post-credit crunch

One year on from the collapse of Lehman Brothers, Insurance Agenda lists the key risk management lessons from the financial crisis:

Risk management needs to be given greater authority and attention
Corporate risk management has been the subject of significant reappraisal given the near collapse of the financial system. The overriding view is that risk managers lack influence in the companies in which they operate. During the boom times, it was too easy for traders to lean on the risk department and get their approval where it shouldn't have been given. Non-executives, the ultimate risk managers, were also incapable of applying the brakes. The UK government's Walker Review proposed measures to address these failures, including beefing up the role of non-execs and boosting the independence and ability of risk managers to challenge the board. It remains to be seen if they will enforce these requirements with sufficient vigour.

Incentives should reward long-term stability, not short-term profit
Sadly, greed was the hallmark of the great banking crisis of 2008. One of the main lessons is that financial incentives are perhaps the biggest factor in determining human behaviour. It wasn't just the money-hungry traders that led the financial system off the edge of a cliff; thousands of fraudsters, large and small, proliferated in a system that rewarded far too heavily short-term financial success. Regulators have proposed action to ensure remuneration policies discourage excessive risk taking. Legislation has not had much success at curbing human behaviour in the past. Investors, shareholders and taxpayers will all be hoping that in the future it might.

Don't believe everything the models say
Risk models were widely used by the financial sector but proved completely inadequate at signalling or averting imminent disaster, through a combination of bad risk management and inaccurate reading of the models. Also, most models were based on historical data that was incompatible with developments in the modern financial system and the phenomenon of systemic risk. The principal lesson here is not to rely too heavily on mathematical models. Institutions should pay more attention to the data that populates risk models and combine this with human judgment. Regulators are also much more eager for financial firms to use stress testing and scenario planning in their response to dramatic events.

Build reserves in the good times to draw upon during the bad
The amount of capital that banks held as a buffer between their assets and liabilities was at the heart of the crisis. Banks weren't holding enough, so when it came to the crunch, taxpayers were forced to pump trillions into the system to prevent it from imploding. US and UK policymakers are leading the way in calling for banks to adopt counter-cyclical capital buffers that are built up in the good economic times so that they can be drawn on during the bad times. Many other firms, including insurance companies, plan to build bigger financial buffers over the next year.

Final thought
As the financial sector seeks to rebuild its reputation and regain trust among investors and regulators, the balance of power needs to shift back towards risk management. If risk managers can arm themselves with the appropriate levels of authority, clear visibility into their businesses, and the ear of senior management, they will become an integral part of any future recovery.
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Key points

- Risk managers need to be given greater influence and authority within their companies to challenge risky proposals
- Regulators are aiming to modify human behaviour by proposing that companies' financial incentives don't encourage excessive risk taking
- Institutions should mix risk modelling with human judgment, to enable better detection and aversion of disaster
- Financial institutions should adopt counter-cyclical buffers: capital reserves that can be drawn on during difficult times

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Laying down the law

Insurance lobbyists have their work cut out with the latest round of legislative proposals

It's that time of year again. As politicians gather in Brighton and Manchester for their annual party conferences, and the next session of parliament gets underway, insurance lobbyists are gearing up to get their voice heard. On key issues, from flooding to liabilities, there is much work to be done before the next election. Whoever wins, the ABI along with other trade bodies and the major insurers will be keen to get their ear. Here are five of the top issues currently occupying their minds:

1) The draft Flood and Water Management Bill is currently passing through the legislative process. It includes measures for a more co-ordinated approach to flooding, with clear responsibilities for the many public authorities, plus an enhanced role for the Environment Agency. The ABI has given its backing to the bill, and it and all the major insurers are pushing for the bill to be passed before the end of this parliament.

2) The Equalities Bill has just passed committee stage in the House of Commons. Insurers are particularly concerned about clause 190, which raises the possibility that insurers will be prevented from using age as a factor in assessing risk. There is also a concern that insurers will be required to publish the data they use to calculate premiums, which they claim would be anti-competitive. The ABI is lobbying to win insurers exemption from this bill.

3) The wrangling over pleural plaques continues unabated. The Scottish parliament has passed an act overturning the House of Lords judgment that made pleural plaques uncompensatable. Four insurers are currently seeking a judicial review of this legislation. Meanwhile, there is pressure from trade unions and campaign groups to introduce a similar bill in Westminster, which is being vigorously opposed by the insurance industry.

4) The government will publish the Financial Services and Business Bill when parliament resumes. The bill comes on the back of the July white paper, 'Reforming Financial Markets'. Key proposals are expected to include an enhanced role for the FSA and the continuation of the tripartite regulatory system. The ABI and individual insurers will be lobbying to ensure that insurers are not subject to the more stringent regulation now required by the banks.

5) In Europe, discussions continue over the Solvency II directive. While the UK insurance industry has broadly signed up to the direction of the new legislation, there is some disagreement over its implementation. The ABI believes European regulators have taken an unnecessarily conservative approach to implementing the directive in the consultation papers released over the summer, and are lobbying both the UK government and the European authorities to have this reversed. The arguments centre on the degree of capital reserves required.

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Key points

- The draft Flood and Water Management Bill seeks to create a more co-ordinated approach to managing flooding
- Age discrimination, as outlined in the forthcoming Equalities Bill, remains a key concern for insurers
- The issue of compensating pleural plaques continues to be vigorously debated by insurers and campaigners
- Insurers are lobbying to ensure they are treated differently to banks in the new Financial Services and Business Bill
- Solvency II continues to be a hot topic for the industry

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➔ Solvency II will injure European insurers, ABI warns Darling, 3 September 2009

➔ Government delays ruling on pleural plaques compensation, 23 July 2009

➔ ABI sets out its own plans for flood management, 7 July 2009

➔ New bill allows age risk assessments 30 April 2009

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Demonstrating value

Insurance firms should work with their clients to promote the benefits of risk management

As companies seek to slash costs, risk management has come under the spotlight. In the first quarter of 2009, 1,311 companies were placed into administration in the UK. Airmic, the UK risk management association, said that its membership has shrunk by 3% over the past 12 months. Some top executives wonder what a risk manager does all day. And when belts are being tightened, many believe the role could be consolidated or eliminated altogether.

To avoid the chop, risk managers need to take every opportunity to show that they are indispensable, so that companies do not see them as a luxury they can do without. Brokers and underwriters may be able to help risk managers demonstrate how they add value in some areas, such as avoiding losses, saving premiums and extending coverage. But there are other areas where risk managers will be on their own, and they will have to show initiative.

Successful insurance managers can deliver big savings for their companies. This is generally well understood. Lockton International asked a sample of underwriters if a risk management function within a company could favourably influence insurance prices; 83% agreed that it could.

But given the current climate, risk managers will find it hard to continue to deliver consistently cheaper insurance programmes. With capital being squeezed on the one hand and claims rising on the other, the insurance market is widely expected to harden any time soon. If this translates into higher prices for corporate insurance, or fewer premium reductions, insurance buyers may find it difficult to take the message back to their bosses.

If brokers and insurers want to retain favourable relationships with clients, they should be prepared to respond to the challenges facing risk managers. Companies will be looking to squeeze as much free risk engineering or claims management assistance from their service providers as they can. Important facts that risk managers will want to have at their fingertips may include a figure representing the sum they have saved the company over past years, although it is not always easy to show how many risks or potential disasters have been avoided. Despite this, insurers and brokers should be able to provide their clients with the information they need to show how they add value.

It is going to be tough. It will be hard for risk managers to continue to secure premium decreases from the insurance market. With buyers increasingly shopping around for the best deal, underwriters and brokers will have to work hard to hold onto business. Those trying to maintain their key relationships should be sympathetic to the issues facing businesses today. They should work with their clients to find innovative ways of reducing the total cost of risk and demonstrating the specific benefits that risk management brings.

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Key points

- Risk managers need to show they are indispensable to avoid the chop
- As the market hardens they will find it harder to achieve consistently cheaper insurance premiums
- Brokers and insurers should be prepared to help them face up to this challenge by providing them with the information and services they need

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→ Promote the risk manager! April/May 2009

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David Sandham • Editor • Global Reinsurance

Joining forces

Following recent merger activity in the market, what are the pros and cons of consolidation?

The reinsurance industry is buzzing with talk of mergers and rumours of more to come. There have been two high-profile unions recently: Validus's fierce battle for IPC, and the less fraught merger of PartnerRe and Paris Re. But what are the pros and cons for firms considering merger?

Size matters

For: Mergers are a way for smaller reinsurers to increase financial strength. Reinsurers can combine their capital base and so increase their attractiveness to cedants. For example, PartnerRe's merger with Paris Re has produced the world's fourth-largest reinsurer, bringing shareholders' equity to about $6bn.

Against: Big is not necessarily beautiful. Several smaller reinsurers, such as Tokio Millennium Re, have demonstrated excellent results, whereas the giant Swiss Re has suffered problems. Furthermore, cedants like to deal with a diverse spread of companies. They are concerned about concentration of risk, and do not want to become over-reliant on only a few reinsurers.

Shareholder value

For: Mergers are a way for reinsurers that are valued poorly by the stock market to come to the attention of investors. Non-specialist investors find it hard to differentiate between reinsurers based on subtle differences in strategy, but will pay more attention to larger companies.

Against: Investors also know that historically most mergers do not add value, and they may penalise companies that have difficulties (real or perceived) in digesting the new acquisition and in retaining key staff. Also, theoretical efficiencies can turn out to have unforeseen snags. In the case of PartnerRe and Paris Re, the integration of the two technology platforms will not be simple, for example. More generally, companies often find they have overpaid for their targets.

Business strategy

For: Merger can be a way for a reinsurer concentrated in one line to diversify its book, thus spreading risk. This was the argument used by Max Capital and IPC in their agreed merger (which was later called off). Combining with Max offered IPC diversification.

Against: A counter-argument is that reinsurers should stick to their core business and leverage their expertise in core areas, instead of wandering into terra incognita.

An exit for investors

For: Mergers can offer an exit route to private equity investors. Paris Re agreed to the approach by PartnerRe because six private equity companies wanted to exit their investment. A merger may be welcome when an IPO is not possible because of volatile stock market conditions.

Against: A merger is an exit only if the bid is in cash or for publicly traded shares. Also, private equity often has high profit requirements, and may set a price that few buyers are willing to pay.

Takeover tactics

For: The Validus-IPC merger has shattered the myth that hostile bids cannot succeed in the relationship-driven reinsurance business. Some of Validus's legal tactics were creative: for example, applying to the Bermuda Court for a scheme of arrangement for IPC.

Against: Validus did not succeed because of its legal tactics, but because it convinced IPC shareholders and offered them a cash element as well as shares. Generally, companies may be shy of making merger deals during hurricane season, when nature could scupper all calculations.

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Key points

- Arguments for mergers are: increase financial strength; attract stock market investors; diversify book; they can offer exit to private equity; and hostile tactics can work
- Arguments against mergers are: small can be beautiful; mergers don't always add value; mergers may stretch competence; and the hurricane season is not the best time to merge

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→ Let battle commence, 8 September 2009

→ IPC board approves new Validus offer, 9 July 2009

→ PartnerRe to buy Paris Re for $2bn, 6 July 2009

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