

## **The Insurability of Risks**

### *Perspectives for the Insurance Industry*

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When we agreed on today's topic, no one could have foreseen this year's unparalleled series of catastrophes. Hurricanes Katrina, Rita, and Wilma came at the end of an already extraordinary sequence – four hurricanes in the US in six weeks last year and the tsunami at the end of December. The New Year began with floods in the UK. In late summer, we saw forest fires in Portugal and Spain, followed again by floods in Switzerland, Germany and Austria. Finally, we witnessed the tragic earthquake in Kashmir that has brought death to more than 50,000 people and left millions without shelter.

These catastrophes underscore the importance of insurance. Millions who had bought coverage are now in a position to rebuild their homes and businesses and hopefully put their lives back together. In the last months, a few colleagues and I visited the areas devastated by the floods in Switzerland and hurricane Katrina, receiving first-hand insights into the human, financial and societal issues brought on by the catastrophes. Hearing an eyewitness account gave us a deeper appreciation for the emotional side of our business. Our visit also sparked some creative thinking about constructive next steps. We know that there is still a lot of work before us.

Unfortunately, there are also people who did not buy insurance. Let me set aside the tragic events in Kashmir where insurance is almost non-existent and focus on the aftermath of Katrina. I am sure there were many reasons why people in Alabama, Louisiana and Mississippi failed to purchase adequate coverage. All we know is that they are now in dire straits. We understand their plight and need for assistance in an extraordinary difficult situation.

I am aware of intricate legal and contractual problems that make the extent of the industry's exposure to hurricane Katrina an ultimately political issue. This is neither the time nor the place to dwell on issues relating to the causes of flood losses and the relevant policy exclusions. It will take most likely years and probably many law suits before we will arrive at closure on these questions.

But let me make one point: what is difficult to comprehend are law suits that – if successful – would force our industry to cover claims that are outside contractual agreements. Saying that insurers have deep pockets and demanding that they should pay for exposures for which they did not collect premiums and did not reserve sets a dangerous precedent.

The denial of contract certainty, as implicitly proposed by litigation in the aftermath of Katrina, could drive our industry out of the business of providing coverage against catastrophic events. Indeed, the sanctity of contracts is fundamental to the concept of insurability, and its violation would impair the provision of insurance through private insurers.

Let us take a closer look at these issues.

The mitigation, and hence the insurability of risks, is indeed a topic that has occupied society for hundreds if not thousands of years. So I would like to start out with a brief discussion of the role insurance has played and continues to play in our society. I will then offer a brief definition of insurability and examine the special issues raised by terrorism and large catastrophes. My remarks will be limited to the contribution by private insurers and exclude programs that are provided only by governments.

But the role of government is vital. The state must create and guarantee the institutional framework in which private markets operate. In special circumstances it may also provide guarantees or backstops that increase the capacity of private insurers. This makes insurability closely related to the presence – or absence – of government intervention. Hence, defining the right regulatory framework is important for our industry to meet its economic role. This is a topic I will return to repeatedly in the course of my remarks.

Let me say upfront that I do not object to regulation. In my view, a stable regulatory framework is a necessary condition for insurability. I also believe that regulation must be strong to be credible. Ultimately, strong and sound regulation will enhance the capabilities of our industry and foster an environment that supports growth and prosperity. This is a point well worth pondering in the aftermath of recent catastrophes, when so much depends upon our industry's ability to fund a large part of reconstruction.

Ladies and gentlemen, let me now turn to the concept of insurance.

The desire to protect one's assets and mitigate risk seems to be universal. In earlier times when insurance was not widely available, the death of a breadwinner would reduce a family to starvation or charity, and only the wealthiest could afford to protect themselves against potential losses.

Today, insurance is ubiquitous in industrialized countries, and most people have ensured protection of their non-financial assets. Some time ago, a Canadian insurance company wrote in its customer letter:

“When a man has adequate insurance covering his life, so as to provide for his family; insurance on his home... protection against liability claims ... insurance according to the needs of his business; and insurance that will provide him with maintenance upon his retirement: that man can sleep well at night because he has financial peace of mind.”

Not surprisingly, for insurance to bring us financial peace of mind has required centuries of developments and refinements. We know that the concepts of risk pooling across many independent agents and the fundamental idea of portfolio diversification were already well established in the Renaissance. A bit later, in 1687, Edward Lloyd opened a coffee house near the Thames on Tower Street. It quickly became the meeting place of what today we would call marine underwriters and the hot spot for everybody dabbling in insurance. A later source tells us:

“Underwriters were willing to write insurance policies against almost any kind of risk, including house-breaking, highway robbery, death by gin-drinking, the death of horses,

and ‘assurance of female chastity’ – of which all but the last are still insurable.”

Needless to say, complaints about insurers’ willingness to pay are equally old. In the 14th century, Francesco di Marco Datini, a Florentine merchant whose business connections went as far as Barcelona and Southampton, wrote to his wife:

“For whom they insure, it is sweet to them to take the monies; but when disaster comes, it is otherwise, and each man draws his rump back and strives not to pay.”

Insurance wouldn’t be what it is today without the contributions of the Bernoulli family of Basle who gave the world no less than eight mathematical geniuses. After the path-breaking work by Jacob Bernoulli and his brilliant nephew Daniel, risk was no longer something that had to be endured. Rather, risk had become a set of opportunities open to choice and to meaningful business decisions.

There can be no question that insurance plays a major role in our market economies. The widespread introduction of insurance in the Italy of the 13th century ranks next to what the invention of the letter of credit means for modern banking and the contemporaneous development of double entry bookkeeping for accounting by Genoese and Florentine merchants, which was first written down by the Franciscan monk Luca Pacioli. Double entry bookkeeping provided an understanding of cost and revenue streams, and it gave us the tool for the valuation of capital. The letter of credit facilitated movements of capital over time and across borders, while insurance protected the owners of capital from loss.

In short: the introduction of insurance stood, just like the innovations of the letter of credit and double entry bookkeeping, at the root of modern capitalism. They were a necessary condition for the modern corporation to emerge and grow. Without the ability to protect against loss, the capacity for entrepreneurial risk-taking would have been rather limited and the current prosperity of our market economies would have not been achieved.

Clearly, the supply of and the demand for insurance have always been subject to society’s perception of risk. What strikes me as peculiar is that known and easily quantifiable risks – such as driving private motor cars – are readily ignored, while rather marginal risks – such as electromagnetic waves allegedly causing brain tumors – are blown completely out of

proportion. At the same time, we are seeing a growing compensation mentality. Everybody is perceived to be a victim of one thing or another, regardless of his or her own risky behavior, and everybody feels entitled to compensation.

These developments may not be surprising. But when applied to insurance policy issues, they could be creating a perfect storm, severely impacting insurability. We do not even have to stretch our imagination. The American tort system is a living example of what can go wrong when an unwillingness to accept responsibility for one's own risky behavior and a compensation mentality join forces.

Tort is a legal word that in plain English means "damage caused by negligence." This is basically an ancient concept that for most of its lifetime has provided welcome protection to victims of careless behavior. Unfortunately, in the past few decades it has come to be abused – which in the process has turned the US tort system into a huge business liability.

What happened is a fundamental shift in the meaning of carelessness. Events once ascribed to fate or bad luck are now "torted" onto companies or individuals, especially, and not surprisingly, on those with deep pockets. The result is a huge rise in malpractice claims, product liability suits and accident damages awarded.

But ask yourself: are fast-food outlets careless in selling to people who eat too much? Is it negligent not to warn customers that knives can cut, alcohol may intoxicate or that lottery tickets are, just what it says, a lottery? Of course, the answer is no in all cases. But unfortunately, that is not the politically correct answer anymore; the tort system has already assumed a life of its own.

Most visible is an explosion in costs. US tort costs have climbed an inflation-adjusted ten-fold in the past 50 years. By the end of this year, the total annual cost per person is expected to be close to 1,000 dollars. For the average 2-1/2 people American household, that is a staggering 8% of its income. We are talking "hidden tax with no representation", the kind of tax over which the American colonies started a revolution more than 200 years ago.

Unfortunately, behind this array of numbers lies also a human cost. Asbestos claims, for example, have pushed into bankruptcy more than 80 companies that once employed thousands of people, including the venerable giants GAF, Johns-Manville and WR Grace. The threat of malpractice has prompted doctors and hospitals to reduce services, with the neediest patients usually among the first whose service has been reduced or cut completely. Some doctors now say – off the record, of course – that it is better to let a patient die than to attempt heroic surgery, fail and risk a lawsuit.

Now it would be another thing if the tort system set things right that were wrong in the first place and compensated victims for true losses. But payments return less than 50 cents on the dollar to people they are designed to help, of which only 22 cents go to compensate for actual economic loss. There is certainly a good reason for reforms that must address the rights of those who are truly injured, while weeding out frivolous claims.

It is important to note that Europe has not gone down the American road. The difference between the tort practices in America and the European continent is rooted in different legal traditions. US common law draws from precedents; hence, it is prone to escalation based on “bad, precedent-setting cases.” In contrast, continental law is statute-based, which limits the flexibility of the courts on this side of the Atlantic.

While it would be preposterous to suggest that Americans attempt a wholesale change of their legal system, I am nevertheless optimistic about the feasibility of tort reform in the US. For starters, adopting three European practices would make a tangible difference in reducing the adverse impact of the US tort system:

- First, loser-pays – US companies often settle frivolous suits, because fighting and winning would consume even more time and money. In Europe, however, nuisance suits are less attractive, because losers usually bear all legal costs.
- Second, standard damage settlements – in the US, identical injuries can produce pain and suffering awards of 1,000 dollars in one case and 100,000 dollars in another. Within a given European country, awards tend to be standardized.
- Third, limited contingency fees – US tort lawyers frequently work for a share of the money paid to settle the claim, which can approach astronomical sums. In contrast, most European lawyers work for flat hourly fees.

But changing only the incentives of the legal system will not suffice. For the abuses of the tort system to stop, we must accept more accountability for our own actions. This point has recently been reinforced by Britain's most senior judges. In 2003, the five law lords on the Appellate Committee of the House of Lords – an equivalent to the supreme courts in other countries – ruled that individuals must accept responsibility for their own actions, calling for an end to the “culture of blame and compensation.”

The judges ruled against a man who was paralyzed after diving in to a lake at a country park despite warning signs. He subsequently went on to sue two local authorities for not preventing him diving into the lake. While acknowledging the personal “terrible tragedy,” the judges commented:

“The pursuit of an unrestrained culture of blame and compensation has many evil consequences, and one is certainly the interference with the liberty of the citizen. Of course there is some risk of accidents arising out of the “joie de vivre” of the young, but that is no reason for imposing a grey and dull safety regime on everyone.”

The issue of accountability will turn up again in my observations on insurability to which I will now turn.

Rather than bore you with technical details, I shall concentrate on the principle. The limits of insurability are reached when conditions of assessability and randomness are not met. If expected losses cannot be anticipated, measured or observed, they cannot be insured; and if losses cannot be insured, the markets will offer no insurance coverage at all.

But for private insurers to offer coverage, we must go one step further. Insurability cannot be divorced from the institutional framework that ensures the functioning of markets. The point I would like to repeat in this context is the importance of contract certainty. Since many of our contracts are long-term in nature, the selling and pricing of a product without knowing its cost are particular challenges. This is also what fundamentally separates us from banks. Whereas a bank's loss is capped by the amount of the loan, insurance losses or claims payments can be potentially unlimited. The outcome depends to a large degree on the interpretation of the contract in light of an evolving jurisprudence.

This can be easily seen in the case of asbestos where we are paying for claims today that are related to policies written decades ago. In such an environment, insurers and their customers must depend on the sanctity of contracts. If contract certainty is undermined, our ability to underwrite long-tailed businesses would quickly diminish. That is why I am concerned that lawsuits filed in the aftermath of Katrina could impair the adequate supply of catastrophe coverage in the future.

Let me illustrate the principle just established with the examples of terrorism and natural catastrophes.

Terrorism meets the criteria for losses that are not easily insurable – if indeed they are insurable at all. Data available from past events reveal little about future risk and the horrendous loss potential. The risk of coordinated terrorist actions may also impair the geographic diversification of risks. If, furthermore, we accept the premise that terrorism is war, then terrorism risks cannot be covered by the private sector alone.

Hence, there is a role for the government to provide a backstop for private capacity to stay in the market. Reducing the risks of loss associated with terrorism through governmental intervention is akin to providing a public good. How this might be worked out would be the topic for another evening. Obviously, there are many issues to be sorted out, such as developing meaningful scenarios to estimate the probability of future terrorist attacks and modeling the expected losses for which private insurers would be held responsible with a reasonable degree of accuracy. For now, it suffices to point out that a number of countries have developed workable solutions to mitigate the risks and losses associated with terrorism, where both the government and the private sector are making a contribution.

Large natural catastrophes are different. For one, they do not violate the principles stated above – randomness and assessability. To be sure, they have not always been perceived as insurable. But insurers have learned how to make them manageable, although the sheer scale of destruction can be huge. Let's briefly examine the recent hurricanes.

While we have no conclusive evidence that recent catastrophes are the result of global warming, it will be prudent to factor in the obvious. Seven of the ten costliest hurricanes in

the US have struck in the last 15 months, and the trend seems to continue. One reason why hurricanes have become so costly is simply a reflection of economic growth in very exposed areas.

An example is the buildup along US coastal regions in the second half of the last century. In 1926, Miami was a small town of tens of thousands of people. On September 12 of that year, a category 4 hurricane struck Miami, Pensacola and parts of Mississippi and Alabama, killing in total 243 people. It nearly demolished Miami Beach and shoved seawater into the City of Miami. When the winds finally stopped howling, thousands of survivors scrambled aboard northbound trains and left, vowing never to return.

But return they did, and many more joined them on the trek to the Gulf shores. If the same caliber hurricane were to hit Miami today, it could, according to calculations by the National Oceanic and Atmospheric Administration (NOAA), cause insured losses of close to 100 billion dollars. That is more than double what we expect Katrina will cost the industry.

Today, roughly half of the nation's gross national product, involving about 60 million jobs, comes from US coastal regions. Not all of these people live in regions prone to hurricanes; but the ones living in the danger zone are like sitting ducks when big storms strike. No one can say that these risks were not known. Let me quote from an official report:

“Continued coastal growth and inflation will almost certainly result in every future major land-falling hurricane (and even weaker hurricanes and tropical storms) replacing one of the current costliest hurricanes. If warnings are heeded and preparedness plans developed, the death toll can be reduced. In the absence of a change of attitude or laws restricting building near the ocean, however, large property losses are inevitable.”

Sadly, this warning from a 2001 NOAA report was not heeded.

Unfortunately, the US example can easily be extended for the rest of the world. Half of the world's population lives in coastal regions, many of which are vulnerable to extreme weather events. Consequently, the risks to these people's assets are high, and the risks of losses are expected to grow almost exponentially. According to the UN, mega-catastrophes

of the type that traditional models expected to occur once every 100 years, are now predicted to happen every 25 years, and the losses will be 10-times higher than those currently experienced.

These figures – and the underlying behavior – bring me back to accountability. If people are living in areas prone to natural catastrophes, we must ensure that they can also live with the consequences. This calls for a prudent risk management that includes precautionary public measures and adequate private and public insurance. Our industry is prepared to assist its customers. We know where the large exposures are, and we have the instruments to make their associated risks manageable. But for our efforts to be successful, they have to be conducted within a framework enabling insurability. The recent catastrophes may have been a wake-up call. Insurability cannot be taken for granted. It is an evolving process, which must be based on a public understanding of the role the insurance industry plays in our society.

It behooves our industry to be in the lead in facilitating such a public understanding. This requires a profile and an engagement in the public arena that most of us have avoided in the past. But insurance is not only indispensable in the modern economy; our industry may also be at the cusp of a profound transformation. By and large this transformation is driven by a growing demand for risk mitigation and risk management services, which should make the case for insurance even easier.

Let me be more concrete and first address the factors driving the demand for insurance.

I just talked about catastrophes and the fact that economic losses associated with hurricanes and coastal floods are rising rapidly. I also touched on the costs associated with the court-supported empowerment of consumers that has given rise to increased liability risks and an excessive growth of the tort burden. Add to this emerging systemic risk, potential threats due to the application of scientific breakthroughs such as nanotechnology, or the spread of contagious diseases, which could harm not only the world's population but also our global economy.

I could go on. Undoubtedly, there is no limit to the demand for risk management solutions. The challenge for our industry is to better understand these risks and to develop

products and solutions that are brought to market based on the appropriate technical pricing. Judging by past performance, this will require our full attention. I still recall that poor underwriting results struck me most when I joined the insurance world in 2002. I said then that it is indeed a peculiar industry that for many years never made a profit in its core activity. In fact, the US property and casualty industry, for which we have the best data, did not have a profitable underwriting result between 1978 and 2003, and only returning to profitability last year.

This brings me to the second reason why I believe our industry is bound for change. We cannot stay in business without being profitable in our core activity. While high investment returns may have compensated for poor underwriting performance in the past, this will not likely be so in future. We must go forward with operational and financial discipline; and we must take a fresh look at the business models that have been in use in our industry for more than 100 years.

Let me share with you a few ideas that may shape the future contours of our industry.

- In the past 10 to 15 years, banks have shown us how to de-risk their balance sheets through the securitization of credit risk and shift revenue to fee-based services. It strikes me indeed as rather peculiar that risk mitigation should stop on our balance sheets. Just looking at credit risk, we observed how banks sliced it in many different ways and passed it on to other market participants. I believe there is room for us to do the same, and I believe we could do so with appropriately structured products.
- Associated with this, I believe insurers still underutilize their capital. Basel II has forced and perhaps also enabled banks to drive their businesses with leaner capital structures. A comprehensive risk management involving finite risk, contingent capital and run-offs could do the same for us. Of course, this requires that we succeed in developing the right methodologies for controlling remaining risk and that regulators comprehend and support our internal models.
- I believe there is also scope for our industry to improve customer service by making a more intelligent use of available information technology. This is not a call for E-tyzing our business yet again. Many went that route in the nineties and they were subsequently forced to write off ill-advised investments. But information technology plays a vital role in our back offices. It could serve us well in better understanding the

needs of our customers. Nifty competitors have shown again and again how risk that was perceived to be uninsurable – people with poor driving records, for example – have become manageable by slicing customer data differently. There is plenty of scope for us to improve in many areas.

Again, I could go on. Insurers have always pushed the frontiers of insurability through innovation, and I trust that we will continue to do so. I believe it is fair to say that the potential of insurance is still underused. But the recent years have seen exciting developments expanding the instruments available for risk transfer and risk management and linking work traditionally done by specialists in finance and underwriting. Now is the time to harvest the fruits of these developments and bring them to the market.

As excited as I am about the future of our industry, I am equally excited about doing business from Switzerland. In light of the Bernoulli's seminal contribution to insurance, it is perhaps only fitting that Switzerland should be the current home of several of the world's large leading insurance companies. They date back to the Golden Age of the 19th century, when today's giants in the Swiss production and financial services sectors were founded. In describing the birth of many well known firms, the late Stanford historian Gordon Craig speaks of the triumph of the liberal economic policy framework that made a town like Zurich – and by extension Switzerland – prosperous.

Clearly, Switzerland continues to be an excellent place for business. Access to a pool of talented people, a stable macroeconomic environment supported by prudent fiscal and monetary policies, and openness to the flow of international trade and ideas are the main factors of this country's success in the global economy. We must take care of this heritage by ensuring that the keys to lasting prosperity are not lost.

Let me be a bit more specific on the implications for our industry in Switzerland.

Insurance is a demanding business. The frontiers of knowledge are constantly moving and new ideas are adopted rapidly. That is why research and development are indispensable for our industry. A strong commitment to the growing and continuous training of our talent based on a closer interaction with the leading schools and research departments in Switzerland could give us a decisive competitive advantage.

But almost equally important are the provisions of an appropriate regulatory framework that will allow our firms to discharge their economic role and operate on a level playing field. While I believe that Switzerland has, by and large, a well-calibrated regulatory structure, there are always issues that warrant further discussion. Let me focus on three of them.

First, the proposed integrated financial market supervisory authority, FINMA in short. With this proposal, Switzerland plans to integrate supervision of the insurance and banking industries, following the example of the United Kingdom, Germany and Austria – just to mention a few. Clearly, joint supervision is based on the recognition that banks and insurers are often confronted by similar issues that seem to justify common supervision.

But seemingly similar issues should not muddle the fact that banking and insurance are different businesses. In particular, the long-term nature of many insurance contracts I mentioned before defines an important difference between insurers and banks. Hence, an integrated supervision must ensure that banks and insurers are treated differently whenever the nature of their business is different. Above all, this requires that entities in charge of banking and insurance supervision have very specific skills to analyze and regulate their specific sectors competently.

Having said this, I believe that putting the Federal Banking Commission and the Federal Office of Private Insurance under one roof is a step in the right direction. It has the potential to increase the smooth functioning and effectiveness of Switzerland as a hub of the global financial services industry. I particularly welcome that FINMA has the potential to become a strong regulator. In my view, as I said earlier, strong regulators are principles-based, technically competent and well respected in the industry and by their peers.

These characteristics will go a long way in providing a competitive advantage to our financial services industry. It is in the nature of an export-driven country like Switzerland that its companies are exposed to a multitude of foreign regulators when doing business abroad. My company, for example, is doing business in more than 120 countries. This means that we are in compliance with as many regulatory regimes and quite often as many conflicting regulatory requests. Strong supervision in Switzerland lends credence to the

claim that our businesses are meeting tough regulation. It will go a long way in reducing the burden of an often onerous regulation imposed abroad.

My second point relates to the Swiss Solvency Test being developed in line with the revision of the Federal Law on Insurance Supervision. By introducing an economic view that considers all risks in the balance sheet rather than just focusing on liability risk, the solvency test is reflecting a trend toward an increasingly risk- and market-based insurance supervision. This again is a step in the right direction.

But, as always, the devil is in the details. For one, we do not yet have clarity with respect to the resulting target capital requirements, and, second, our regulators are developing prescriptive guidelines on internal models, which could be different from Solvency II currently under construction in the European Union.

This illustrates the importance of getting the Swiss Solvency Test right. We must ensure that there is as little ambiguity as possible in defining the necessary requirements. At the same time, we must create a level playing field with respect to our European competitors. To repeat, regulation at home should be tough. But it must also be fair, and it should not impose a burden relative to the regulation imposed abroad.

My final point deals with the perennial issue of the minimum interest rate guarantee. I am actually surprised that this continues to be an open issue. Together with my colleagues in the life insurance business, I am concerned about proposals currently discussed in the federal parliament that would unduly tie the minimum interest rate to past investment performance and short-term market movements. This would disregard investment risk and ultimately undermine the financial stability of our private pension system.

In light of these developments, let me repeat the principles our industry has defined. They are based on flexibility and transparency. First, the minimum interest rate should remain flexible enough to reflect market conditions. Second, the formula must be transparent. All participants must be in a position to calculate and understand it readily. We owe this to our customers who demand accountability. But we also owe it to our shareholders who expect that our life and pension businesses are based on a viable investment model. But such a model remains elusive given the current rule for determining the minimum interest rate.

Ladies and gentlemen, the insurability of risk is more than a question of technical analysis. Once the conditions of assessability and randomness have been met, we must look at the institutional framework underpinning our transactions in private markets. The history of our industry has shown again and again that we have always explored innovations that extend the boundaries of insurability. I am convinced that we will continue to do so.

Our industry is prepared to play a major role in fostering growth and prosperity. Mankind has always lived with risks. Our challenge is to promote the public's understanding of these risks and facilitate appropriate risk management solutions by pushing the envelope of insurability. The key role of our industry is to enhance entrepreneurial risk-taking, which is the driving force behind our economic well-being. If we stifle risk-taking through ill-advised government and regulatory intervention, we will do so at our own peril. But if the regulatory framework is conducive, insurers will not hesitate to make their contribution to our future prosperity.