

Insurance Banana Skins 2009

The CSFI survey of the
risks facing insurers



In association with

PRICEWATERHOUSECOOPERS 

CSFI

Centre for the Study of
Financial Innovation

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Preface

This is our second *Insurance Banana Skins* survey – and, my, how the world has changed in 18 months. Back in 2007, the top fears were over-regulation (which, it was felt, might squeeze the life out of the industry) and natural catastrophes. Now, it is all about investment performance, equities and capital availability. I think David Lascelles, the author of both the insurance and banking *Banana Skins* surveys, sums it up best: ‘The insurance sector feels that it may be unjustly penalised for the sins of the banking sector.’

There might be some debate about how ‘unjust’ this is, but it is very clear that the insurers are living in a new environment – an environment created by the banking crisis. In particular, it is an environment characterised by:

- low or negative investment returns;
- an acute shortage of capital;
- a dreadful macro-economic outlook;
- a backlash against financial complexity;
- increasing political involvement, even in mature markets; and
- the inevitability of much tougher regulation at all levels.

Obviously, all of these affect the individual pillars of the insurance industry in different ways and to different degrees. For the life companies, for instance, investment returns are the major threat. As one respondent put it, with some understatement, there is a real danger of a loss of faith in annuities. For the non-life sector, capacity and pricing are the big issues, along with the problems that tend to come with a macro-economic slowdown – notably a surge in claims and an increase in fraud. Plus, the industry’s problems are bound to be exacerbated by the regulatory crackdown. For the reinsurers, sustaining capacity looks like the big problem, along with management of the pricing cycle.

And then, of course, there is reputational risk; insurance is at least as vulnerable here as banking.

One could go on. But what makes everything worse this year is a pervasive sense that the insurance industry isn’t as well prepared as it should be. Compared to 2007, the percentage of respondents who said the industry was ‘well-prepared’ to meet the challenges was down from 21% to a paltry (and terrifying) 4%.

Thanks, as usual, to David for pulling the survey together (in this case, with a little help from the folks at Survey Monkey). Thanks, too, to PricewaterhouseCoopers, whose sponsorship of IBS (and BBS as well) is much appreciated.

Andrew Hilton
Director, CSFI

This report was written by **David Lascelles**
Cover by **Joe Cummings**

Foreword

Welcome to Insurance Banana Skins 2009, a unique survey of the risks facing insurers, which has been produced by the CSFI in association with PricewaterhouseCoopers.

We are pleased to be continuing our support for this initiative. The Banana Skins format (a banking edition is available also) provides valuable insights into the emerging and ever-present risks and concerns at the top of the boardroom agenda and how these perceptions change over time.

Many organisations will use the results to help judge the efficacy of their own risk registers and to gauge how these industry-wide findings compare with their own assessment of risks. Key questions include whether companies are confident that their risk appetites appropriately reflect the exceptionally unstable and uncertain market conditions that form the backdrop to this report.

In keeping with this volatile financial environment, investment performance, equity markets and capital availability now head the list of insurance Banana Skins, having not featured in the top ten in the previous survey in 2007 (over-regulation, natural catastrophe and management quality rated highest in 2007). Macro-economic trends are now ranked fourth, having not made the list at all in 2007. Concerns over counterparty exposures, reinsurance security and broader systemic and solvency risks have also come to the fore.

These risks have always been present even if they have only recently come to the centre of the radar. The near total change in companies' perception of the most dangerous threats underlines the importance of thorough identification and frequent re-appraisal of emerging risks and possible scenarios. Although some risks such as economic downturn cannot be avoided, there may be scope for more forward-looking evaluation and management of these challenges. Insurers might also look at how to mitigate their financial risks more effectively, for example, through more proactive application of their risk appetite and a more robust risk management framework. The result would be more sustainable returns, which will be a prized advantage at a time of intense competition for limited available capital.

Respondents' concerns over excessive regulation and natural catastrophes have been superseded by what they see as more pressing threats. Although economic recession and financial market instability now dominate boardroom debates, no company can afford to take their eye off other potentially calamitous risks. Diligence will be essential in ensuring that any new regulation that follows the financial crisis is rational and appropriate. While dwarfed by other losses within the financial sector, the 2008 windstorm season was still the third highest insurance loss in history, highlighting the continuing risks posed by an ever more volatile climate.

I hope that you find this survey insightful and thought-provoking. If you have any feedback or would like to discuss any of the issues raised in more detail, please contact myself or one of my colleagues.

Finally, I would like to thank insurers and industry observers for taking the time to participate in this research and the CSFI for producing such a timely and interesting report.

Ian Dilks

Global Insurance Leader
PricewaterhouseCoopers LLP (UK)

About this survey

Insurance Banana Skins surveys the risks facing the insurance industry at a time of great stress in the financial sector, and identifies those that are seen as most pressing by insurance practitioners and close observers of the insurance scene.

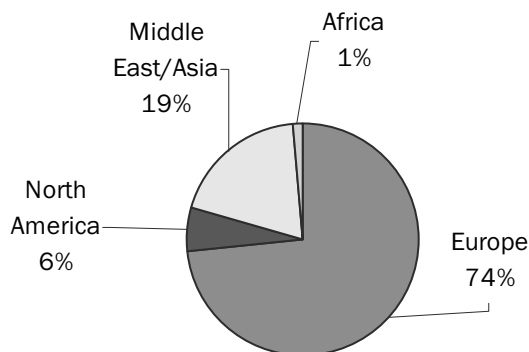
The report, which updates a previous survey in 2007, was conducted in November and December 2008, and is based on 403 responses from 39 countries.

The questionnaire (reproduced in the Appendix) was in three parts. In the first, respondents were asked to describe, in their own words, their main concerns about the insurance sector over the next 2-3 years. In the second, they were asked to rate a list of potential Banana Skins, both by severity and whether they were rising, steady or falling. In the third, they were asked to rate the preparedness of insurance institutions to handle the risks they saw. Replies were confidential, but respondents could choose to be identified.

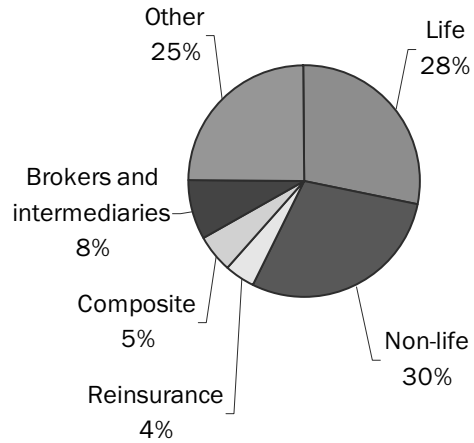
The breakdown of responses by country was

Bahrain	1	Indonesia	10	Serbia	2
Belgium	3	Ireland	1	Singapore	4
Bermuda	9	Italy	1	Slovakia	3
Canada	5	Jordan	1	Slovenia	1
China	3	Kuwait	1	South Africa	7
Czech Republic	3	Latvia	1	Spain	1
Denmark	17	Lithuania	4	Switzerland	5
Dubai	1	Luxembourg	1	Taiwan	2
France	2	Malaysia	6	Thailand	16
Germany	13	Malta	2	Utd Arab Emirates	4
Hong Kong	4	Netherlands	2	UK	204
Hungary	6	Poland	6	Ukraine	1
India	24	Russia	15	US	11

About half the respondents were located in the UK. This gives the survey results a strong UK orientation, though it also reflects the fact that many non-UK insurers run their international operations from the UK. The regional breakdown is tilted towards Europe for the same reason.



The next chart shows the breakdown by type of respondent. Three quarters of the respondents were insurance industry practitioners. The remainder were close observers of the insurance scene such as analysts, regulators, consultants, academics, suppliers and clients.



Within the insurance industry, 69 per cent of respondents identified themselves as senior management or board level.

Summary

The top three risks identified by respondents to the survey are all connected with the fall-out from the credit crunch, and its impact on the strength and profitability of the insurance industry.

The ability of insurance companies to get through the crisis depends above all on their **investment performance** (placed No 1), i.e. achieving sufficient returns to protect capital, remain profitable and meet commitments to customers. Key here are the **equity markets** (No 2) on which the industry will depend heavily for income if, as expected, the crisis produces a fall-off in insurance business and a surge in claims. An extended period of extra low **interest rates** (No 11) would also hurt income and reduce the appeal of savings products.

The resulting squeeze on profitability could affect the industry's solvency, making **capital availability** (No 3) a key consideration in the period ahead.

The scale of financial market disruption will depend on **macro-economic trends** (No 4) about which the majority of respondents to the survey were gloomy, particularly those in North America.

The risk of **Too much regulation** (No 5) has fallen from the top position it occupied in the last survey. But it has not disappeared, only been overtaken by more urgent issues. There is now widespread concern that the crisis will trigger a regulatory crackdown on the financial sector which will put pressure on the insurance industry to increase capital and take on more compliance

costs at a time when resources are very stretched. The insurance sector feels that it may be unjustly penalised for the sins of the banking sector.

The next set of risks is linked to the industry's ability to manage its way through the crisis and avoid unnecessary losses. Concern about the strength of the industry's **risk management techniques** (No 6) has risen sharply in the wake of the crisis at AIG and revelations about insurance companies' exposure to **complex instruments**

Insurance Banana Skins 2009

(2007 ranking in brackets)

- 1 Investment performance (11)
- 2 Equity markets (13)
- 3 Capital availability (26)
- 4 Macro-economic trends (-)
- 5 Too much regulation (1)
- 6 Risk management techniques (14)
- 7 Reinsurance security (27)
- 8 Complex instruments (19)
- 9 Actuarial assumptions (8)
- 10 Long tail liabilities (7)
- 11 Interest rates (22)
- 12 Managing the pricing cycle (5)
- 13 Management quality (3)
- 14 Managing costs (-)
- 15 Insurance industry reputation (-)
- 16 Distribution channels (6)
- 17 Corporate governance (23)
- 18 Political risks (16)
- 19 Pricing new risks (17)
- 20 Reinsurance availability (28)
- 21 Managing technology (12)
- 22 Natural catastrophes (2)
- 23 Fraud (30)
- 24 Back office (15)
- 25 Retail sales practices (20)
- 26 Terrorism (18)
- 27 Business continuation (29)
- 28 Climate change (4)
- 29 Product development (-)
- 30 Demographic trends (24)
- 31 Managing mergers (31)
- 32 New types of competitors (10)
- 33 Contract wording (25)
- 34 Pollution (21)
- 35 Too little regulation (32)

Profitability and solvency are the key underlying concerns

The security of the reinsurance sector is a rising concern

(No 8), specially those in the credit insurance market. The **security of reinsurance** arrangements (No 7) is a fast-growing concern with worries about the capacity of the reinsurance sector to meet a surge in claims on risks that have been laid off by primary insurers.

Profitability on the non-life side of the industry will depend heavily on **the pricing cycle** (No 12). Insurers are hoping that a capacity shake-out will enable them to push up rates, but the contrary view holds that insurance business will fall away as clients seek to cut costs.

The big movers

The financial crisis has completely transformed the risk landscape for insurers since the previous survey in 2007, bringing dramatic changes to the ranking of insurance Banana Skins. Here are the big movers.

UP

Investment performance: Crucial to sustaining profitability and solvency.

Equity markets: High insurance sector dependence for income.

Capital availability: Once taken for granted, now tight.

Risk management techniques: Weaknesses exposed by the crisis.

Reinsurance security: Rising risk of counterparty failure.

Complex instruments: Seen as the heart of the problem.

Interest rates: Low rates will hurt industry revenues and reduce returns on savings products.

DOWN

Too much regulation: Overtaken by more pressing concerns.

Management quality: A longer term problem.

Managing technology: A secondary risk in the current financial climate.

Natural catastrophes: Fewer big incidents.

Climate change: Losing its urgency as an insurance risk.

A growing concern is potential damage to the **insurance industry's reputation** (No 15) caused by insurers' attempts to push up premiums and take a tougher line on insurance claims, as well as disappointing returns on savings products. The industry expects to see an increase in **fraud** (No 23), a common reaction to hard times. **Corporate governance** risks (No 17) are also expected to grow as companies come under greater pressure to deliver results.

The survey showed a striking fall in concern about environmental issues. **Natural catastrophes** fell from No 2 last time to No 22, possibly because of fewer major recent events. **Climate change** also dropped sharply, from No 4 to No 28, reflecting a sense of declining urgency about the issue. **Pollution risks** eased noticeably, from No 21 to No 34.

Concerns about structural change to the insurance industry were also less prominent. The threat of **new competitors** fell from No 10 to No 32 because respondents felt the insurance market had become less attractive. Similarly, the prospect of **mergers** remained low at No 31.

Types of respondents. The survey showed a striking similarity between the top level concerns of the life, non-life and reinsurance sectors: all of them focused on financial market issues. However, lower down there were differences of emphasis.

Environmental risks are sharply down

The life side homed in on the risks to the savings business and the challenges of the interface with customers: retail sales practices and distribution. The non-life side was concerned with capacity, pricing and claims management. Observers of the industry focused on the strength of the insurance industry's solvency, on risk management and reputation.

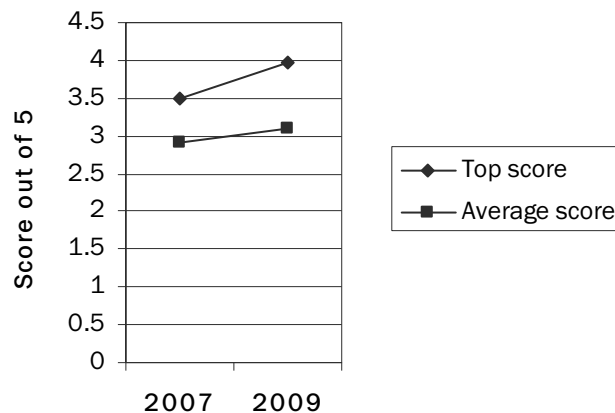
Geography. There was also a strong similarity between the responses from North America, Europe and Asia, the main regions represented in the survey. The impact of financial turmoil and poor business conditions dominated all three. A common concern was the prospect of a regulatory crackdown at a time when the industry is already feeling the effects of the credit crisis. The possibility of insurance company failures resulting from the crisis was widely mentioned, particularly in emerging markets where the strength and management capability of the industry is still evolving.

Preparedness. Respondents were asked how well prepared the insurance industry was to handle the risks they had identified. The results were more negative than in the last survey. Only four per cent said "well", down from 21 per cent. Eleven per cent said "poorly", up from three per cent. The remainder gave a "mixed" reply.

Overall, the responses to the survey showed that the level of risk sensitivity in the insurance industry has risen since the last survey in 2007. The **Banana Skins Index** shows the average score given to the top risk in the two surveys, and the average score of all the risks. Both are up.

Insurance companies are seen to be less well prepared to handle risks

Insurance Banana Skins Index



Who said what

A breakdown of the results by respondent type and region shows a strong common concern with the impact of the financial crisis on business and markets: the effect of tumbling asset values on profitability and capital, and the worsening outlook for insurance sales and claims. However there are also striking sectoral and geographical differences

Life insurance

- 1 Investment performance
- 2 Equity markets
- 3 Macro-economic trends
- 4 Too much regulation
- 5 Capital availability
- 6 Risk management techniques
- 7 Managing costs
- 8 Retail sales practices
- 9 Interest rates
- 10 Distribution channels

Concerns about investment returns dominated responses from the life insurance industry, particularly as they affect the ability to pay out on savings products such as annuities and pensions. The probability of an extended period of low interest rates was a big preoccupation. Generally, the outlook for savings was seen as very negative. Client interface issues were also high: retail sales practices and distribution channels where regulatory interest is high. For this reason, life insurers also had the highest concern about excessive regulation.

The downturn raises different concerns on the life and non-life sides

Non-life

- 1 Capital availability
- 2 Investment performance
- 3 Equity markets
- 4 Managing the pricing cycle
- 5 Macro-economic trends
- 6 Too much regulation
- 7 Reinsurance security
- 8 Actuarial assumptions
- 9 Managing costs
- 10 Risk management techniques

The non-life side shared the industry's broad concerns with the state of the markets and the impact of declining asset values on profits and capital. But specific concerns were very different. The outlook for pricing was seen as volatile: capacity shrinkage might harden rates, but demand for insurance is also expected to fall in a recession. At the same time, claims are likely to surge, as they always do when times are bad. The ability to lay off risk with reinsurers was also a worry. Like the life side, the non-life sector saw cost control and better risk management as the key to survival.

Contrasting views from insurance practitioners and observers

Reinsurance

- 1 Investment performance
- 2 Capital availability
- 3 Macro-economic trends
- 4 Managing the pricing cycle
- 5 Complex instruments
- 6 Natural catastrophes
- 7 Interest rates
- 8 Reinsurance security
- 9 Risk management techniques
- 10 Long tail liabilities

The reinsurance industry is also feeling the pressures of the economic crisis. The big issue is whether it can sustain capacity in a market downturn, hence the concern with investment performance and capital availability. Successful management of the pricing cycle is also crucial, and here the outlook is very uncertain. The reinsurance sector showed the highest concern with exposure to complex credit instruments, which are likely to cause large losses, and with natural catastrophes for which reinsurers usually pick up the tab.

Brokers and intermediaries

- 1 Capital availability
- 2 Investment performance
- 3 Equity markets
- 4 Reinsurance security
- 5 Reinsurance availability
- 6 Macro-economic trends
- 7 Management quality
- 8 Managing the pricing cycle
- 9 Too much regulation
- 10 Long tail liabilities

The top concerns in the broking community are very much aligned with those of the insurance industry in general: capital and the state of the investment markets. But they differ in other respects. Brokers have a higher concern with the strength of the insurance industry and with pricing at a time when the market is at a big turning point. They also put concerns about the quality of insurance company management high on the list. They were less bothered about the risks of too much regulation and a post-crisis regulatory crackdown.

Observers

- 1 Capital availability
- 2 Equity markets
- 3 Investment performance
- 4 Macro-economic trends
- 5 Complex instruments
- 6 Actuarial assumptions
- 7 Long tail liabilities
- 8 Reinsurance security
- 9 Risk management techniques
- 10 Insurance industry reputation

Observers of the insurance industry believe, like the industry itself, that the management of financial resources will be crucial over the current difficult period. But they tended to be more outspoken, showing concerns with the solvency of the industry and with the likelihood of company failures. They also focused on the area of risk: the quality of actuarial science, the exposure to complex instruments, and the overall management of risk. They showed the highest concern with the industry's reputation, which is always vulnerable in times of stress.

North America and Bermuda

- 1 Investment performance
- 2 Macro-economic trends
- 3 Capital availability
- 4 Equity markets
- 5 Too much regulation
- 6 Managing the pricing cycle
- 7 Reinsurance security
- 8 Risk management techniques
- 9 Long tail liabilities
- 10 Interest rates

Concerns about the financial markets dominated responses from North America and Bermuda, but of the three geographic groups, this was the one where the macro-economic outlook scored highest. Respondents generally expected a severe downturn in the equity markets, and a long period of low interest rates. Concerns with a regulatory crackdown were also stronger than in other parts of the world, with a major restructuring of insurance regulation on the cards in the US. Other top risks included pricing, the security of reinsurance, and the management of risk itself.

Europe

- 1 Investment performance
- 2 Equity markets
- 3 Capital availability
- 4 Macro-economic trends
- 5 Complex instruments
- 6 Reinsurance security
- 7 Too much regulation
- 8 Actuarial assumptions
- 9 Long tail liabilities
- 10 Risk management techniques

Europe's top focus was entirely on markets and their impact on profitability, capital adequacy and solvency. Although macro-economic worries were strong, they were less so than in North America. From No 5 downwards, all the concerns have to do with steering the business through what is likely to be a very testing time: managing risks, many of them unfamiliar, and being made to share the blame for what respondents feel is essentially a banking rather than an insurance crisis. This section includes East Europe and Russia where the market outlook is bleak.

Top concerns are strikingly similar across geographical regions

Middle East and Asia

- 1 Equity markets
- 2 Investment performance
- 3 Capital availability
- 4 Macro-economic trends
- 5 Managing costs
- 6 Too much regulation
- 7 Managing the pricing cycle
- 8 Risk management techniques
- 9 Interest rates
- 10 Retail sales practices

Respondents from the Middle East, India, Southeast Asia and China have very similar top level concerns to the western hemisphere: a preoccupation with financial markets and their impact on profitability, solvency and the business outlook, which looks poor throughout the region. Many of the operational concerns are also similar: regulation, risk management, pricing. Notable is the high level of concern with cost management, and retail sales practices which are hard to control in the highly populated and less well organised markets of the region.

The rankings



1. Investment performance (11)

The top risks are about capital and profit

The insurance industry's ability to deliver an adequate investment performance in today's shell-shocked environment is seen as the key risk facing its members. The pressures are many: to remain solvent, profitable, and able to meet client claims and expectations. The challenges are also many: falling asset values, market volatility and extra low interest rates. The senior economist of a major European reinsurance company said that "a sharp decline in investment valuations" was probably the greatest threat facing the industry. The concern is not simply lower prices, but the fact that many insurance companies developed a heavy dependence on investment income during the bull market, and may not be able to replace it.

For life insurance, investment performance is the key to survival during these difficult times. The issues are dominated by the need to generate capital and produce returns on policyholders' savings. A former UK regulator said: "The collapse in equity values and other holdings (especially property), a period of potentially low interest rates and public disillusion with the attractions of long-term saving make for a terrible external environment. I expect a rash of prudential issues as a result (e.g. over past guarantees and bonuses). We could even see a repeat of the bank recapitalisation scheme for the insurers".

Specially vulnerable are companies offering savings products with guaranteed returns. The group corporate strategist of a large UK insurer foresaw "a complete loss of faith" in annuities if a large life company failed. The head of tax at a large life company said that "the cost of guarantees and loss of earnings from reduced asset values could have a material detrimental impact on profitability and solvency".

On the non-life side, companies are struggling to sustain investment contributions to profits, and protect their reserves. The finance director of a Lloyd's managing agency said that "traditionally investment returns have been a major contributor to the results of insurance companies. However, based on current experience, they are unlikely to contribute much in the next year or so".

Emerging markets are suffering too

Geographically, this Banana Skin was the top concern in North America and Europe. But it was also a big issue in emerging markets, for example in Russia where share prices have collapsed. In South Africa, Izak Smit, the managing director of Absa Life, said that "market risk has become much more of an issue in the current credit crunch environment. Extreme volatility has to be managed".



2. Equity markets (13)

A clear indicator of the changed financial climate: this risk has risen sharply. The collapse of equity markets - and their volatility - could prove very damaging to insurance company performance. "This will be critical for many insurers and asset management companies," said the head of global operations of a large international insurer.

Is asset allocation shifting away from equities?

The comments on this Banana Skin echoed many of those made about Investment Performance (No 1): the risk that falling share values and yields will damage insurers' ability to meet claims and guaranteed returns.

Many of the responses contained a tone of bewilderment. "Where is the bottom?" wondered a Swiss insurer. "Is the worst over? I wouldn't bet on it," said a respondent from an Irish life company. A Russian respondent asked: "Where is the sage who can say how they will behave?" Some respondents feared that the industry was so shell-shocked that it would miss the market upturn. "Some good opportunities are likely to be missed as a result of loss of confidence," said Madeleine Grinyer of the CSC consultancy.

But there was also some resilience. A UK respondent thought the risk was not as bad as it once was because "asset allocation has shifted away from equities". A Bermuda marine insurer also thought that equities "still offer the best long term returns, but with serious short term consequences. The difficulty is to know where to weight the portfolio".

Concerns about the equity market tended to be stronger in Europe and emerging markets than in North America.



3. Capital availability (26)

The availability of capital to sustain the insurance industry as it battles with recession and turbulent markets is seen as a key risk facing all major sectors: life, non-life and reinsurance.

This Banana Skin provides a dramatic measure of changed conditions. In our 2007 survey, the insurance sector's access to capital was taken for granted; the danger was too much capital chasing too little business. Today, the risk has been turned on its head. The insurance industry faces heavy losses on its ongoing business and investments, and it may need more capital to maintain solvency levels. However, it is no longer so freely available, or only at a prohibitive price. "This will be a big challenge," said the director of group risk at a large international life company.

The main worry is whether, in the event of a major withdrawal of capital in the near to medium-term, new capital will be attracted as easily and quickly as it has in the past.
Alan Punter
Independent intermediary

The managing director of a leading European reinsurer said that "recently recapitalisation after a major depletion of industry capital has been relatively easy; in the future recapitalisation should not be assumed".

Capital shortage will impact the business in many ways. It will put stress on the insurance industry at a time when regulators are pushing through new rules on capital adequacy. It will also constrict capacity and drive up the cost of insurance (though that might not be a bad thing. See section on pricing No 12). A South African broker thought that a shortage of capital "might leave many risks at the upper end uninsurable".

Constraints on capital are a worldwide problem. Respondents from America, Europe and Asia all expect times to be tough. An Indonesian respondent said it will be "more difficult to attract capital into life insurance in this time of financial crisis".



4. Macro-economic trends (-)

The weakening global economy is a major concern for the industry. This Banana Skin - which was unranked in the benign times of the last survey in 2007 - is seen as fourth in potential severity, and as one of the fastest-rising risks as the world heads into recession. Sebastian Schich, principal economist at the OECD in Paris, said: "The significant deterioration in global financial markets and the real outlook is starting to have a more visible adverse effect on the insurance industry".

A bad recession would hit the insurance industry in many ways. Falling markets will damage capital and depress investment returns, and an economic slowdown will

A severe deflationary recession will add business, operational, strategic and underwriting risks to existing market and liquidity woes, with a few insurers not nimble enough to respond quickly enough to developments.

Group actuary
UK medical insurer

reduce business levels and cut into profitability. Many respondents were concerned about the prospects for "lapses", i.e. customers not renewing their policies. As one of them pointed out, "insurance is a discretionary purchase". Respondents also feared that a recession would push insurers to seek short term gains - through aggressive pricing,

opportunistic investment or gimmicks - at the cost of longer term profitability.

For the non-life side, a recession is likely to lead to a sharp rise in claims, not all of them sound. Rosanne Bachman, managing director of Pinwheel Consulting, said: "Most likely we will see claims increase, and at the same time we will see premiums decreasing from insureds going out of business or a reduction in turnover". On the life side, Bob Yates, an analyst at Fox-Pitt Kelton, was concerned that a slowdown "will generate Japanese-style interest rates in Europe and the US, and squeeze margins on traditional 'spread' products". Savings products - pensions, annuities and life insurance - could all be hit.

**North Americans
are gloomier about
the outlook than
Europeans**

The North Americans ranked the risk of a major economic downturn more strongly than the Europeans (No. 2 vs No 4.). But the impact will not be limited to the big industrial countries. Respondents from many emerging markets are feeling the draught too. Fadi Chammas, acting general manager of Alico Life in the United Arab Emirates, was concerned that "all financial institutions will face problems in the current environment as clients and potential clients hoard cash". In Lithuania, Audrius Linartas, deputy chairman of the supervisory authority, said that the insurance industry "is not well prepared to deal with macro-economic risks" because of "a lack of expertise, knowledge and human resources". The chief financial officer of a large Russian life company saw his business having "a direct dependence on the duration and severity of the crisis".



5. Too much regulation (1)

The risk of too much regulation has dropped from the No 1 position it occupied last time. However, it has not disappeared, only been overtaken by more pressing matters. In absolute terms, this Banana Skin scored only slightly less than last time (3.41 vs 3.49 out of 5).

Fears of a 'knee-jerk' reaction to the crisis

Although many of the responses read like a litany of complaint against the regulators, there are clearly issues of cost, intrusion and regulatory fairness which insurance practitioners feel are threatening their business. This was a risk that was ranked much higher by the insurance industry than outsiders. Geographically, concern about it was higher in North America than in other markets.

Where 2007 concerns were about regulatory distortions, the focus now is on an over-the-top regulatory reaction to the financial crisis. "There is a real danger of a misguided regulatory knee-jerk reaction to the financial disaster of the last five years," said Michael Wainwright, a legal adviser with London lawyers Eversheds.

The main concern is that the crisis will lead to increased costs and more intrusive supervision as well as closer political scrutiny – all at a time when the industry is facing new rules on capital adequacy and financial reporting, i.e. Solvency II (see box). The head of tax at a large European life company feared that a knee-jerk

Solvency II – the problem or the answer?

Much of the concern about regulation as a Banana Skin centres on Solvency II, the EU's blockbuster directive which will set capital requirements for the insurance industry, and will also be implemented in local versions in a number of non-EU countries.

The comments on this subject, many quite strong, reflected the wider frustration which the industry feels with growing regulatory intrusion in these demanding times. The group risk director of a large life company said that Solvency II "will eat up capital without providing genuine returns to shareholders".

Some respondents felt that the directive would damage the industry by commandeering resources and imposing a mechanistic approach on risk management. Others focused on the structural impact. Christian Nielsen, chief executive of Dansk Glasforsikring, feared that tougher capital requirements could finish off many smaller companies. "If that happens, it would be very bad for consumers everywhere".

There were also technical concerns about the impact of Solvency II on the cost of pensions, on investment incentives and on consumer confidence if insurers are seen to reduce capital, which some respondents expected would be the case. It was also feared that Solvency II could drive up the cost of insurance, for which the industry would take the blame.

reaction would "limit product innovation, restrict investment and/or increase the costs of doing business". One concern was that insurance companies would end up at a competitive disadvantage vis-à-vis state-supported banks. Another was that adding more layers of regulation was unlikely to solve any problems, and would have unintended consequences. "It is anti-competitive," said one, "and despite all the regulation we have at the moment, everything still goes wrong."

The concern was not just with the quantity of regulation, but the quality. There were many comments about regulators being "too bureaucratic, too rule-driven, too dependent on models" and unwilling to trust the judgment of management. Respondents felt that regulators were focusing disproportionately on "granular issues" such as Treating Customers Fairly, product pricing and financial crime when the really pressing question was solvency.

Concerns about the growth of regulatory risk were widespread, coming equally from developed and developing countries. The leading risk for the developed world was the impact of regulation on competitiveness, and for the developing it was the industry's ability to cope with a huge increase in regulation, both as to cost and skills. A senior insurer in Thailand complained of "the introduction of a number of new regulations without impact study or adequate consultations with the industry, and without adequate time for implementation".



6. Risk management techniques (14)

Concerns about the insurance industry's ability to manage risk have edged up in a financial storm which has damaged its reputation and financial strength. It has also left insurers heavily exposed to complex and newfangled risks such as credit derivatives and structured products. Many respondents thought that insurance companies bought into these without understanding either the risks or where the ultimate exposure lay.

How good are insurance companies' risk controls?

The liquidity crunch

The liquidity crisis in the banking sector is having its impact on insurance as well. With banks tightening up on credit lines, insurance company liquidity is coming under pressure. A Swiss insurer said: "As sources of liquidity become less accessible and more expensive, there is a risk that insurers with short term cash flow needs will be tempted to generate cash through underpriced long term exposures". The risk is particularly high for insurance companies which suffer credit downgrades and lose their bank lines. Unlike banks, insurance companies cannot usually go to their central banks for cash.

Although the liquidity crunch is widespread, it is particularly acute in countries with less well developed banking systems. In Russia, Viktor Ioun, chief executive officer of Genesis Capital, said that "until now, most companies measured their performance on a cash basis: the increasing flow of premiums was sufficient to cover both current payments and administrative expenses. If market growth is less than 20% in 2009, which is very likely, dozens of companies will go bankrupt".

The lack of liquidity in financial markets is also affecting insurance companies' ability to manage their investment portfolios and trade in timely fashion, adding to the problem of generating adequate investment returns.

An industry observer said: "Under the current circumstances, liquidity risk management on the part of insurance companies is becoming an increasingly important task".

Investment banker David Potter said that the "main risk is because companies departed from doing insurance - people, houses, cars - and got involved in exotica. I do not believe they understood the risks involved in the various financial products they 'insured'. I still don't think they understand or even know what they have on their books". Clifford Dammers, a financial markets lawyer, said that weaknesses in risk analysis would force companies to "recognise enormous losses on their assets".

However there is also the wider issue of how insurers deal with unprecedented market conditions. A US banker who supplies services to the insurance industry said that “many models were rendered ineffective by the significant market moves, counterparty risks and changes of correlation”. The chief executive of a US life company said that “for the first time in my experience we are confronted with a threat of systemic risk that extends throughout the world”.

Basel II has not worked for banks, so why will Solvency II be any different for insurers?
Risk manager
UK life company

Respondents felt that risk management was an area of general weakness in the insurance industry for a variety of reasons including a lack of skills, an overdependence on actuarial science, and a poor risk culture. Michael

Mainelli, chairman of Z/Yen risk systems group, thought that the industry “has reporting and analytics for warning and control that are below capital markets standards”. Roderick Hampson, chief financial officer of HSB Engineering Insurance, said insurance companies should be able “to fund complete, accurate and effective risk controls over all facets of their business. This has to be not only endorsed by boards but demanded of senior management who must be held accountable to shareholders, employees and customers for any failure of risk management”.

However, there was also a widespread view that risk management will get a lot of attention in the period ahead. Gerd Gehlenborg, a risk officer with Germany's Gegenseitigkeit Versicherungen, said that “risks will be better controlled in the coming years. They are getting more focus”.



7. Reinsurance security (27)

Concerns about the ability to lay off insurance risk are rising fast

This is one of the big ranking changes. Concerns about the security of the reinsurance sector have rocketed because of market stresses caused by the financial crisis. “There has to be a risk that the reinsurance industry will demonstrate some serious dysfunctional behaviour,” said a former regulator. The downgrading of credit ratings in the sector is evidence of trouble. Counterparty risk is growing and “creditor quality becomes crucial,” according to a Swiss insurer.

Much of this comes down to the fact that recent additions to reinsurance capacity consisted of “new capital”, i.e. hedge funds and private investors hunting for yield who had never been tested in a serious downturn. Several respondents singled out newcomers as a potential source of trouble if hedge funds are hit by the crunch. “The strength of some reinsurers could come under pressure if liquidity issues continue,” said an insurance consultant. The chief financial officer of a large Indian non-life insurer said that this risk “becomes very important in the wake of the global meltdown”.

But the managing director of a large reinsurance company said he was “astounded” at the lack of differentiation shown by the market between different ratings of reinsurers. “There is a short-term view that dominates insurers' thinking, which is disconcerting,” he said.



8. Complex instruments (19)

Complex products, particularly derivatives, are very much part of the financial crisis, and the insurance sector has not been spared their contagion, hence the sharp rise in this Banana Skin. Insurance companies are exposed through their participation in securitisations and risk management products such as credit default swaps (CDS), many of which have fallen drastically in value.

Observers of the insurance industry (who ranked this risk higher than insurance practitioners) questioned whether it was qualified to enter these high risk markets. “Are most companies equipped to handle complex instruments well?” wondered a banker. Insurance industry respondents also had their doubts. “Do we understand them, really?” asked the head of group insurance and investment risk. Expected answer to both questions: plainly no. This risk was ranked more highly by the Europeans (No 5) than the North Americans (No 15).

Back to basics?

The rise of credit risk

Credit risk has become a big issue for insurance companies, in several ways.

- Financial assets: are the bonds and deposits they hold as investments safe in a world of growing corporate default and bank failure?
- Structured products: how safe are the credit risks that insurance companies have taken on by investing in complex debt obligations?
- Reinsurance: will insurers be able to collect on risks that they have laid off with other companies?

Respondents were concerned that insurance companies had acquired unprecedented amounts of credit and counterparty risk - not traditionally an area of analytical strength. By insuring credit risk, the insurance industry may also end up picking up the tab for many of the banking industry's loan losses.

The group finance director of a major international broking firm said: “Our counterparty risks with clients, insurers, banks, brokers and pension investments have significantly increased in 2008 due to the global financial crisis. We are taking steps to better understand and mitigate our counterparty risks”.

But what happens next? Have all the losses been identified and accounted for? The group risk director of a large international life company said that the fall-out had been “dramatic, but the risks still remain in many pockets around the industry”. A London-based broker said “I presume they have addressed the exposure going forward”.

Have the lessons been learnt? Many respondents thought the insurance industry should “go back to basics” so far as capital market transactions are concerned. The group actuary of a large medical insurer admitted: “We still have a way to go on understanding problem securitisations”.



9. Actuarial assumptions (8)

The actuarial calculations that underlie the insurance business are being tested as never before by today's stressful environment. Many respondents felt that they would be found wanting. "In practice, actuaries seem to be well behind others in risk management!" said the head of investments at a UK life company. David Green, a former regulator and now adviser to the UK's Financial Reporting Council, saw "a continued slow adjustment of actuarial standards and practice to reality". An independent financial adviser thought that "the insurance industry can no longer rely on actuarial models to determine their pricing and funding strategies".

However, while respondents felt that actuaries were "missing" trends in areas such as longevity and climate change, the real problem was that exceptionally volatile markets had exposed the limitations of models. "The root of the credit crisis is in the inability of models to cope in stressed environments," said the managing director of a financial guarantee company. Another said that the models were getting better - but the risks were getting worse.

Are risk models up to today's volatile markets?

There was also concern that actuaries would become more conservative during the financial crisis, reacting to conditions rather than analysing them. "This worries me a lot. When they put a finger up and it does not 'feel right' they seem to change an assumption or adjust a model," said a non-executive director of a life company. But John Thirlwell, a non-executive director of Novae Syndicates, said that in his experience "actuaries are well aware of the limits to which their models can be used".



10. Long tail liabilities (7)

Long tail liabilities (claims that crystallise after a long period) continue to be a challenge for the industry, particularly as regards how to price them - and the legal issues they often provoke. "No doubt there is something nasty developing out there," said an insurance group actuary. This was a risk singled out by the reinsurance sector.

Although this risk has slipped a bit in the rankings, some respondents felt that it could be aggravated by a volatile economic environment, particularly a rapid rise in inflation which would drive up the cost of settlements.

One of the areas mentioned was the tangled fall-out from the sub-prime debacle where many legal issues have yet to be tested. An investment banker in the insurance field described this as "a second order impact of interest rates, plus uncertain inflationary effects". Another UK-based insurance executive said he expected this to be "an emerging issue in Europe for the next couple of years".

A second area of uncertainty identified by respondents was climate change where, again, the novelty of the risk could create unexpected long-term liabilities.



11. Interest rates (22)

Interest rate risk is on the downside

This risk has risen sharply for obvious reasons: the crisis in the money markets. The managing director of a large US bank which provides services to the insurance industry said: “We are in a period of massive interest rate volatility which will have unexpected impacts of great severity”.

The risk is particularly on the downside: lower interest rates which squeeze insurance industry profitability and reduce the appeal of savings products. The management of guaranteed savings products will be a major challenge. Many saw the risk particularly strong for the life sector. The head of global operations of a large international insurance company said that “a period of low interest rates will make life difficult for life insurers”. (See box on the outlook for savings p28)

Many respondents expected to see an extended period of low interest rates, or at best a short one followed by sharply rising rates as central banks battle to contain the inflationary consequences of the current relaxation. “Lower interest rates equals more pressure on profits,” said an underwriter in the non-life market. Some said the problem was not the absolute level of rates but spreads: separate interest rates for different classes of risk. These have become much wider and more volatile, making it harder to price risk.



12. Managing the pricing cycle (5)

Will a recession cause insurance prices to go up or down?

A major question, as the world heads into recession, is what happens to insurance pricing. There was a clear division between those who expect to see a big capacity shake-out which would allow prices to harden, and those who fear that a weaker market will merely lead to cut-throat competition.

This was an issue of greater concern to the non-life and reinsurance sides (who voted it No. 4) than life (No. 22) because pricing depends crucially on underwriting capacity. Ed Brittain, managing director of brokers Jardine Lloyd Thompson, saw the outlook in “a lack of capacity...leading to increasing premiums at a time of recession”. Other respondents felt that insurers would try to raise prices, but in so doing harm relations with hard-pressed customers.

However, many respondents thought that insurers would be disappointed if they hoped to push up prices. A consultant to the insurance industry observed that “insurers are currently expecting rates to firm as funds become more difficult to raise. But they may be surprised by the extent to which customers withdraw to conserve cash”. A Lloyd's underwriter said that “if there is a difference between the actual stage of the cycle and that which practitioners are assuming, then a lot of business could end up with narrower margins than those predicted”. A reinsurer said that a number of players would be driven by the need to preserve market share and client relationships “rather than show price discipline”.

These concerns came from many parts of the globe including North America and Asia. Polish respondents complained of “price dumping” in a weak market. In Hong Kong, the chief financial officer of a property and casualty insurer said there was “a *very soft* market with too many insurance companies (over 100)”. In India, it was a special concern because insurance pricing has recently been deregulated.

The ups and downs of the insurance cycle are a major challenge for the non-life industry, and these are very challenging times. The head of risk management at a large Canadian non-life company said: “We haven’t got any better at this”. Another insurer bewailed “the lack of analytical skills in the property and casualty sector” which “results in a reactive approach to pricing and creates a volatile insurance market”. One respondent said it was time for the industry “to break away from a self-induced cycle and to charge risk-adequate prices”.

What next for the life ‘model’?

One of the big issues facing the life insurance industry is the viability of its “business model”, with its complex combination of insurance and asset management. Many respondents felt that it could be put to the test by the current business environment with its threat to savings products; some even feared that it was “bust”.

The non-executive director of a UK composite wondered “whether the life industry will continue to carve out value from long term savings and annuities, as competitors strengthen their offerings in individual parts of the value chain”. A consultant said that “most life companies cannot decide whether they are asset-gatherers/distributors, often selling other people’s products, or asset managers...Overall I believe the life industry should revert to writing life cover and give up as investment/product managers. Getting from here to there is the difficult bit”.

Nor were these primarily British concerns. In Belgium, the chief financial officer of a large insurer asked: “What is the future design of long-term life insurance products?” In Russia, the head of product development at a large insurer, said that “the role of insurance as a savings element is under question as regards traditional products, for example guaranteed interest rates”.



13. Management quality (3)

Insurance needs ‘to be able to attract and retain top talent’

Concern about the quality of insurance company management was one of the headline findings of the last survey where it came No. 3 on the Banana Skin list. This time, it has fallen in the rankings, though the absolute score was very similar (3.16 vs 3.27). The comments about this Banana Skin (which came from those inside the industry as much as outside) tended to be quite strong: “Generally poor” said a consultant, “Typically dire” said a life insurer, “On the whole, less than required” said another.

The weaknesses that were mentioned included poor strategic vision, low adaptability to a fast-changing environment, and the difficulty of securing high calibre personnel because of the industry’s image as old-fashioned and bureaucratic. Tim Johnson, a London executive recruiter, said one of the main challenges facing the industry was “the need to be able to attract and retain top class talent”.

As last time, it was brokers and outsiders to the industry who tended to rank this risk more highly than insurance practitioners themselves. The finance director of a London broker saw “a lack of professional skill base throughout the industry”. However, a number of insurance industry respondents also recognised a problem, particularly in the area of skills. The director of internal audit at a large life company foresaw “skills shortages as organisations look to develop new products to

meet changing customer needs, plus the lack of sufficient risk management capability”.

Manpower pressures are particularly strong in emerging markets. Almost all respondents from Asia and East Europe put management issues high on their list. Patrick Steinmann, chief financial officer of Zurich Insurance Indonesia, was concerned about the “scarcity of expert manpower”. A Russian chief executive said that insurance was seen as “less prestigious for mid-level managers and top-level executives”.

The question is how management will come through the crisis. A corporate finance director expected that “earnings pressures will force changes in management which will increase pressure on quality”. Other respondents were concerned that recent reputational damage to the industry would not help recruitment.

The risks for the non-life business

The non-life side of the insurance business faces severe pressures during the coming global downturn. On the underwriting front, there is likely to be a fall in demand for insurance products and also a surge in claims, including fraudulent ones. There may also be more class actions in the contentious environment that now exists. The temptation for companies will be to keep prices down to hold on to market share.

There will also be a reduction in investment income on which insurers increasingly rely to sustain their profits. Here, companies may be tempted to go for short-term investment gains at the cost of longer-term profitability and balance sheet strength.

The chief financial officer of a Canadian non-life insurer said that “the current turmoil in the financial markets and its consequences are a huge risk for the Property & Casualty industry. One issue is going to be companies' investment portfolios. Even companies who adopt very conservative investment practices are finding themselves adversely affected by declining equity values”.

He went on: “Another issue will be the extent to which a global recession affects the overall market for P&C products. There is no confidence at the present time in financial markets and financial companies, such that all institutions are seeing their share prices fall and market capitalisation being eroded. I believe it will be some time before this changes.”



14. Managing costs (-)

One of the keys to surviving the recession

Cost management has become a pressing issue with the prospect of declining revenues.

Life companies tended to see this as more of a risk than other sectors. This was “a rising challenge as markets fall” according to the group risk director of a leading life insurance company. Some respondents focused on specific areas of cost, such as regulation, risk management, acquisitions, systems etc.. The chief executive of a Hungarian composite insurer, faced with slumping sales and rising cancellations alongside fixed costs, said that “complex modification” to the business would be necessary.

But on the risk scale this was only seen as middling, possibly because, in the words of the head of global operations of a large French insurer, “much cost has already been taken out”.

Some respondents saw an opposite risk: cutting costs too far. This would lead to “the hidden cost of poorer controls over pricing and claims management, or inadequate training and development of staff,” according to the chief financial officer of a UK insurer.

Cost was a bigger issue in some markets than others, for example Russia where a respondent said that costs “can become a fatal factor for companies in an economic downturn”.



15. Insurance industry reputation (-)

This risk was not included in the previous survey because it was felt that reputation is a composite of risks which we assess separately: governance, management quality, sales practices etc.. However, many respondents said it should be added, and they were right. Reputation emerges very clearly as a risk, particularly now that confidence in financial institutions generally is low. “This is the big one,” said Con Keating of the pension indemnity insurance group, Brighton Rock. “We have taken significant hits to our reputation as an industry,” said a risk management officer with a Canadian non-life insurer.

The industry has taken several ‘hits’

These hits seem to apply to all the major sectors. On the non-life side, the industry has a poor reputation on claims response, which is likely to get worse as insurers and claimants toughen up in the period ahead. “Insurance companies face a credibility gap with consumers because of their policies on responding to claims, i.e.

Loss of confidence in the industry is a key concern. Falling investment markets, increasing pension fund deficits and contagion of the public negativity within the banking sector may all be expected to dent confidence and damage business levels. Falling confidence raises the spectre of increased regulation as a “knee-jerk” tourniquet to soothe public morale.

Manager of group risk
Irish life company

too tough, too much hassle, delays in paying...,” said a former US financial regulator. The life side could be hit by the decline in confidence in savings products. Christopher O'Brien, director of the Centre for Risk and Insurance Studies at Nottingham University Business School, said that “insurers need to restore customers' confidence in their products and their ability to meet their obligations fairly and reliably”.

But some respondents wondered whether the industry's reputation was being unfairly tainted by a crisis that was essentially about banking. Although the troubles of AIG showed that insurers could be vulnerable, the industry is only indirectly in the firing line. The chief risk officer at a large UK insurer was concerned that government failure to control the money markets was having “a knock-on impact on insurers, both in terms of insolvency and reputational damage,” and obliging them to bail out the banks through the financial services compensation scheme. Another respondent said insurers were “not as bad as banks”.



16. Distribution channels (6)

The insurance industry's 'Achilles heel'

The means by which insurance companies reach their customers raise difficult issues of structure and customer fairness. They are also controversial, particularly on the latter point. One respondent described this Banana Skin as “the Achilles heel of insurers”.

The risks mentioned in this area were many. The chief one lies in striking the right balance between sales and advice in the savings and investment market – not allowing the first to bias the second – which is why this risk was ranked much higher by life industry respondents (No. 10) than non-life (No. 27). Many respondents wondered whether commission-based distribution through independent financial advisers could survive the controversies over conflicts of interest and – in some countries – corruption.

There are also difficult strategic choices between in-house and agency distribution, between human and electronic channels, on levels of disclosure, the growth of “wrap platforms” etc. which make this a particularly tortuous subject. Geographically, the challenges are also widespread.

The key question is how insurance companies will emerge from an intense period of regulatory attention to this area, notably the EU’s Insurance Mediation Directive and, in the UK, the FSA’s recent Retail Distribution Review (RDR) which aims to improve the quality of advice given to customers.

The results of the RDR are potentially far-reaching for the UK industry as it struggles to strike the right sales/advice balance. Many respondents wondered whether the industry would find the solution itself or have one imposed upon it - at great cost. “Can the independent advice/broking channel update its business model without regulatory intervention?” asked Paul Smee, the chief executive of the UK’s Payments Council. “Can there be an unforced migration away from commission (whose level will come under pressure)?” However, one respondent felt that the RDR would solve nothing. “Only a determined effort from one or more key players will lead to a cost effective, reliable advice/sales models that can appeal to the mass market,” he said.



17. Corporate governance (23)

Confidence in insurers is low

This risk has crept up a bit, mainly because the governance of financial services companies in general is in the public eye, and confidence in insurers as well as banks is low.

Many respondents discerned a major business risk in the growing public mistrust of insurance and savings products. The group corporate strategist of an international composite insurer saw “a complete loss of consumer trust across most major markets globally”. Management quality, transparency and conflicts of interest were all mentioned as issues.

The consensus is that the crisis will trigger initiatives to beef up corporate governance practices. However, there was a division of view over whether this would be good for an industry which some still see as weak on corporate governance, or merely load it with more unnecessary rules.

Among those who thought corporate governance still had a way to go, an insurance industry non-executive director said: “Board experience and skills are problematic”. A corporate finance director thought that the pressures of recession would prompt companies “to override” the checks and balances of corporate governance. However, others saw legislative threats on the horizon. “More Sarb-Ox,” said a group actuary.

On a separate issue, some respondents pointed out that governance is also an insurance risk for underwriters of directors’ and officers’ indemnities. The possibility of costly class actions by aggrieved customers against insurance companies’ “deep pockets” in the current litigious environment is strong, according to an underwriter specialising in the area.

The trust factor

The tsunami of the financial crisis in banking will be perceived by the public as a financial services-wide failure. Public trust and confidence is at an all-time low.

There is a need to reassert the importance of professionalism and ethical behaviour - and to be seen by the public to do so. Now is the time for industry leadership. It is important for the industry to promote global standards, otherwise heavy-duty regulation will be the order of the day, despite the fact that it might be counter-productive in the way Sarbanes-Oxley was.

David Thomson
Director
Chartered Insurance Institute
London



18. Political risk (16)

Although this risk has fallen slightly, its scope has widened considerably. This is no longer a matter of political shocks in volatile countries, but of growing political interference in the industry more generally.

Political meddling is on the rise

A strong concern is that political “remedies” for the stricken banking industry will hit the insurance sector as well through tighter regulation of the whole financial sector. These could include tougher capital requirements and consumer protection rules - even pressure to buy government bonds to help finance yawning budget deficits. Alan Fairhead, head of global corporate underwriting at Zurich Financial Services, was concerned that government moves to prop up weak insurers would merely “prolong the soft cycle” and weaken the industry in the long run.

Knee-jerk regulation, the impact of government aid/stakes, balance sheet erosion - the combination of all of these could lead to a capital-impaired yet government-guaranteed segment of the industry competing price away and threatening their well-run counterparts.
Group executive committee member
Swiss composite insurer

The head of global operations at a large UK non-life company said these were “very uncertain times, and even western governments may not be as rational as they have been in the past”. Another respondent saw the risk of “increased protectionism and nationalism”.

Outside the immediate preoccupation with crisis fall-out, there is continuing concern with political meddling in insurance more generally: compulsory insurance with fixed premiums, draconian consumer protection legislation, pressure to settle claims, higher taxes, mandatory compensation schemes... Although many of these concerns came from emerging markets, they were also echoed in the US and Europe. A UK-based respondent said that the Financial Services Authority “is now acting for the consumer only [and] is far too political”.



19. Pricing new risks (17)

The emergence of new risks, particularly those related to new technologies such as genetics, nanotechnology and unfamiliar health risks pose a challenge to the industry as to how to price them. So do the changing patterns of natural catastrophes, climate change etc. where events seem to be reaching new levels of unpredictability. Insurers who underprice them face large losses.

The topical question is whether the current environment makes pricing easier or harder. One respondent thought that it might become easier if the recession produces a capacity shake-out which pushes up rates and margins. However, others saw the industry's higher cost of capital and consumer belt-tightening making it harder to price products that would yield market share profitably.



20. Reinsurance availability (28)

A reduction in reinsurance capacity is a potential risk at a time when investment markets are turbulent and capital is constrained. New sources of capital such as hedge funds may withdraw, making it harder for insurers to lay off risks at an economic price. A US broker said that “consolidation of the number of insurers, in addition to tighter regulation over leverage, will potentially limit the ability of insurers to hedge the benefits they provide. This will result in either higher consumer cost or a reduction in the number of features or benefits an insurance company can or will be able to provide”.

Some insurers expect to see the market tighten for big ticket items and hard-to price risks. In some geographic areas, such as the Middle East and Russia, this could have a big impact because international reinsurance capacity helps make up for local shortages of capital.

This risk was of particular concern to brokers and non-life companies. More broadly, people seemed relatively relaxed about it. One respondent even thought that “higher margins will increase capacity”. The most pressing concern on the reinsurance front is with the security of existing arrangements and a possible deterioration in the creditworthiness of counterparties. (See No 7)

**Is ‘new capital’
about to
withdraw?**

A recession could lead to cuts in IT investment



21. Managing technology (12)

Although this risk has fallen quite sharply because, in the words of the head of global operations at a large French insurer, technology was “largely in hand,” there is still a strong sense that the insurance industry is not as wired up as it should be, compared to the banks, for example.

Some respondents saw a reluctance in the industry to invest in this area, despite the control and cost gains that would result. This tendency may be sharpened by the economic downturn. Karen Pauli of US financial services research firm Tower Group said: “Industry results are not good, but carriers must still invest in technology that impacts risk management and customer/distribution. Failure to do so will result in them losing market share”. Another respondent saw the industry inhibited by the fear of IT cost overruns “in a lower profit, lower capitalisation environment”.

The result is an industry that remains vulnerable on the technology front. The managing director of a large reinsurance company said: “People underestimate the fragility of the support systems that are the lifeblood of a company. I'm not saying that they aren't properly supported, but rather that we underestimate the ease with which something could go wrong”.

Will God 'take a rest'?



22. Natural catastrophes (2)

Perceptions of this risk are closely linked to recent history.

The previous survey was conducted while hurricane Katrina and the Asian tsunami were still fresh in people's minds, hence its high position. This time, the perception is that extraordinary events have been fewer, hence the sharp fall. Comments from respondents also suggest that it is closely associated with climate change, where the perceived insurance risks have declined too (see No. 28). The head of investments at a UK life company said: “God moves in a mysterious way, but may be inclined to rest, given the recent workload in the Caribbean,” though another respondent opined: “We're probably overdue for a disaster in a major developed part of the world - Japan or California earthquake”.

This was a risk which the North Americans scored more highly than the rest.



23. Fraud (30)

The risk of fraud is rising with the onset of an economic downturn - as it always does. “Fraudulent claims, thefts, arsons etc. all generally rise in times of recession” said the finance director of a managing agency. One respondent pointed out that the risk was not just customers: “Fraud will inevitably increase both in terms of customer base, and also in terms of management and staff”.

Fraud was seen as a specially looming risk by the non-life side. Increasing fraud will test the quality of claims settlement procedures and consumer protection laws (i.e. whether they impose unfair obligations on insurance companies to pay out).

These concerns were particularly strong in “young” insurance markets, such as Russia.

Growing concern about fraud was an observation from most parts of the globe, and a further aspect of the rising costs that all insurance companies face.

With the financial crisis there is a danger that we will see customers filing more claims, both because their tightening financial situation will make them more aware of claims which they would previously have paid themselves, and also because people will tend to become more “creative”, even fraudulent.

Robert Thorndahl
Chief financial officer
Nykredit Forsikring
Denmark

A poor relation compared to the sales side



24. Back office (15)

The sense that the insurance industry is less efficient than it could be is strong - and one reason is the back office which is seen as backward, accident-prone and a poor relation compared to the sales side.

The head of group insurance and investment risk at a large UK bank saw “old legacy systems and products causing increasing difficulties” and a London-based consultant said such systems were “an increasing constraint on productivity and business performance improvement”. The Lloyd’s of London insurance market was mentioned as an area in need of an IT makeover.

In Germany, Peter Metzler, managing director of Delvag, the Lufthansa insurance arm, expected to see a “significant change in the importance of back office systems and product development in insurance products for the consumer market”. Geographically, some of the strongest concerns were from East Europe and Asia. Mayank Bathwal, chief financial officer of Birla Sun Life in India, saw insurers “handling a large volume of business without a mature back office”.

However, this Banana Skin has fallen, and some respondents thought things were getting better. A consultant saw it as “a key area” where “hopefully residual risk is now not too high”. This risk was seen as higher by observers of the insurance industry who placed it at No 16 than by practitioners who put it in the mid-20s.



25. Retail sales practices (20)

Although there was a fall in this notoriously risky area for insurance, it remains problematic. “Perpetually suspect” was how the head of investments at a UK life company described it. Another respondent pointed out that it was not only a question of current practice but of “past sins coming to light”. Some respondents even felt that while retail sales would slump in a downturn, the mis-selling risk would grow because of greater pressure to generate business and hence to engage in bad practice. One even predicted that there would be “a populist backlash against all financial institutions which manifests itself in a flood of complaints about ‘mis-selling’ of products that have performed poorly because of economic factors”. The risk was more of an issue for the life side, which placed it at No 8, versus No 32 for the non-life side.

Although this risk has received a lot of regulatory attention in recent years (the FSA's Retail Distribution Review, the Treating Customers Fairly programme, the EU Directive on Insurance Mediation), it was felt that regulation was still inadequate or unclear, even excessively tilted towards the customer, suggesting that this Banana Skin will persist.

Bleak outlook for the savings business

A major worry on the life insurance side is that the crisis will cause lasting damage to the savings business, i.e. life and pension products. The combination of loss of confidence in financial institutions, low returns and hard-pressed personal finances made a depressing picture for many respondents.

The head of risk and compliance at a large UK life company was concerned that "deflationary pressures coupled with recession and a low propensity to save in the UK (-1.1%) will lead to net outflows of investment in pension and savings products". The funding of pensions and guaranteed annuities at a time of collapsing markets is another major concern.

Apart from current market conditions, respondents raised longer term issues about the prospects for savings. One was public disillusionment with finance. Another was the perception of an uneven playing field between insurance companies and banks: that regulatory treatment of sales practices tended to inhibit saving but encourage borrowing. An insurance strategist expected that the higher costs imposed by regulation, guarantees and risk management processes "will make the whole product offering unattractive/unaffordable for the average consumer".



26. Terrorism (18)

There seem to be two reasons for the sharp fall in this Banana Skin. One is Barack Obama. Many respondents think that the new US president will ease international tensions and reduce terrorism risk. The head of investments at a UK life company said that "the Obama election heralds an era of international rapprochement".

The Obama effect

The other is that even if there are incidents (and their number seems to be declining), the industry will be able to manage them. "I don't think their cost will be crucial" said a UK consultant. However a Bermuda-based ship insurer was not so sure: he used one word: "Piracy". And the chief manager of an Indian life company, responding before the Mumbai attack in December, said that "a high level of risk management is required because of potential terrorism".



27. Business continuation (29)

The risk of serious disruption to the business - through terrorist attack, computer failure etc - is seen as low order, particularly compared to a few years ago when the whole industry was on red alert. This view echoes the decline in concern about terrorism as an insurance risk (see No 26).

However some respondents noted that the term “business continuation” has acquired a new meaning in a crisis-hit world. A consultant saw this, in the wake of events at AIG, in terms of “the risk of loss of confidence, most probably with a life insurer”. Other respondents saw risks in the areas of suppliers, management skills, sustaining cash flow and sales, and managing costs.

Are we heading for a 'perfect storm'? Constraints on capital raising affecting the liquidity/balance sheets of risk carriers...continued losses from significant weather events ('exceptional' is no longer exceptional)...rising trends in unemployment affecting claims ratios on mortgage payment protection insurance products...pressure on costs, prompting consumers to shop around more, driving up attrition and acquisition costs...
Chief operating officer
Mortgage insurance supplier
UK

Green issues downgraded by the recession



28. Climate change (4)

How fashions change! The only obvious reason for the sharp decline of what respondents last time described as “the hot topic” is that green issues have been downgraded by the recession. “This will move into the background due to the economic situation,” said one respondent. The incidence of climate events has also been lower.

But it will be back. Richard O'Brien, a partner of Outsights scenario planning consultancy, said: “This is a long term issue, and will be very volatile in occurrence and impact”. Some saw it not merely in terms of storms and floods but consequences, such as the spread of tropical diseases. Alice Chapple, a director of green business group Forum for the Future, said that the combination of rising weather events and increased population concentrations in vulnerable areas would force insurers “up the learning curve” for new construction methods.

However, there are still doubts in the industry as to whether climate change is a genuine issue, or merely one “got up” by the green lobby. This was “a red herring” said a respondent from a life company who gave it the lowest possible score.



29. Product development (-)

This was a previously unranked risk which was included to sound out views on the importance of product innovation. The fact that it came 29th suggests that the answer is that it is not seen as high risk, at least in today's business environment. Andreas Bachofner, a director of Shires Partnership in the UK, said there were currently “hardly any new products in non-life and reinsurance”. An executive from a life insurer said that low rates of return and high distribution costs meant that “a typical retail product can rarely be justified”.

Many respondents made the point that the insurance sector has a poor reputation for product development. “Slow, cumbersome and not very imaginative”, “too often confuses complexity with innovation”, “insufficiently close to their customers”, “price the only differentiator” were among the comments made.

**Not enough
product innovation
– or maybe too
much**

The main risk seen by respondents is that the crisis will slow down product development and leave the insurance sector more exposed to competition, particularly from banks on the savings side. The finance director of a large UK life company said that “capital scarcity will make for an environment where all costs are closely scrutinised, and new developments/innovations are in short supply. Opportunities to assist policyholders may be missed (new risks, products etc.)”.

On the other hand, much of the current crisis could arguably be blamed on excessive product innovation, for example in the derivative and credit insurance areas. The managing director of a large US bank which provides services to the insurance sector said that “sales-led product development” had created new risk management problems, leaving insurance companies with “hard-to-hedge positions in illiquid markets”. Surveying recent events, Edward Bace, an analyst with Fitch Ratings, said it was time to go “back to vanilla”.



30. Demographic trends (24)

The main concern here is growing longevity, with its effects on a wide range of products in the savings area: annuities, pensions and life insurance where insurers end up making losses if people live too long or the products are mispriced.

Several pension insurance respondents expressed concern about these trends. One wondered whether pension funds would be able to reinsure longevity risk on economic terms. An insurance advisor saw the market “taking fright” about companies exposed to longevity risks.

Nonetheless the risks in this area are seen to be low and falling in the great scheme of things because the changes are slow enough for the industry to see them and adapt. “It should be manageable,” said one respondent.

Some respondents even saw this as an area of opportunity. The longer people live, the more they are likely to need services such as savings and medical insurance. The present environment should also generate stronger demand for job and payment protection insurance.

However some demographic trends are different, for example in Russia where the population is declining and people are not living longer. The chief financial officer of a large Russian life company said there were “fewer active and solvent clients”.



31. Managing mergers (31)

This remains a low risk area, mainly because of the lack of activity. The head of global operations of a large French insurer said he didn't “see much M&A activity over the next 12 months”.

However, some respondents thought that the crisis could trigger a wave of consolidation in major markets, and in specific sectors such as reinsurance. An Irish respondent thought that “the possibility of consolidation within the industry can only be increasing”. In the UK, a respondent saw sterling's weakness triggering a wave of acquisitions by overseas firms.

**Plenty of time to
see change
coming**

This raises the question whether mergers create or destroy value for the industry. An insurance non-exec observed that the insurance sector “is not very good at this. We can merge the book, but the people and process issues are another matter”. Another issue is that insurance companies tend to get bought by other insurance companies, so little new capital comes into the business.



32. New types of competitors (10)

A bad time to enter the insurance market – or maybe a good one

The threat of competition from new entrants has fallen sharply because the sector is much less attractive. “Lack of capital will constrain innovation” said the director of a broking firm. Others saw barriers to new entrants: the rise in regulation, the apathy of consumers and industry protectionism. Peter Bennett, director of financial ethics firm Fair Money, said: “We need more competitors but those in the market won’t let it happen”.

Nonetheless, respondents thought that outsiders would be watching for signs of weakness where they could take advantage. One said that any casualties in the insurance sector would open the way for “greenfield new entrants without the baggage of past business”. Others pointed to growth in state-sponsored savings and pensions programmes arising from the financial crisis, such as the UK’s National Pension Savings Scheme. Emerging offshore centres, both those offering insurance and savings products, are also potential competitors.

It was a different story from countries like Russia and India, where foreign competitors have made big inroads and put pressure on domestic suppliers. The chief manager of an Indian life company said there was “a big risk with new entrants entering the industry on a regular basis”.



33. Contract wording (25)

Weak wording could be exposed by tougher market conditions

The concern here is that loose wording in insurance contracts will open insurance companies up to larger claims. Several respondents noted that an economic downturn tends to aggravate the problem, either because insurers deliberately loosen wording to win business, or because claimants try harder to pick holes in contracts. The managing director of a Danish non-life company expected that “broad and undefined coverage driven by a soft market will cause serious future losses”. Another respondent said that “you only realise the weakness in times of stress”. The chief underwriting officer of a global corporate insurer said: “Recession increases litigation”.

A potential aggravation to the risk lies in the massive growth of the insurance sector’s exposure to unfamiliar and complex credit insurance contracts whose wording may be about to face its first test in the courts.

But as a risk, it has fallen a few places. A group executive member of a large Swiss composite insurer said that “broadening has ceased”.

There was also the issue of plain language, though here a respondent thought that contract wording was “getting better...less lawyer speak”. A German respondent noted that this area was now covered by new insurance contract legislation.



34. Pollution (21)

A ‘permanent smog cloud over Asia’

The risks of pollution and contamination are seen to be falling - at least in the developed world - which accounts for the decline in this Banana Skin. Asbestos, for example, was described by one insurer as “well contained and reasonably understood”.

But not elsewhere. Many respondents saw this as a rising risk in the developing world, with China and India frequently mentioned. The group actuary of a large UK healthcare insurance company said: “With a permanent smog cloud over Asia, our problems are only beginning”. Litigation was also seen as a growing risk in this area.



35. Too little regulation (32)

Still many points of weakness in regulation

Too little regulation is the least of the industry's worries, as it was last time. Excess is the real problem.

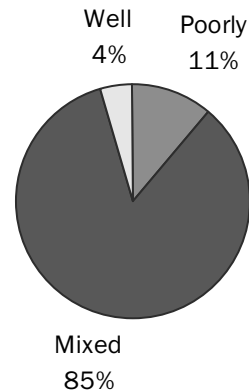
However, several respondents felt that there were risks in this area too, notably in the US where a highly fragmented state-based regulation system leaves plenty of cracks for companies to fall through. This may soon be remedied by the creation of a federal regulatory commission, a development which a former US financial regulator said would be welcomed by large insurers because it would “eliminate hassle” and open the prospect of “a federal cheque book being available in times of trouble”. Though, for that reason, it may also pose a threat to smaller local insurers.

Respondents flagged several areas where they felt that regulation was inadequate: derivatives, particularly the credit variety, monoline insurers, rating agencies, complex groups with bits that escaped supervision. Several respondents from the emerging world also felt their regulatory systems were inadequate or insufficiently harmonised internationally, for example in East Europe, the Middle East and Asia.

Preparedness

We asked the question: “How well prepared do you think the industry is to handle the risks you have identified?” Respondents could answer: poorly, mixed or well.

The insurance industry is seen to be less well prepared



Eighty five per cent of the respondents replied “mixed”, usually because they identified strengths and weaknesses within the industry, and within their own organisations. Only four per cent thought the industry was well prepared, and 11 per cent thought it poorly prepared. The reasons given for good preparedness included foresight, healthy finances and an ability to withstand strong competition. The reasons given for poor preparedness included weak internal controls, inadequate risk management, and stretched financial resources.

This is a more negative result than in the 2007 survey when 21 per cent answered “well”, 76 per cent answered “mixed” and only three per cent said “poorly”.

Appendix: The questionnaire

CSFI

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Insurance Banana Skins 2008

We are asking senior insurers and close observers of the financial scene to describe their main concerns about the insurance industry as they look ahead. We'd be very grateful if you would complete this questionnaire and return it to us by December 5th 2008.

Name Position

Institution Country

Which part of the insurance market do you represent?

Broking/intermediary Life P&C/Non-life

Reinsurance Other (please state)

Replies are in confidence, but if you are willing to be quoted in our report, please tick

Question 1. Please describe your main concerns about the risks facing the insurance industry (both individual institutions and the system as a whole) as you look ahead over the next two to three years.

Please turn over

Question 2. Here are some areas of risk which have been attracting attention. Looking ahead, how do you rate their severity, and how do they compare with last year? Use the right hand column to add detail. Add more risks at the bottom if you wish.

	Severity 1=low 5=high	Trend Rising Steady Falling	Comment
Accuracy of actuarial assumptions.....	<input type="checkbox"/>	<input type="checkbox"/>
Back office/systems quality	<input type="checkbox"/>	<input type="checkbox"/>
Business continuation.....	<input type="checkbox"/>	<input type="checkbox"/>
Capital availability.....	<input type="checkbox"/>	<input type="checkbox"/>
Complex instruments.....	<input type="checkbox"/>	<input type="checkbox"/>
Contract wording/coverage.....	<input type="checkbox"/>	<input type="checkbox"/>
Corporate governance.....	<input type="checkbox"/>	<input type="checkbox"/>
Demographic trends.....	<input type="checkbox"/>	<input type="checkbox"/>
Distribution channels.....	<input type="checkbox"/>	<input type="checkbox"/>
Equity markets.....	<input type="checkbox"/>	<input type="checkbox"/>
Fraud.....	<input type="checkbox"/>	<input type="checkbox"/>
Insurance industry reputation.....	<input type="checkbox"/>	<input type="checkbox"/>
Interest rates.....	<input type="checkbox"/>	<input type="checkbox"/>
Investment performance.....	<input type="checkbox"/>	<input type="checkbox"/>
Long tail liabilities.....	<input type="checkbox"/>	<input type="checkbox"/>
Macro-economic trends.....	<input type="checkbox"/>	<input type="checkbox"/>
Management quality.....	<input type="checkbox"/>	<input type="checkbox"/>
Managing costs.....	<input type="checkbox"/>	<input type="checkbox"/>
Managing mergers.....	<input type="checkbox"/>	<input type="checkbox"/>
Managing technology.....	<input type="checkbox"/>	<input type="checkbox"/>
Managing the pricing cycle.....	<input type="checkbox"/>	<input type="checkbox"/>
New types of competitors.....	<input type="checkbox"/>	<input type="checkbox"/>
Political risks.....	<input type="checkbox"/>	<input type="checkbox"/>
Pricing new risks.....	<input type="checkbox"/>	<input type="checkbox"/>
Product development.....	<input type="checkbox"/>	<input type="checkbox"/>
Regulation: - too much.....	<input type="checkbox"/>	<input type="checkbox"/>
- too little.....	<input type="checkbox"/>	<input type="checkbox"/>
Reinsurance: - availability.....	<input type="checkbox"/>	<input type="checkbox"/>
- security.....	<input type="checkbox"/>	<input type="checkbox"/>
Retail sales practices.....	<input type="checkbox"/>	<input type="checkbox"/>
Risk management techniques.....	<input type="checkbox"/>	<input type="checkbox"/>
Specific risks:			
- climate change.....	<input type="checkbox"/>	<input type="checkbox"/>
- natural catastrophes.....	<input type="checkbox"/>	<input type="checkbox"/>
- pollution/contamination.....	<input type="checkbox"/>	<input type="checkbox"/>
- terrorism.....	<input type="checkbox"/>	<input type="checkbox"/>
.....	<input type="checkbox"/>	<input type="checkbox"/>
.....	<input type="checkbox"/>	<input type="checkbox"/>

Question 3. How well prepared do you think the industry is to handle the risks you have identified?

Poorly Mixed Well

CSFI PUBLICATIONS

1. **“Financing the Russian safety net”**: A proposal for Western funding of social security in Russia, coupled with guarantee fund for Western investors.
By Peter Ackerman/Edward Balls. September 1993 £40/\$65
2. **“Derivatives for the retail client”**: A proposal to permit retail investors access to the risk management aspects of financial derivatives, currently available only at the wholesale level.
By Andrew Dobson. Nov 1993 (Only photostat available) £10/\$15
3. **“Rating environmental risk”**: A proposal for a new rating scheme that would assess a company’s environmental exposure against its financial ability to manage that exposure.
By David Lascelles. December 1993 £25/\$40
4. **“Electronic share dealing for the private investor”**: An examination of new ways to broaden retail share ownership, inter alia, by utilising ATM networks, PCs, etc.
By Paul Laird. January 1994 £25/\$40
5. **“The IBM dollar”**: A proposal for the wider use of “target” currencies, i.e. forms of public or private money that can be used only for specific purposes.
By Edward de Bono. March 1994 £15/\$25
6. **“UK financial supervision”**: A radical proposal for reform of UK financial regulation, (prepared pseudonymously by a senior commercial banker).
May 1994 £25/\$40
7. **“Banking banana skins”**: The first in a periodic series of papers looking at where the next financial crisis is likely to spring from.
June 1994 £25/\$40
8. **“A new approach to capital adequacy for banks”**: A proposal for a market-based alternative, using the concept of ‘value-at-risk’, to the present mechanistic Basle approach to setting bank capital requirements.
By Charles Taylor. July 1994 £25/\$40
9. **“New forms of Euro-Arab cooperation”**: A proposal for a new public/private development finance corporation to promote employment-generating projects in the Arab world.
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10. **“Banking banana skins II”**: Four leading UK bankers and a senior corporate treasurer discuss lessons for the future from the last banking crisis.
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17. **“The City under threat”**: A leading French journalist worries about complacency in the City of London.
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20. **“Twin peaks”**: A regulatory structure for the new century” A proposal to reform UK financial regulation by splitting systemic concerns from those involving consumer protection.
By Michael Taylor. December 1995 £25/\$40
21. **“Banking banana skins III”**: The findings of a survey of senior UK figures into where the perceived risks in the financial system lie.
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22. **“Welfare: A radical rethink - The Personal Welfare Plan”**: A proposal (by a banker) for the private funding of health, education, unemployment etc. through a lifetime fund.
By Andrew Dobson. May 1996 £25/\$40
23. **“Peak Practice”**: How to reform the UK’s regulatory structure. Implementing “Twin Peaks”.
By Michael Taylor. October 1996 £25/\$40
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By Stavros Pavlou. September 1997 £25/\$40
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