

# CSFI

## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET  
LONDON W1J 7AB

TEL: 020 7493 0173  
FAX: 020 7493 0190

### **Remarks from the CSFI / Generali Fellowship Launch by Shirley Beglinger**

Generali and the CSFI have launched the first Fellowship for Insurance this year with the stated aim of getting the insurance industry to think about its challenges in a joined-up manner rather than as independent and unconnected pieces of different mosaics. As we know the insurance industry doesn't do joined up thinking, and quite often it doesn't seem to do any thinking at all.

Nevertheless, we've got to get the brains in gear, because the light at the end of the tunnel is one of several oncoming trains. In no particular order, they include:

- sub-prime and its effect on investment portfolios and underwriting results
- Indeed there's the general pathetic feebleness of insurance pricing because this quarter's premium is more important than next quarter's underwriting loss.
- IFRS and fair value accounting is beginning to roll through balance sheets, and it is likely to introduce even more volatility into company results than is already inherent in our business. When that happens, stock analysts will probably hate us even more than they already do.
- There's securitisation and its effect on the nature, duration and price of insurance capital. The days when insurance shareholders behaved like absentee landlords charging peppercorn rents are gone.
- Distribution is another headache. In the UK everyone seems to be buying brokers or paying ridiculous amounts to Towergate in the hopes of securing distribution. At the same time the brokers are scared silly that they're about to be disintermediated by the internet. Or by supermarkets.
- And the elephant in the room is Solvency 2, due to take effect in 2012, and which nobody really wants to acknowledge because it's just too big, too technical and too blooming difficult.

So we all stick our fingers in our ears and hum loudly while Standard and Poors tells us that under Solvency 2 as many as 25% of all European insurers would not meet Minimum Capital Requirements. Every 4th European insurance company must either find a new business model or disappear as an independent entity. That's a scary statistic.

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E-mail: [info@csfi.org.uk](mailto:info@csfi.org.uk)  
Web: [www.csfi.org.uk](http://www.csfi.org.uk)

And perhaps the industry as a whole needs a new business model. Bankers have introduced the industry to securitisation and ILS and all sorts of good stuff, and this has enabled us to jazz up the back end. But out front, Non-life insurers haven't given their customers anything fundamentally new for over 50 years. And it seems to me that the customers are increasingly turning up their noses at the prospect of paying good money for often shoddy service and outdated products.

Innovation is desperately needed before wide swathes of the industry meander into obsolescence. Innovation in turn generally requires joined up thinking or better yet group thinking, and insurers suffer from a terminal case of 'Not invented here syndrome'. So perhaps it needs a think-tank like the CSFI, which never hesitates to bite the hand which feeds it. And at least one company to take the lead in thinking outside the box.

Going back to inspiration provided by our banker friends, the unexpected thought leader back in the early 90s was JP Morgan, a Wall Street firm known at that time for Ivy League Attitude and for steadfast rejection of new fangled stuff. At a time when banks kept their credit loss data under lock and key and threat of death, Morgan posted theirs on the still fledgling internet. Then they corralled a group of other banks and hooked up with a modelling company called KMV. That group of banks pooled their data and produced a set of tools and which became known as Credit Risk Metrics. And Credit Metrics for the first time enabled banks to trade debt and credit risk with each other. Credit Metrics laid the foundation – although this is perhaps not the time to mention it – for a huge and liquid market where trillions of dollars of securitised everything are traded every day. Even those of us who have never heard of Credit Metrics have in some way had our net wealth increased by that trading.

Those founding banks didn't take the giant leap lightly or for altruistic reasons. They had realised that an unspectacular change in US legislation had fundamentally changed the way America saved and borrowed money. That change was about to disintermediate them out of existence or at least out of profit. Creating Credit Metrics and its associated deep and liquid trading pool enabled them to deliver on a strategy which may have read something like 'Make the maximum amount of trading profit by making the most efficient use of risk bearing capital'. And it worked.

Which brings us neatly back to our elephant in the room. I'm not generally keen on stuff coming from Brussels, but Solvency 2 is genuinely a paradigm-shifting piece of legislation. At one stroke the industry is being hauled into the 21st Century. Thanks to Lamfalussy, EU supervisors can no longer drag their heels on bits of regulation which don't suit their national flag-carriers. Instead, the EU is giving Companies and groups the opportunity to

calculate their own capital requirement, for their own risk profile, using their own data. There is space to consider the efficiency of hybrid capital and risk securitisation. But it all pre-supposes that insurers actually have lots of clean data, and can access that data easily. Since the industry has hitherto taken a caveman attitude to IT, I'm a little sceptical on that front.

The EU also presupposes that companies will recognise how modern finance and modern technology is changing the shape of the insurance value chain and position themselves accordingly. They might be a distributor, or an aggregator or simply a holder of risk. Each position has its appeal, but it takes data and a lot of intellectual firepower to figure out where one really wants to be. The companies who profit most from Solvency 2 will be those who think long and hard and outside the box about what they have to do between now and 2012 in order to achieve the corporate objective of 'maximum trading profit by making the most efficient use of risk bearing capital'.

Modernity and efficiency are coming soon to a theatre in our offices, and it behoves us to think about Solvency 2 as both a threat to our existence and a huge opportunity to reinvent our industry. The Fellowship aims to think about the various facets of the challenge during the coming months. There will be a series of round-table discussions, the first of which we hope to hold on June 11. The working title is 'The Changing Shape of insurance capital: Barbarians at the gate or Darwinian survival?' There is a list of other proposed round tables beside the entrance. Any feedback or alternative proposals gratefully received, and of course we hope for a lively turnout. Notes will be taken, and during the course of the year, we shall attempt to join up the dots.

Thank you.