Sustaining growth and innovation in the insurance sector

Insurance Governance Leadership Network Summit

November 2015

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ViewPoints

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On September 30 – October 1, 2015, Tapestry Networks and EY welcomed more than 30 board directors, members of executive management, and distinguished guests to the second Insurance Governance Leadership Network (IGLN) Summit in New York.

This summit came as the sector faces one of its most difficult periods in recent memory. After weathering the financial crisis and the ensuing multitude of new regulations and supervisory expectations, insurers are now turning their attention to new challenges: earning adequate investment returns safely during the longest period of low rates in history; navigating capital market uncertainty as monetary policies shift and diverge; pursuing digital transformation and the novel business models it enables; and governing new forms of direct engagement between shareholders and boards in an age of investor activism.

For the first time, the IGLN was co-located with its companion banking network, which enabled two combined sessions on capital market liquidity and board-shareholder engagement. The combined insurance and banking group totaled more than 50 directors, executives, regulators, and industry experts representing 27 leading global insurers and banks, with combined institutional balance sheet assets of more than $25 trillion.

We are pleased to share *ViewPoints* that capture the spirit of summit conversations, as well as insights from prior meetings and ongoing conversations with IGLN participants. It is divided into five sections as follows:

"Global insurance outlook: more challenges ahead for leading insurers." Challenges facing complex insurers loom large, are growing rapidly, and show few signs of abating. With organic growth uncertain, insurers with growth aspirations are responding with an array of actions, including investment in technology solutions and consideration of acquisition opportunities. Participants focused the dialogue on two general areas of challenge and opportunity: 1) structural changes confronting the sector, including non-traditional competition, increasingly outmoded traditional product structures, the challenges of asymmetric information in an age of big data, and 2) strategic responses, including heightened merger/acquisition activity, and new interest in the insurance sector from venture capital groups, overseas investors, and asset management organizations. The network was joined in this discussion by Peter Babej, Managing Director, Global Co-Head Financial Institutions, and Gautam Chawla, Managing Director, Financial Institutions, at Citigroup Global Markets.

"New opportunities in asset management governance." The asset management function of large insurers has been tested by a variety of sources since the financial crisis. These include extended low rates of return, increased regulatory oversight, and an evolving set of investment options with less familiar risk, return, and liquidity

characteristics. As insurers emerge from the financial downturn, boards and top management are addressing new issues arising from changing macroeconomic conditions, significant directional changes in economic policy, volatile capital markets, and unknown investment and liability performance. Participants identified several areas where board-level governance of the asset management function could be improved, including linking decisions to business strategy and liability structures, considering changes in business models necessitated by the extended low return environment, spending more time on issues of talent and outsourcing, and simplifying and focusing board packages. The network was joined by three guests to aid in the discussion: Simon Harris, Global Insurance Leader at Moody's; Woody Bradford, CEO of Conning; and George Hasiotis, Managing Director of Cambridge Associates.

"Market liquidity: an unintended systemic risk?" Insurance and Bank Governance Leadership Network (BGLN) participants see new sources of risk, in part as a result of the very reforms aimed at making these institutions safer. The potential consequences of a lack of liquidity in certain capital markets, including bond markets, are of particular concern. Participants concluded that liquidity is significantly reduced since the financial crisis in normal market conditions and declines to near zero during times of market distress. A serious disruption in markets could cause significant challenges for banks and insurers and could be triggered by a rise in rates and herd mentality. Financial institutions can address these challenges through reduced frequency and volume of trading activity and through thoughtful, comprehensive-stress testing scenarios. Participants were joined by Michael Lillard, CIO Fixed Income, Prudential Financial.

"Leading insurers explore new models for growth and innovation." Growth in the digital age will follow a different path than it has in the past. Firms are highly committed to accelerating growth through the implementation of new ideas, emerging technologies, innovative business models and novel forms of partnership. Innovation and ensuing growth are not simply the result of deploying new technologies however; they require new structures, processes, and supportive cultures to sustain them. Participants focused on three areas of inquiry: 1) forces driving innovation and disruption, 2) the need for more dramatic organizational responses, including changes in culture and organizational design, and 3) rising dislocations and risks in the industry. The network was joined by Peter Hancock, CEO of AIG; Joan Lamm-Tennant, CEO of Blue Marble Microinsurance; Mike Paulus, Partner at Andresseen Horowitz; and Chris O'Hehir, Partner at EY.

"Board-shareholder engagement in an era of increasing activism." Increasingly active shareholders, focused on financial performance, firm-wide strategy, and more effective governance practices, are reshaping the corporate governance landscape. Growing demand from the investor community to meet directly with the public company directors they elect is at the heart of this transformation. This heightened focus has increased direct board-shareholder engagement and has motivated boards to provide a clear strategic narrative, create new structures to handle shareholder engagement, engage with investors on possible changes, and consider including an activist investor on the board. Participants were joined by Doug Braunstein, Founder

and Managing Partner, Hudson Executive Capital; and Ann Yerger, Executive Director, EY Center for Board Matters.

We encourage you to share these V*iewPoints* with your colleagues for discussion of the ideas they contain and the implications for your institution and the insurance sector at large. We look forward to continuing the conversation in 2016 and beyond.

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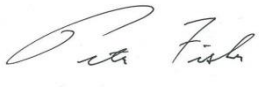
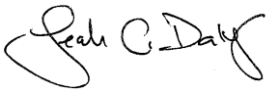
Sincerely,





Shaun Crawford
Global Insurance Sector Leader
EY

Peter Fisher
Partner
Tapestry Networks

Leah Daly
Principal
Tapestry Networks

November 2015

Global insurance outlook: more challenges ahead for leading insurers

The insurance sector as a whole faces strong headwinds, which show few signs of abating. These challenges are well known and include significant structural change resulting from new technology and changing customer preferences, as well as an array of negative secular trends. One participant summarized, *"It is a very challenging top-line environment. There is some growth, but it is very muted. Particularly in [property and casualty], a lot of capital is chasing a lot of the same business."* Another spoke to the experience of life companies, noting, *"Traditional life is a proxy for the broader economy … and that is growing very slowly."* Regardless of the subsector, *"Thinking of ways to deploy capital in an efficient manner is on everyone's minds,"* said one director.

> *"I have to say that insurance, as a sector, is not very attractive. It's not the sexiest place to be."*
> – Participant

While sectoral challenges are very much on the mind of leading boards, directors were keen to discuss strategic responses to these conditions. For example, how are boards deploying capital or thinking about the product portfolio or consolidation? This *ViewPoints* summarizes the network discussion,[1] which clustered into two key areas of focus:

- The insurance industry faces fundamental and structural change on many fronts
- Ongoing challenging conditions have given rise to some common strategic responses

The insurance industry faces fundamental and structural change on many fronts

Insurers are well versed in the litany of challenging conditions facing the sector. These challenges are economic, political, regulatory, legal, social, and technological. As a result of these pressures, the industry is experiencing increasing competition, muted growth, and an excess of capital. *"It is very much a buyer's market,"* said one director. *"Competition is always intense for the best risks, but rates are coming down for higher risks as well."* While acknowledging the many challenges facing insurers, participants were keen to explore several trends that may prompt insurers to restructure or fundamentally rethink approaches to products, services, and distribution. These trends include the convergence of asset management and insurance, the influx of alternative capital and securitization of insurance risk, the need for new and more responsive offerings, and new competitors.

> *"The securitization of insurance risk will continue."*
> – Participant

Non-traditional competition is on the rise

Insurers face a growing number of competitors for parts of their business and value chain. Participants noted the following trends:

- **Insurance and asset management sectors are converging.** Hedge funds, pension funds, sovereign wealth funds, and other sources of non-traditional capital continue to enter the market in both life-annuity and property-casualty insurance. To date, much of this capital has been focused in the catastrophe and reinsurance space, but it is starting to move into other areas. One participant noted, *"Asset managers are keen to get into insurance because it is a source of permanent capital … and can lead to real incremental return on equity."* Participants cited examples including Apollo's business with Athene, Canadian pension funds' purchase of mortality-risk business, and the significant growth

of sidecars.[2] However, the reverse is also true as more insurers move into third-party retail and institutional asset management. *"For insurers, managing assets is another source of capital. I think this trend will continue,"* said one participant.

- **Big-data companies are exploring the insurance sector.** Insurers also worry about the steady march of big-data and technology companies into insurance. *"What happens if Google or Amazon enter not as a distributor but as an underwriter? They believe they analyze data better for risk selection,"* said one director. For now, at least, this fear has not truly materialized. One director cautioned, *"I think people realize that they have to reinvent themselves. What other industry has the willingness to take risk and only find out the results much later? Our willingness to mutualize risk and the advantages it brings are the main reasons Google won't become an insurance company."*

"I detect a certain industry helplessness around innovation. We have been the same for 100 years. What now?"
– Director

Many existing insurance products are outmoded

There is a growing recognition that many popular insurance products were designed for a reality that no longer exists, and product advances are not keeping pace with changes in society. There are two primary, interrelated drivers:

- **Advancing technology.** *"What does car insurance look like in a world of driverless cars?"* asked one participant. Another participant cited a statistic that auto insurance could shrink from roughly 36% to 10% of the US market due to changes in technology. Connected homes and, more broadly, the Internet of Things (IoT) will continue to change usage and ownership patterns. At the same time, one participant noted that cars have been getting safer for years and technology will not be phased in overnight: *"There were 60 million cars sold in the US last year. None of them were self-driving."* So insurers may have time, but they should be prepared to adapt, according to one director: *"As much as we talk about this change, I guarantee people will make money. It is not a question of the product getting smaller, but how do I tap into that 10%?"*

- **Changing customer and social norms.** Participants were quick to observe that individuals coming of age today have different expectations regarding ownership, and different expectations of providers, than previous generations. These attitudes and norms are the result of new technological advances and changes in family structures. One participant said, *"Look at the sharing economy as well. Everything is moving in that direction. It is driven by millennials not wanting to own anything."* Though the effects of the sharing economy are difficult to document, one 2014 study estimated that the growing popularity of car-share programs has resulted in more than 500,000 fewer car purchases, with the sales decline expected to grow significantly in the coming years.[3] Likewise, many insurers are already exploring usage-based, pay-as-you-go models for products and insurance. Quite apart from the sharing economy, one participant summarized some of the familial and social trends contributing to the need for new insurance solutions, noting, *"I heard a fascinating presentation recently where they talked about how the modern family is completely different compared to when basic insurance products were developed. You look at marriage equality, the aging population in the workforce, children moving back home – needs are not the same as they were."*

"When fewer people own things like homes or cars, or those things take care of themselves, the insurance has to change as well."
– Director

Increasingly asymmetric information could destabilize underwriting

While big data presents tremendous opportunity for insurers, it also increases the risks associated with information asymmetry and adverse selection. One executive said, *"You can go and get your genetic profile for $1,000. In five years it will cost $100. A person can go to our company and buy an annuity or life insurance using this information. It is basically insider trading. This has more potential to change the world than anything."* A director agreed and noted, *"Some people have called it the Garden of Eden. Once upon a time, we were all innocent. No one knew the probability of events. We are not in the garden anymore. Now there is more knowledge, but there are ways to know what the insureds know."*[4]

"Innovation sounds great, but it can lead to information asymmetry."
– Director

Insurers plan to capitalize on increasing amounts of information and to know more, or at least as much as, their customers do. However, they will be constrained by legal and regulatory decisions regarding who owns the information and what factors may be used to underwrite. One director noted, *"European regulators have already banned male and female price differentiation even though it is predictive."* Another participant suggested that price optimization, a practice through which retailers use data to assess customer price sensitivity and adjust pricing, will be a very important topic for US regulators in 2016.

"It will be interesting to see how we [come to] understand the ethics of data."
– Director

Among subsectors, reinsurers face the greatest challenges

Participants wondered how strong the reinsurance sector is. *"Where will it be in 5–10 years?"* asked one director. Reinsurers face negative growth forecasts and a surge of surplus capital. Current negotiations ahead of January renewals suggest future rate reductions may be more than 10%.[5] Many participants agreed with one director who observed, *"There are massive problems across the industry and it is difficult to see there won't be a restructuring. There is already quite a bit of M&A [mergers and acquisitions]."* Given the enormous challenges, participants predicted more consolidation and fundamental business model shifts:

- **Consolidation.** Persistent low interest rates and pricing pressure led to a string of deals in Lloyd's and Bermuda insurance markets in 2015. Many participants suggested that current conditions will continue to reconfigure the industry, and only the largest groups may survive. One director said, *"Unless you are one of the largest groups, what are you really providing? There is not a lot of differentiation, and then you are just like the new entrants flooding the market."*
- **Changing business models.** Several groups have scaled back offerings, focused more on niche products, and even ventured into primary insurance. Unfortunately, increasing primary insurance offerings will threaten to put reinsurers in competition with their clients.

Despite some predictions of sweeping change, one director reminded participants of the power of the reinsurance cycle: *"I wouldn't cry too much for reinsurers. All you really need is a drop in capital markets to wipe out some of the capital, or some*
(Continued overleaf)

significant depletion event, another hurricane. It will cause overcompensation of third parties. They will raise rates on all the people in this room. I don't see primary insurers in a situation where we don't need reinsurers."

Ongoing challenging conditions have given rise to some common strategic responses

Given the difficult dynamics facing the industry, many insurers feel somewhat constrained in terms of their strategic options. *"When you look around, you don't see too many good choices,"* said one director. In many ways, boards are following the same strategies they have in recent years: they continue to improve efficiency, pricing, and segmentation, and to reduce cost. New digital capabilities such as analytics and the cloud facilitate these now-continuous efforts. With greater regulatory capital requirements and lower returns, insurers continue to seek better ways to manage assets and liabilities. The result is often the assumption of more risk in both areas, or efforts to curtail some risk on the liability side of the balance sheet. In this discussion, participants explored several trade-offs and considerations associated with derisking, increasing the relevance of products, and industry consolidation.

"The desire to give capital back to shareholders is one strategy. The other is to think about alternative growth, including investing in new businesses or consolidation."
– Participant

Product derisking can be at odds with meeting customer needs

Insurers face an important strategic conundrum: many high-demand products are also capital intensive in a time when many insurers want to move toward less capital-intensive products. Several directors noted that their boards want to create products that address real and pressing needs. *"We need to be problem solvers,"* said one director, *"offering products that meet critical challenges."* However, for various reasons, as several noted, products like long-term care insurance, guaranteed annuities, and cyberinsurance are either not viable or have not lived up to customer expectations.

"There is an understood need for better retirement products. If we can just solve how to make money and make the regulators content."
– Director

According to one participant, *"There has been a significant derisking of product … and a restructuring of what is sold into less capital-intensive and more fee-based offerings. The overall capital intensity is less. This will continue."* One director described the challenge: *"The only way to make [some products] work is to do something more asset intensive. Maybe they find a home in alternative asset management. The only way to find a reasonable buyer is for someone to make an aggressive move on the asset side."* In addition to unfilled product needs, several insurers noted that whole markets remain unserved or underserved: *"Anyone who analyzes protection gaps sees they are enormous and growing. The need for insurance is very high, but it doesn't happen."*

Despite high valuations, M&A activity is accelerating

In 2015 the volume of M&A in the insurance industry increased significantly.[6] Participants generally agreed that the long-predicted M&A wave has finally arrived and brought with it important implications and considerations for the industry.

Local and sectoral conditions are fueling acquisition activity

"The industry is less interesting than it has been and yet prices and deal volumes are higher than ever. Why?" asked one participant. According to experts and boards alike, adverse

local and market conditions are driving some insurers to look in new geographical markets, and driving other financial entities to consider portfolio diversification through insurer acquisition:

- **Chinese groups.** For acquisitive Chinese insurance and non-insurance groups, US and European markets offer better returns than the domestic market, along with a certain degree of safety from government intervention. One participant suggested, *"The most sophisticated people in China have no clue where the government is heading … They want to acquire before the next set of restrictions."* In that context, even overvalued insurance assets may be appealing. Another participant concluded, *"From the Chinese perspective, there are questions that matter a lot more than 'Am I overpaying by 5%?' We will see more Chinese activity. I'd say a year ago it was two companies. Now there are 15–20 looking hard at us."*

- **Japanese groups.** Japanese groups face difficult domestic conditions and seek footholds outside of the home market. *"Japanese insurers are getting a 0% yield at home,"* said one participant. *"They are in a domestic environment that is shrinking. Their stock market performance is leading to unrealized gains that are fairly significant. They want to utilize excess capital. As well, the continued weakening of the yen is making now the right time to take advantage of diversification away from the home market."*

- **Asset managers.** For an increasing number of asset managers, insurance books can offer uncorrelated assets, steady dividends, an attractive tax wrapper in some countries, and the chance to drive return on equity through improved investment performance.

The wave of acquisitions raises important considerations for insurers

Participants discussed some of the challenges associated with acquirers who are not familiar with insurance as well as some of the operational concerns associated with M&A:

- **More boards are discussing M&A options.** *"You can't look around and not consider your options,"* one director said. This does not mean the sector will undergo the sweeping restructuring of the 1990s, but several directors acknowledged that M&A is back on board agendas after a notable absence.

- **Some acquiring groups lack industry experience.** One participant spoke for several when he acknowledged the risk presented by owners without experience: *"[Firms] are not doing this because they know the products or the reserves. We see insurance and they see assets. They don't want to talk about risks or underwriting. It is about 'What is the asset leverage and the balance sheet I can deploy?' There is a disconnect between what they are looking for and what the asset is."* Furthermore, some groups may find it difficult to get regulatory approval, particularly if they are unwilling to disclose their shareholders. This regulatory hurdle may incent some would-be acquirers to move toward real estate or other asset classes.

- **Acquirers face a host of operational and integration challenges.** Despite the benefits and synergies, consolidation creates significant operational challenges and execution risk. In the last wave of mergers, legacy underwriting and reserve issues were a problem for a number of acquirers. Many wonder if similar issues might emerge in a

> *"Foreign investors could buy a major life insurer, but they will never know how to run it. Or they could buy a trophy property or a hotel chain."*
> – Participant

few years. Likewise, efforts to expand quickly and to export one model to another institution or geography have run into challenges. Finally, some participants wonder if the regulatory hurdles associated with belonging to the group of internationally active insurance groups or systemically important insurers may prevent some large-scale mergers.

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A variety of factors indicate that the next several years will present an increasingly challenging environment for complex insurers. Economic, political, social, technological, and legal challenges are on the rise. But, as one participant observed, *"It is not all doom and gloom. There is clearly a lot of opportunity. We just need to be prepared to harness it."* To respond to these conditions, and in search of growth, insurers are exploring a variety of strategies. Derisking and M&A activity are increasingly popular strategies, but insurers also understand they are not serving customers as well as they could. Most directors agreed that innovation has to be an increasingly important part of the growth strategy, and they discussed innovation at length throughout later portions of the summit.

New opportunities in asset management governance

The asset management function of large insurers has faced challenges from a variety of sources since the financial crisis, including extended low rates of return, increased regulatory oversight, and an evolving set of investment options with less familiar risk, return, and liquidity characteristics. As insurers emerge from the financial downturn, boards and top management are addressing new challenges arising from changing macroeconomic conditions, significant shifts in economic policy, likely volatile capital markets, and ultimately unknown investment and liability performance.

This *ViewPoints* summarizes the network discussion of asset management, which clustered into three key areas of focus:

- Directors must understand new risks to ensure investment strategy is sound
- Returning to fundamentals is essential for good asset management decisions
- Boards can significantly improve their governance of the asset management function

"Asset management challenges are an important conversation. It ties heavily to the issue of low interest rates and monetary/systemic risks. There are also new types of things popping up that we haven't seen before."
– Executive

Directors must understand new risks to ensure investment strategy is sound

As a result of shrinking returns, insurers have begun to explore new asset classes and opportunities. While these areas may afford opportunity, insurers must also consider the expertise they need to appropriately manage them. As one participant summarized, *"Insurers are searching for yield. How are they getting it? What are the risks in the asset class? Do they have the right people? How does it intersect with regulation? How is the board managing all of these considerations together?"*

An unprecedented investment environment is motivating insurers to seek enhanced return in novel areas

Many of the most significant asset management challenges flow directly from the drastic changes in monetary policy that followed the financial crisis. Central banks in developed countries have maintained the lowest policy rates in generations for periods never before experienced. As the global economy heals, regional monetary policy continues to shift, and the timing, nature, and speed of those shifts are likely to disrupt global capital markets in unforeseen ways. Insurers are also dealing with new regulatory and capital regimes, and many have significantly changed their investment portfolio construction.

Insurers are moving into higher-risk territory

The asset management function is feeling pressure from management, the board, and product vendors. *"The asset management function is being directed to enhance return to meet business objectives. Investment vendors are pushing new products,"* remarked one participant. As a result, many insurers have moved more significantly into areas of higher risk, including illiquid alternative investments (private equity, venture capital, real estate, infrastructure, structured deals, and joint venture investments), higher-credit-risk fixed income, and longer duration assets with significant interest rate risk. Investment performance, market liquidity, and portfolio correlations of these newer assets across the

economic and policy cycles may create unfamiliar investment dynamics over the next few years. Pricing in more traditional assets also may adjust significantly as policy rates move from unprecedented levels to historical norms.

These opportunities come with new risks

"Insurers are searching for yield and trying to take advantage of opportunities that others cannot pursue because of their ability to hold assets over the long term and worry less about liquidity. The real question: are they doing this with the right controls and risk management?" observed one participant. Another noted, *"By nature, alternative assets are designed to be uncorrelated to liabilities and bonds. It should be part of your surplus, not your general account. Make sure you have a lot of liquidity and are willing to take at least a 10% haircut."* Participants have identified oversight challenges specific to newer asset classes, including finding appropriate talent to manage and oversee new investments, determining the optimal mix of in-house and outsourced management, properly assessing the degree of illiquidity return premium and liquidity constraints inherent in new investments, and assessing potentially volatile political risk associated with infrastructure investments. One participant noted, *"Government and politicians want insurers to invest in infrastructure projects, but the regulatory system does not always encourage that behavior. Solvency II charges applied are not supportive of companies making big investments in infrastructure. Authorities are saying they will have high capital charges, but then other officials are saying, 'We need your help in investing to grow the economy.'"* Another added, *"Everyone is into infrastructure now, but infrastructure is a million things. There is risk in a prison or wind farm that you don't have in a school. Do you have the expertise to know the right investments?"*

> *"You have to be very thoughtful when you diversify away from credit and interest rate risk. That is what you know."*
> – Executive

Do firms possess the necessary knowledge?

To address new risk considerations, firms need to consider whether to acquire talent or consider outsourcing. To this point, a participant commented on the knowledge and access challenges in alternatives, *"The average hedge fund is a lousy selection. The implication at the board level is do you staff up internally or via an adviser?"* Observing the trend to outsource, one participant said, *"Outsourcing firms are getting twice as many wins."* Another raised the question of the board's oversight qualifications: *"Always think, do the people entrusted with the recommendations have the skills and experience underlying it? How would a new investment behave in 1929, 2008, during the taper tantrum?"* Another remarked on outsourcing considerations, *"There is a tradeoff. You cannot claim you are really good at asset management without in-house experts, but if you are good at it, then it requires hiring all these experts, which is highly costly."*

Returning to fundamentals is essential for good asset management decisions

Participants asserted that contrary to some current practices, boards and management should begin with first principles: what business are they in, how are the liabilities structured, and therefore what type of investment portfolio, risk, and return characteristics best support that strategy? Successful investment strategies require careful consideration of asset-liability matching. Participants outlined several steps forward:

Acknowledge the new normal

"From a credit perspective, the answer to the low-interest rate environment is not to get a high yield, but to change your business model to operate in a low-yield world. You have to adjust to the new normal," one participant said. Several others emphasized unique factors in the current low-rate environment may make it persist longer than expected: the severity of the financial crisis, the overwhelming debt overhang that persists in many economies, significant aging of the population in the developed world, and historically low labor productivity growth rates. Those factors will tend to slow recovery. Participants suggest insurers should be questioning their business model, product set, geographic footprint, pricing, and product design.

Identify the broader implications of asset management decisions

It is essential when overseeing asset management operations and decisions to identify the broader implications for portfolio-level characteristics of risk and return, regulatory connections related to capital requirements and stress tests, interactions with the insurer's liability structures, and effects on asset-liability matching. One participant identified three top priorities to aid insurers in this regard, *"First make sure your fixed income portfolio is ready for the next stage of the credit cycle, not the last. Second, diversifying your portfolio is a key priority. Third, you need robust integrated asset allocation and risk management platforms. If you are not doing these three things, then you are at a disadvantage."* Several participants agreed emphatically when one participant noted, *"The importance of the three-to-five year time periods for asset management track record is lunacy. It incentivized people to do things that are not in their interest for the portfolio. You have to start with liabilities and risk profiles and go backwards."* Another noted, *"The way assets and liabilities interact is something you have to have in your belly. You can take the best asset manager in the world and they still won't think about that in the right way."* As newly structured investment portfolios behave in less familiar ways and insurers seek new sources of uncorrelated returns with adequate duration, it may become more challenging to align asset returns with liability structures.

> *"When I think about the traditional way insurance invests its funds, there is an eye on liabilities. How is changing the investment strategy impacting asset-liability matching?"*
> – Participant

Incorporate long-term asset management dynamics into the business model

Given the unprecedented low-rate environment, elevated capital market pricing, and no clear end to these conditions in sight, insurers need to adjust their business model. One participant observed, *"The longer the pressure persists, the more likely are credit rating changes. Insurers might move away from selling certain products like guarantees. They might become more like asset managers, like a Fidelity."* Another noted that UK insurers were already shifting in that direction: *"I don't understand how the UK life insurers can make money. They are against a brick wall. Asset management is where they are all moving."*

Boards can significantly improve their governance of the asset management function

Insurer boards and executive management teams have been revisiting how best to design their governance structures and processes to address the new challenges arising from current macroeconomic conditions, changes in portfolio construction, entry into less familiar

investment areas, and ongoing compliance with regulations. Participants recommended improved focus in meetings and streamlined review materials.

Boards should focus on liability structures, talent, regulation, and business model rather than less important elements of the asset management function

Many directors indicated insufficient time was being spent on asset management oversight, while undue attention was being given to less important elements such as return profiles, benchmark comparisons, and tracking error. One participant observed, *"Targeting a return to a benchmark is lousy. Boards get enamored to yield and forget the business they are in. They have this idea to chase yield independent of the business model."* Others commented on resource allocation and areas of focus, *"It is a complicated question. I sit on boards where 60% of the earnings are coming from investment. Five hundred ninety-seven people will be working on underwriting with only three doing investment. Boards don't have a clue and they are happy as long as the returns are there."*

One director summed up the challenge and opportunity that lay in front of boards, *"When you spend the meeting talking about tracking error, that is a problem. Start with your business strategy and how your investments fit. Maybe you make a profit from your investments and not in your core business like the Berkshire model. When you are going for yield, make sure you understand your strategy."* Another emphasized the importance of connecting asset management structures to related business fundamentals, *"You have to start with liabilities and risk profiles and go backwards. There is a huge education component to get to that place."*

Additionally, participants said that boards need to consider the performance of both investments and liabilities under a wide range of alternative economic scenarios and stress test to achieve adequate alignment. They also noted the importance of regulatory considerations, *"Metrics are important. Economic capital means different things to different people. Boards don't ask enough questions. Solvency II has a huge bias in government assets. Do you have expertise in this space? I'm hearing that boards are not asking the right questions. It is really about do you have enough talent and the right resources. What are the barriers to doing this right?"*

Streamlined review materials can improve governance significantly

Many directors indicated there is a need to simplify the information, focus board attention on the most important issues and questions, and reduce the volume of materials. A participant lamented the volume of board materials: *"We have a 1,200 page board book. The PowerPoint on the investment portfolio is not proportional to the importance to the firm. Regulators want a lot of other things. The real challenge is getting the time to discuss the investment portfolio."* Many participants agreed on the benefit of shorter, simpler board packages and summary pages that identify key issues and questions and make connections to corresponding liability profiles and asset liability matching. Another commented, *"Boards' interaction with management and asset managers pre-crisis was 'the more complex you are, the more you were needed.' The pendulum has swung to simplify the message. Give me in plain English what this product means."* Another asked, *"Who is doing the execution? On the flip side, companies need to keep in front. Boards don't have complete information and knowledge. When we see a 120-page PowerPoint deck it*

is not as helpful as a key summary page, [which] … helps to frame your insights and adds to ours. I love really good metrics to drive better decisions. You will have insights that we don't have."

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Insurers know that optimal oversight and management of the asset management function, together with the alignment of the investment portfolio with expected liabilities, are critical to long-term success. This opening discussion provided an important platform for exchanging ideas, sharing lessons from collective experience, and broadening perspectives on these key topics.

Market liquidity: an unintended systemic risk?

"Liquidity equals confidence; it is not hard to define. You can forget all the rest."
– Director

The financial crisis of 2008 revealed that neither regulators nor institutions had a clear picture of the risks building up in the financial system. The regulations crafted in response to the crisis have focused on ensuring that the largest financial institutions are better able to withstand shocks. Despite these initiatives, participants in the BGLN and IGLN see new sources of risk emerging, in part as a result of the very reforms aimed at making these institutions safer. A participant in the BGLN observed, *"Individually, the banks are safer. Collectively, the system might not be."* Of particular concern are the potential implications of a lack of liquidity in bond markets. One executive said, *"The issue isn't just corporate bonds and a liquidity shortage. It is deeper than that."* Another executive elaborated, *"I think this is more urgent than regulators think. We are sitting in a big asset price bubble. At some point, it will unwind. It is going to happen."*

"Individually, the banks are safer. Collectively, the system might not be."
-Participant

BGLN and IGLN participants are focused on building sustainable business models for their organizations. For both industries, this includes minimizing obstacles to growth and navigating market risks. A serious disruption in capital markets could cause significant challenges for both banks and insurers. Over dinner on September 30, BGLN and IGLN participants, representing more than $25 trillion in assets, convened for a joint discussion on reduced market liquidity as a potential source of systemic risk and the implications. The summit discussion brought together insights from both bankers and insurers, who play very different but often-complementary roles in capital markets. A director noted, *"This is a fascinating area where banks and insurers overlap on many transactions but are subject to different regulations."*

This *ViewPoints* provides an overview of the dinner discussion, along with context from previous conversations on top and emerging risks in both networks, which identified liquidity and its cascading effects as one of the most urgent systemic issues.[7]

Market liquidity is clearly reduced

In a recent speech, NY Federal Reserve Bank President Bill Dudley commented, "Liquidity is dynamic, unobservable, and multi-dimensional in nature, and, as such, can only be measured indirectly."[8] Participants agreed with the challenge of quantifying liquidity, but offered clear evidence that it is significantly less than pre-crisis levels, especially in corporate bond markets. One participant argued, *"Worse liquidity doesn't mean you can't sell the bond. It does mean it is harder, takes longer, and is more situational. The liquidity is not as consistent and is not as predictable in today's world, and this is considered the normal environment."*

"Worse liquidity doesn't mean you can't sell the bond. It does mean it is harder, takes longer, and is more situational."
-Participant

Participants expressed concerns that reduced liquidity in "normal" times suggests that evaporation of liquidity in a crisis could be faster, more frequent, and more severe than in the past, perhaps even worse than in 2008. As one director said, *"There will be a liquidity shortage in the next crisis, full stop."* Essentially, the reduced liquidity in the business-as-usual market could increase the probability that it induces a crisis, with the ensuing feedback effects that much stronger.

"There will be a liquidity shortage in the next crisis, full stop."
-Director

An evolving liquidity crisis could trigger a systemic event in capital markets

Several investment firm leaders, including the Blackstone Group's Stephen Schwarzman and Larry Fink from BlackRock, have cautioned that a lack of liquidity could cause or exacerbate a financial crisis.[9] During June conversations on top and emerging risks, BGLN participants expressed concern that when the Federal Reserve ends its quantitative-easing program and raises interest rates, a sell-off of assets might be triggered, prompting a chain reaction with unexpected correlations and impacts.[10] While many participants still pointed to the impending rate reset from the Fed as a potential trigger, the Fed's postponement of such a rate increase raises questions as to what might trigger such an event. Whatever the trigger, whether rising interest rates, geopolitical events, or a major cyberattack, participants see potential for reduced liquidity to exacerbate a market panic.

Rising rates or another trigger event may prompt a sell-off with few buyers

Participants expressed concerns about how investors will react to increased market volatility and the potential for a massive sell-off in a market with limited liquidity. A director wondered how retail customers would react as interest rates rise: *"On the bond side, for example in the ETF [exchange-traded fund] market, do retail customers understand yield maturity? When they see returns go negative for the first time, will they just sell? If so, where does the liquidity come from? Not the SIFIs [systemically important financial institutions]."*

An increasingly popular investment vehicle, ETFs were created for equities but are now used in bonds; however, since corporate bond markets are generally not as liquid or transparent as equity markets, there exists a potential liquidity mismatch between the ETFs, which are traded on exchanges, and their underlying components. In general, ETFs may prove more difficult to move in and out of in times of stress: steep share-price declines in August started in individual stocks and cascaded into ETFs, causing dozens to trade at sharp discounts to the sum of their holdings.[11] This may also induce circuit-breaker trading halts, which can allow sell orders to accumulate and invoke further market concerns. A participant highlighted the potential implications, saying, *"When discussing these liquidity challenges, we decided it is not about basis points, but how a liquidity event will manifest in ETFs and with retail investors. Banks are at risk."*

"When discussing these liquidity challenges, we decided it is not about basis points, but how a liquidity event will manifest in ETFs and with retail investors."
-Participant

Participants warned that retail investors might not be the only ones that sell en masse. One director worried, *"Shadow bankers and investors in theory are professionals, and these changes in prices will be passed on and stay contained, but I don't think this will happen in practice."*

"In the old days, insurers loved volatility. The gnomes of Zurich would swoop in and buy huge chunks of capital markets at the bottom of the cycle."
-Director

New regulations limit the ability of financial institutions to act as market smoothers

Due to regulatory changes, banks and insurers are now limited in their ability to provide liquidity and reduce volatility, as they have historically. In the past, acting as market makers, banks served as shock absorbers by buying distressed assets. Now, however, many banks have effectively ceased market-making activities in key equity and debt markets, significantly reducing liquidity in the trading markets, especially for corporate debt.[12] A chief risk officer summarized the problem: *"The industry has been firmly trained that size*

matters. Capital requirements, the leverage ratio, etc., have been driving every bank to shrink their balance sheets. Every firm is trying to keep inventory to the bare minimum. If you go back before the crisis, banks had large balance sheets with an ability to absorb corrections … Volatility now is quite significant." Another participant commented, *"It is not just the Volcker rule. The psychology on trading floors is different than it was 10 years ago. As soon as you trade, the compliance people are after you. The traders say it is just not worth the hassle."*

On the insurance side, new restrictions are preventing insurers from taking their traditional long view during periods of volatility. Some commentators are predicting that new accounting and capital requirements for insurance companies and pension funds may cause them to move in an increasingly procyclical fashion.[13] As one director noted, *"In the old days, insurers loved volatility. The gnomes of Zurich would swoop in and buy huge chunks of capital markets at the bottom of the cycle. They were part of the self-correction of the market. Today, it is much more difficult because of capital rules that are more procyclical."*

The sell-off may be magnified by herd mentality

Much of the commentary on a potential liquidity crisis focuses on fears of massive market movements coming at the same time. Some are emphasizing the dangers posed by "price-insensitive" buyers and sellers, including central banks, financial firms under pressure from new regulations, and index-driven mutual-fund managers.[14] The growing role of these price-insensitive participants makes markets less self-correcting via price signals and increasingly homogenized in one direction. In addition, participants worry that the increasing number of high-frequency traders and others who use algorithmic programs to follow trends will magnify price volatility: *"The herd instinct will be magnified by the algorithms, which will amplify the speed and momentum,"* said one director. Another participant cited the specific challenge of fixed-income liquidity: *"just as the desired [trading and sell] volumes rise,"* the depth of the counterparties wanting to buy and trade declines and *"the pipes get narrower."*

> *"Just as the desired [trading and sell] volumes rise, the pipes get narrower."*
> -Participant

All of these factors could mean that an earlier-than-expected interest rate hike or other trigger event will result in an abrupt and dramatic rerating of bonds due to spooked investors, with everyone caught in the same trades needing to get out fast.[15] Because many investments are in illiquid funds, with fewer market makers, the sellers would be forced into fire sales, which could trigger a broader drop in asset prices.[16]

New market participants may behave in unpredictable ways

An executive said, *"What scares me even worse than the broker-dealer situation is the huge number of people investing for duration who have no business doing that. It is the mutual funds buying bonds. You are applying liquid structures – the equity model – to an illiquid asset … That is the bigger risk."* This reflects participants' wider concern about the impact of these new players in the market. A chief risk officer commented, *"The real liquidity issue is the impact of investors who shouldn't be in the market."*

> *"The real liquidity issue is the impact of investors who shouldn't be in the market."*
> -Executive

In curtailing banks' market-making ability, regulatory changes have created a void that shadow bank players, such as mutual funds and asset managers, are stepping in to fill. It is

estimated that in the past year, more than 70% of corporate credit was purchased by investors such as mutual funds in a search for yield.[17] One participant worried that shadow bank players would be more likely to act on herd instinct. The problem is that asset managers rely on potentially less reliable forms of funding in which they are obligated to return investor funds on demand, and the positions shadow bankers have taken may be opaque to other market participants and regulators.

Correlations may not be well understood

Participants said that the real danger of a liquidity crisis is not its immediate impact – which may involve challenges in executing trades and increased volatility – but in exposure to correlated risks. As one director commented, *"The real problem is that things that are not correlated become correlated in times of stress."* Participants expressed concerns about three issues in particular:

- **Models may understate correlations.** Participants agreed that models may understate risk during times of market stress. One participant said, *"I worry about the liquidity of so-called liquid assets [in a liquidity crisis]. Models may also overstate the value of collateral, and counterparties may be less robust than expected. I am skeptical about the value of collateral on the trading books in investment banks."* Several participants raised concerns about model risk more broadly. A director said, *"I am a mathematical modeler by training, and I don't believe them."* Another warned, *"Volatility will be higher, and the correlations will be higher than the models think."* In economic terms, participants expressed fears of *"regime switching"* in which correlation matrices used in a business-as-usual environment become inaccurate during periods of financial distress.

- **Accounting could exacerbate contagion.** Participants fear that the vulnerabilities of pension funds, insurers, and others to liquidity issues could be *"magnified into their firms by mark-to-market accounting."* A director predicted, *"[Vulnerability] will move quickly into our balance sheets, then into capital."* Insurance directors were quick to note that Solvency II has potentially made the problem even more acute. One executive commented, *"The whole framework is creating risks that the regulators don't understand themselves. If volatility all goes one way for a variety of companies, combined with the new framework, it is so complex that nobody knows how it will all play out."* Another participant elaborated, *"Because of mark-to-market accounting, the risk is not just in trading, but in simply holding when the volatility hits."* Procyclical capital rules and mark-to-market accounting may mean companies must sell into distressed falling markets, which could create a detrimental feedback loop. An insurance director stressed the negative impact of adopting mark-to-market accounting: *"Volatility in itself should not matter to insurance as we can hold something for 25 years, but these new regulatory requirements require marking everything to the market."* Another participant added, *"In crisis, there is no liquidity, so there is no fair value because there is no market."*

- **The contagion mechanisms could be faster.** Participants pointed to the possible implications of technological changes on market volatility and, ultimately, a systemic event. One regulator asked, *"Is it a better world because of the reforms, or worse*

"Because of mark-to-market accounting, the risk is not just in trading, but in simply holding when the volatility hits."
-Director

"We will get down to liquidity levels in 2008 like that. Then it will get worse."
-Participant

because it is different and moving faster than ever?" Directors expressed fears that electronification and digitization are fundamentally changing the structure of financial markets. Flash crashes in recent years highlight the impact of these changes, especially the influence of automated trading and the growth of high-frequency trading, which is blamed for exacerbating episodes of market volatility as it exaggerates price movements on low-volume trades, particularly in the event of a crash.[18] Directors also cited the possibility of other technological developments like social media contributing to a systemic event. One participant argued, *"Things like social media will accelerate the impact. The run on the bank will be online. There will be no lines at the branch."* As a result, another participant stated, *"We will get down to liquidity levels in 2008 like that. Then it will get worse."*

Financial institutions and regulators are identifying appropriate responses

Participants highlighted the challenge of preparing for a liquidity crisis. As one director argued, *"In a crisis, liquidity disappears. It is hard to prepare for zero liquidity."* Despite these difficult realities, participants encouraged a combination of firm-level and industry-wide actions.

What can individual firms do?

"Sure, I am worried about it, but it is not clear what there is to do. Manage it as best you can internally? Model it? Hope for the best?" asked one director. Participants offered three responses financial institution leaders can take:

- **Run scenario analyses and adapt stress tests.** Participants emphasized the importance of stress tests in trying to understand the implications of a potential liquidity crisis as well as improving transparency about internal exposures. One director noted, *"There are stress tests we didn't do before that we do now. As well, recovery and resolution planning has improved visibility of trade flows within the organization."* Still, participants questioned how to scope and provide parameters for a stress test relating to liquidity. One participant suggested, *"We separate liquidity from other systemic risks. They are highly correlated, but we start separate."* Others said they simply needed to stress test multiple scenarios: *"The more ways to stress test it, the better."*

- **Reduce risk in assets and trading strategies.** Some participants argued for fundamentally more cautious approaches to trading and liquidity management. One participant suggested, *"You could do less tactical and short-term trading. Instead, do more fundamental and long-term trading. Simply don't buy bonds you are worried about. You can't take liquidity for granted."* Another cautioned, *"You say you want to hold more liquid names, but those will be the ones sold first. Are you safer holding the next level down?"*

- **Ensure the board gives liquidity risk due attention.** Given the magnitude of the potential risk, a director said, *"This is definitely an issue for the board. The question is how does it affect your risk tolerance? It is the board's job to define the tolerance and appetite."* In addition, most directors emphasized the importance of the board pushing back on information from management. One director commented, *"You can't just*

"The more ways to stress test it, the better."
-Participant

"This is definitely an issue for the board. The question is how does it affect your risk tolerance? It is the board's job to define the tolerance and appetite."
-Director

stress test and hope for the best. Directors have to be skeptical of stress tests. For example, are you testing for a shrinking pool of counterparties?" In general, most participants agreed the most important board response is to force discussion and to bring independent thinking. As one participant remarked, *"I sometimes worry about quantifying things because you can take false comfort. I'm more comfortable with ambiguity. If I don't know what it is, I'll ask a lot more questions."* Some directors suggested bringing in a third party to test managements' approach and ensure they are considering the full set of potential issues. Ultimately, participants agreed with one who said just raising the issue at the board is important: *"The response is better if you have the discussion."*

How can communication and coordination across the industry improve?

A director remarked, *"We need a positive, more constructive dialogue with the regulators. We need to identify positive ways to introduce liquidity as opposed to unpicking regulations."* One director suggested that communication is improving: *"We have constant constructive dialogue with our regulator. They have been a little hesitant on disclosing certain information, but they have helped to implement extremely useful exercises."* Some participants were optimistic that the response from regulators will be faster in a future crisis, given the experience of the last one. Yet they also encouraged regulators to take further steps to prepare their own scenarios and response plans. As one participant remarked, *"They make us go through recovery and resolution planning. I hope the regulators are doing the same thing for a market systemic risk so that they have a playbook."* Another said what is needed is *"a three-way dialogue among banks, regulators, and the government, and it should start very soon. We need proposals for solutions."*

> *"We need a three-way dialogue among banks, regulators, and the government, and it should start very soon. We need proposals for solutions."*
> -Participant

One suggested solution involved the use of circuit breakers in extreme market conditions. Some participants viewed this approach as an opportunity to stem the spread of problems from a liquidity event. However, one regulator, citing the experience with ETFs, warned of the potential unintended consequences: *"The fascinating thing about ETFs is there are all these circuit breakers, but they actually aggravate problems because you suddenly can't trade."* One commentator proposed the creation of a new pan-industry market-making utility to replace the market-making role banks previously played.[19]

Will a liquidity crisis force central banks' hands?

A participant predicted that, ultimately, *"central banks won't be lenders of last resort, but lenders of first resort"* because they will have to provide market liquidity in a crisis. Part of the challenge is political pressure opposing government intervention, as well as legal constraints on what the Fed or other central banks are permitted to do. In the United States, the Dodd-Frank Act prohibits the Fed from lending to individual institutions whose solvency is in doubt; instead it "relies heavily on new, complex, and potentially unwieldy regulatory and resolution mechanisms to prevent and tame future crises."[20] The Fed can still use broad-based programs to provide liquidity. As one participant summarized, *"The right focus is on the central banks. There will be a moment of truth, and ultimately it will become a political decision."* One participant stated, *"I don't see any other mechanism other than the Fed doubling their balance sheet. We will need an act of Congress."*

> *"The right focus is on the central banks. There will be a moment of truth, and ultimately it will become a political decision."*
> -Participant

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There has been significant debate in the press on whether liquidity fears are overblown. The *Financial Times* reported, "In absolute terms, trading volumes in corporate bonds and government debt are for the most part climbing," and noted that bid-offer spreads (a popular means of judging liquidity) are at a healthy level.[21] As well, financial commentator Martin Wolf suggested reduced liquidity might actually be healthy: "Keeping markets liquid when panic comes risks making the next crisis worse. We have become addicted to market liquidity. But it is too fragile and perverse in its effects on incentives to be viewed as a universal feature of our capital markets."[22]

BGLN and IGLN participants suggested the danger might be understated, as they are clearly concerned about the potential for reduced liquidity to increase the likelihood of a systemic crisis and exacerbate its severity. As insurers and bankers continue to monitor and prepare for a liquidity event, we hope network discussions will bring attention to the issue and allow for continued engagement among key stakeholders.

Leading insurers explore new models for growth and innovation

At its most basic, insurance is a way to alleviate peoples' fears. One participant noted, *"Insurance addresses fundamental human needs. It addresses fear of the future. Fear of the future is an enduring aspect of the human condition."* The challenge for insurers is that as markets, societies, and technology have evolved rapidly, fears have changed. The key to growth for insurers is to find ways to meaningfully address these newer fears; indeed, for the industry to remain relevant, it must adapt to solve current and evolving problems, not simply those from the past.

"The difficulty lies not so much in developing new ideas as in escaping from old ones."
– John Maynard Keynes

According to most participants, such growth will require tremendous innovation from the sector, though several participants agreed with one who said, *"Historically insurance hasn't been very innovative. The industry has had the luxury of innovation not being part of its core competency."* In addition to ensuring the industry's relevance, innovation may also insulate insurers from mounting disruptive forces. *"Companies are deciding it is important to become more innovative because we are the next industry likely to be disrupted. The barbarians are at the gate. How do I prepare?"* said one director. Indeed, advancing technology is allowing more and more companies to perform traditional insurer functions, such as distribution, data collection, and analysis. One director asked, *"Under the new normal, how do we survive? The best thing you can do in a crisis is reinvention. You have to come up with something to move the needle."* Insurers see innovative growth as a means both to better serve customers and to protect against new competitors.

On October 1, participants in the IGLN met to explore how the boards of leading insurers are thinking about innovation and growth. Most saw new digital technology as an integral part of innovation efforts, but they also recognized the need for insurance groups to think differently about the structures, partnerships, investments, and cultures that are needed to support innovation. This *ViewPoints* explores growth and innovation in the sector via the following key themes:

"There is more innovation in other industries than in insurance, but there is no doubt that insurance will be just as impacted."
– Executive

- Distinct forces are driving both innovation and disruption
- Innovation requires extensive cultural support and new structures
- Digital growth will produce dislocations and new risks for the industry

Distinct forces are driving both innovation and disruption

For insurers, advancing technology is a double-edged sword that can both create a means for disruption and enable great advances within the industry. Many commentators have noted that new and powerful technologies allow entrepreneurs to develop products and services that are "simultaneously better, cheaper, and more customized."[23] Trends such as changing usage patterns and the sharing economy are driving significant change. Over the course of the summit, insurance participants and experts discussed the followings significant technological advances reshaping the industry:

- **Big data and analytics.** Insurance is built on using data to build models that predict behavior and events from an actuarial or probability standpoint. Throughout history, insurers have been the biggest data collectors, but today companies like Google, Apple, Amazon, and Facebook hold that title. One executive observed, *"There was more data*

generated in the last two years than in the whole of history. At the same time, the percentage of data that is useful is declining. It is a big challenge to filter the useful information from the noise." Those companies that can collect data and use it best within the confines of evolving regulation will have the advantage.

"Every single industry is being eaten by software, including insurance because there is no physical product."
– Participant

- **Autonomous vehicles.** Autonomous vehicles, including cars and drones, are becoming more common. Numerous carmakers and technology firms have predicted self-driving vehicles will be widely available by 2020. Tesla CEO and tech proponent Elon Musk went so far as to predict that human drivers would be outlawed in the future.[24] Self-driving cars will significantly reduce auto-related injuries, but they raise many liability questions: Who is legally liable for normal use? What about cyberattack or failure? How does a vehicle "prioritize" among several bad outcomes? Very recently Google, Mercedes, and Volvo each indicated that they would accept liability for accidents that occur when their vehicles are in autonomous mode, suggesting that answers for some of these questions will come quickly.[25] However, one participant noted that the US car fleet turns over every 11 years, so there is not an imminent cliff for auto insurers. However, another predicted, *"You will see auto insurance stagnate or drop. The first company to back self-driving cars and be the first mover will really benefit."*

- **Mobile devices.** One participant suggested, *"Mobile will change the world … The opportunity afforded by this device is an order of magnitude larger than the PC."* First, mobile technology is changing customer expectations and interactions with vendors regarding immediacy and ease of use. Second, phone technology can now monitor and record an ever-growing number of factors that influence insurance, such as driving history, exercise levels, and blood pressure. As one participant noted, *"From an underwriting perspective, you get all of this data from your phone and it will be transformative."*

- **Artificial intelligence (AI) and automation.** In recent years, the use of AI and botsourcing (the replacement of human workers with robots)[26] has increased dramatically. In the near term, such advances can increase productivity, efficiency, and safety while also reducing cost. In the longer term, as robots and AI move into new kinds of jobs, including knowledge-economy jobs, there may be fewer workers required in a variety of industries.[27] This will have implications for those industries, their insurers, and the wider economy.

One result of the rapid adoption of these new technologies is the explosive growth of fintech (financial technology) and insuretech (insurance technology) companies. One participant estimated there are three times more fintech start-ups this year than there were last year. While some insuretech companies are small operations that are likely targets for future acquisition, an increasing number are "full-stack" start-ups. These companies are created to redesign and reimagine processes and industries, rather than to address a specific problem.[28] Insurance is still only about 10% of that pool of companies, but it is expanding rapidly. While insurers express some doubts about the ability of existing insurers to innovate, there is tremendous growth in the number of small technology companies entering the market. Appendix 1, on page 37, lists a sample of disruptive insuretech companies.

"Zenefits is now the biggest broker in California. When you get it right in insurance, the growth is tremendous."
– Participant

Innovation requires extensive cultural support and new structures

Tools, in the form of new technologies, are clearly necessary – though, as one executive noted, *"Today's exciting technology will be commonplace tomorrow."* Innovation also requires talent and a supportive culture that can utilize the tools in novel ways to create value. Without a fully supportive environment, it will be difficult for new initiatives to succeed. Participants have identified the following elements as necessary to create cultures of innovation.

"The key to innovation is creative people, mature processes, and a supportive culture."
– Executive

Change in organizational culture

While there is great interest in the technology and tools of innovation, insurers recognize that tools alone will not enable real change. To support the kind of innovation many believe is required of the industry, insurers must promote changes in organizational culture and associated hiring and talent practices.

Promote greater diversity in talent, break down siloes, and focus on the client

Several participants agreed with one who said, *"We need a wider set of thinking. We need to diversify the skills we apply to actuarial problems."* Actuaries tend to look at history and, as a result, have overlooked important trends. To diversify the workforce, insurers need to hire for different hard skills as well as important soft skills. Participants spoke of the need to hire engineers and data scientists, as well as individuals with high EQ, or emotional intelligence. EQ can enable important attributes such as the ability to persuade others or to ask for help. One participant noted, *"We focus on emotional intelligence so they can relate to the people they are trying to persuade, so they are not viewed as hostile, while at the same time they are changing someone's whole world view. We were going to battle with World War I weapons. We are not getting rid of the infantry; we are just getting better weapons."*

"Board directors should ask more naïve questions. Ask what exactly the actuaries mean? Help break down these silos."
– Executive

More diverse thinking will also allow insurers to transition from a siloed product mindset to a customer mindset. One participant noted, *"The biggest shift in strategy is from product focus to client focus. People have been in property or casualty sector for their whole career, so it is a challenge."* In a previous discussion, one executive noted that most large insurers have *"customer focus"* or *"customer centricity"* as a core tenet; despite this, companies are generally slow to improve upon the customer experience. One director cautioned, *"We all built new assets to compete more effectively in the new digital age, but you look back at the customer interaction and it is horrible. All these new capabilities are not necessarily working better for the customer."*

Finally, one participant emphasized that change will come not just from new hires but also from shifting the focus of all employees: *"I think about innovation in two dimensions. Are we talking about fishing or teaching people to fish? There are big ideas that can be transformational, but it is also about training and developing people so that they are constantly thinking about innovation. If we can get 70,000 people all thinking about creating value, then we can sustain ourselves for another 150 years."*

Promote cultural change

Existing organizational hierarchies can impede progress and may be anathema to digital talent. Participants observed that hierarchical organizations often resist sharing bad news and can squash ideas that are seen as threatening. Given the rapid pace of change, lower levels of large organizations can no longer afford to wait to share problems until they have arrived at a solution. Several participants observed that middle management is often where change efforts fail because of vested interests. One director observed, *"The digital revolution breaks through hierarchy, leaving the middleman flat-footed. We need to change the culture so we are not afraid to admit mistakes. We need to be learning organizations, not knowledge organizations. We need to react in a collaborative way."*

> *"We need people who bring a broader view. These are the people to disentangle the noise from more systemic trends."*
> – Participant

Real innovation can be quite disruptive to the status quo – in some cases, undermining traditionally profitable aspects of the businesses. As a result, it may be far easier for firms to direct investment in technology toward improving existing systems and enterprises, rather than toward new, potentially disruptive pursuits.[29] However, such "self-disruption," whether undertaken as a defensive act against new entrants or in recognition of new opportunities and customer needs, may offer the best path to growth. Unfortunately, as one director noted, *"It is very hard to truly disrupt yourself. There are vested interests. You have to really reformat what a company does and explode business models."*

Finally, digital culture clashes with traditional hierarchies and eschews formality. For some employees, working within a hierarchy may be challenging, particularly if their work is undervalued or treated as threatening. One IT leader cautioned, *"You can't bring enthusiastic youth into an environment that doesn't like, or wants to cut, IT. You have to build a place that talent enjoys. Real talent does not want to work in a cost center."*

Live digital values

> *"If someone is going to take a chunk of our best business, why wouldn't we do that first? We know it is something we have to get right."*
> – Executive

Participants noted successful innovation requires certain values, such as openness to challenge, tolerance of failure, and flexibility. As Amazon and numerous tech companies continue to demonstrate, institutions should accept failure but aim to fail fast and cheaply. Participants shared cautionary tales in which firms quashed revolutionary ideas for fear of the damage to the bottom line only to see another organization capitalize on those ideas. Likewise, some organizations that do not see a quick return on investment terminate projects only to resume them later and at a higher cost. Leadership must not equate lack of short-term, bottom-line impact with failure.

While many firms espouse these values across the firm or within specific functions, several directors cautioned that a culture that lives these values must also compensate in accordance with them. The challenge for large insurers is how to square these values with the structures and processes that are required to coordinate and efficiently run large and complex organizations.

New internal structures and processes

Several participants noted that creativity without structure falters. To achieve the best results, ideation should be partially formalized. Likewise, large groups need a means to share important innovations across the enterprise. Participants outlined several approaches:

- **Formal processes.** *"Innovation, like anything, takes some discipline. You have to manage your knowledge and create opportunities for creativity,"* said one director. Process takes many forms, but some suggestions included running regular ideation sessions and customer panels, crowdsourcing ideas, and establishing protocols or models to vet, develop, and test concepts. Several directors noted that speed and cutting through organizational inertia are as important as, though sometimes opposed to, establishing processes. For many insurers, decreasing the time between idea and implementation may require creating innovation processes outside of the traditional bureaucracy.

- **Innovation labs.** Numerous organizations have created labs to facilitate innovation without requiring broad or rapid change in the entire organization. These entities convene talent from disparate parts of an organization for a specific purpose, create an environment conducive to collaboration, and eliminate bureaucratic red tape. According to one board chair, *"Innovation funds give people the ability to develop things without immediate accountability to the business. It must be kept very separate from the core business. You still need people to grind and bring in the money, and then a separate group to create."* Another director said, *"Companies might consider creating an innovation facility as a separate entity. It is not a line of business on the balance sheet that can be viewed as a liability. This could help reframe innovation as an asset, not a liability."* While such labs benefit from being kept apart from core business, firms must weigh the risk of separation and ensure that there is broad support for the work so it does not become siloed.

> *"A lab situation with bright talent is a less restrictive way to develop new approaches. The challenge that comes with this approach is figuring out how to integrate it."*
> – Director

- **Science teams.** At least one large insurer has a multidisciplinary science team that is designed to improve operations across the enterprise. The team uses data to shift the basis of decision-making from intuition to evidence, and to prevent innovation from being trapped in pockets of an organization. This group has two tasks: to improve major inefficiencies and to come up with so-called breakthrough ideas. *"If they did just [come up with ideas], the cynics would push back. The problem solving is critical to building internal credibility,"* noted one participant.

Wide range of external innovation partners

Partnerships can defray cost and risk for single organizations entering new areas, and can allow insurers to focus on core capabilities rather than build new skills. Despite these advantages, competitive pressures and sectoral barriers have inhibited many partnerships. Several participants observed a softening of the competitive and zero-sum mentality among leading insurers when it comes to pursuit of certain kinds of innovation within the industry. Participants discussed several categories of partnership opportunities:

> *"As we remove friction from the system, it opens up different types of partnerships."*
> – Executive

- **Industry partnerships.** While competition within existing lines is fiercer than ever, there appears to be a growing recognition of the value of industry partnership in developing some new products and markets. Industry partnerships often involve the sharing of data, core competencies, investment, or some combination of these factors. Partnerships may be horizontal (across comparable companies) or vertical (across the value chain). While industry partnerships remain more an exception than a norm, one participant suggested there are specific areas of practice that are ripe for such

arrangements. Loss indices are one example: *"For something like long-term care, having some indices to share that are not tied to one company would attract investors because it removes fear of adverse selection."* However, as firms pursue new types of alliances, they will need to be mindful of antitrust restrictions and may need to seek guidance from policy authorities more often. Appendix 2, on page 34, provides a list of selected new industry and cross-sector partnerships.

"You see insurers partnering with other capital-markets players, particularly in the reinsurance space, but elsewhere as well."
– Director

- **Nontraditional partners.** While there are an infinite number of ways to partner, participants said two forms are most common: data sharing and arrangements that leverage core capabilities (underwriting, investing, etc.). The age of big data opens up a variety of interesting partnership opportunities with private- and public-sector organizations. Such arrangements can better enable insurers to change outcomes and achieve economic returns simultaneously. Specific examples include data sharing with governments, brokers, or clients to improve health and workers' compensation outcomes or to reduce fraud. In addition to data sharing, some insurers are also entering into a growing number of arrangements with capital-markets entities, such as sidecars, which can increase insurance capacity while allowing firms to focus on fundamental strengths.

- **Investment and venture capital (VC).** While improving internal capacity to innovate can be advantageous, many participants acknowledged that because innovation is difficult for large institutions, the most fruitful efforts often come from outside the company. In the last two years, large insurers have increased investment via existing VC firms and, in several cases, created their own VC operations to fund start-ups. VC investment creates the opportunity for early exposure to new technology and lessons learned, and technologies developed by start-ups can be imported into the company. In addition, in the current low-return environment, many insurers want to deploy some capital to new and potentially higher-yielding investments, and VC can facilitate this on a small scale.

"In cyber, what does an expert look like? Is it someone in Silicon Valley or Israel, or is he/she found in a big insurance company?
– Participant

Insurance approaches that offer opportunity in the digital world

Culture, together with the right tools and investment, creates the most fertile environment for innovation; however, insurers are still trying to determine which products and strategies offer the best growth opportunity. Participants identified three approaches through which insurers can provide better value:

- **Address modern risks.** Cyber, energy, business interruption, reputation, and supply chain are just a few of the rapidly growing risk areas. They present insurers with an opportunity to create improved products that address emerging fears. One participant advised, *"The things scaring you on cyberinsurance are scaring every business, which seems like a great opportunity. Whether that means you will more quickly confront the channel model or be the first to take the risk on self-driving cars and lose money in order to learn that business is an open question."* The challenge for most insurers is that products in these areas can push the bounds of insurability. Insurers may have limited experience in areas where risks are large, evolving, and can concentrate with large numbers

rather than dissipate as with more traditional risks. As insurers attempt to innovate in new product areas, they will face a trade-off: being entrepreneurial could result in a first-mover advantage, but limited experience also makes first-movers susceptible to a host of poorly understood risks.

- **Reduce risk by changing behavior.** Both consumers and insurers increasingly will be in possession of better data. Insurers can use this information to pivot from response to prevention by advising customers on their risks. One participant said, *"We can see this … as a tremendous opportunity if we change our role from underwriting risk to changing risk in a consultative position, by getting the insured to adapt and change their behavior over time."*

- **Expand into underserved markets.** One director said, *"There is an opportunity for the industry to enlarge … The world population is 7 billion, and 2.5 billion are right on the verge of entering the middle class. They have needs, are vulnerable, and insurance is only part of the necessary ecosystem. It includes financial inclusion, access to credit, banking the unbanked, and protection."* The challenge for insurers is to overcome the frictional and innovation costs. High expense ratios make it difficult to deliver valuable products, but new technology and partnerships may offer solutions to reduce cost.

Digital growth will produce dislocations and new risks for the industry

While the upside to innovation is apparent, participants also noted that more innovation, coupled with broader changes in the marketplace, will produce and enhance risks in the industry. Participants identified the following likely dislocations and risks for the insurance sector:

- **New goods will alter the marketplace.** Old models and products for insuring goods will become obsolete as new products come online and usage patterns change. While this is hardly a new phenomenon, the pace of change is faster than it has been before, leaving less time for insurers to adapt.

- **Some broker activities will disappear.** According to one executive, *"If all you provide is search capacity, Google does that much better."* In some arenas, where brokers act as a barrier between customer and provider or simply offer search capability, they may be disintermediated. One participant noted, *"We are not trying to replace brokers, but we will work with them in a different way. In many ways, brokers are a buffer to our clients. It is like doing surgery with ski gloves."* On the other hand, small- and medium-sized enterprises will continue to rely on intermediaries for risk management. Brokers with deep expertise and relationships will become more valuable.

- **Insurers will profit based on the core business, not on bells and whistles.** As transparency increases, customers will be clearer about what they need and want. Likewise, services that can be performed better or more cheaply elsewhere will migrate. Several participants advocated letting go of nonessential functions so insurers can do what they do best. As one director noted, *"We are the guys that focus on bad things. This is a very specific skill. Pooling is at the heart of it. Everything else is just*

"When you strip away the least value added services, it will be disruptive to those who enjoyed the rents of the previous system."
– Executive

interesting. Let them take the bits they are better at and let us do our core work." At the same time, changing and simplifying products will reduce profit. However, most agreed with one participant who said, *"We need to ensure we are protective partners, and not rent seekers."*

- **All risks become cyberrisks and are increasingly interconnected.** As more objects and people interact digitally, risks that were once discrete and separable may fuse. Business interruption, car accidents, fire, or device failure represent just a few of the traditional insurable risks that may result from cyberintrusion. In addition, risks that were once thought to be unconnected may prove to be linked in a digital world. For example, one participant noted that social unrest can trigger *"hacktivism"* and increase the incidence of cyberattack on public and private systems. Furthermore, as one director noted, *"Cyberrisks are difficult to insure against because they accumulate and concentrate."*

> *"As the Internet of Things takes off, no risk isn't cyberrisk. It will be impactful to every risk you insure."*
> – Director

- **Information asymmetry increases.** *"Many of us will be disintermediated by our customers who know more than we do,"* said one director. Genome sequencing and other advances may give customers access to more information than their insurance partners. Insurers will need to find ways to ensure they have the same amount of information as clients and are not at significant risk of adverse selection and moral hazard.

- **Risk pooling unravels in the face of increasingly granular data.** Some participants fear that big data could fragment risk pools, creating smaller and smaller pools. Ultimately, more individuals could become uninsurable, creating significant public policy dilemmas. Assuming regulations keep pace, insurers may be able to use new data to resegment and repool. Insurers will need to work with the public sector and must maintain a societal view that extends beyond their own insureds.

- **With too much focus on innovation and technology, insurers risk missing important trends.** Several directors worried that discussion of innovation is a convenient distraction from immediate challenges like tough market conditions. Equally, one director warned that too much focus on innovation could distract from other, less obvious trends: *"We spend a huge amount of time on tech and use analytics everywhere. It is a constant discussion on what we are doing, why we are doing it, and where we are doing it. These are really the fireflies before the storm. If you focus on the shiny items, you are missing it. You need to understand the underlying cultural and demographic shifts that are occurring."* While advancing technology can capture the imagination, insurers will be caught flat-footed if they fail to focus sufficiently on current conditions and important demographic trends.

> *"Regulation is not adapting as fast as algorithms."*
> – Participant

- **Regulation will adapt more slowly than culture and products.** *"How do we do this when regulatory constraints are not adapting as fast?"* asked one director. Participants are interested in understanding how regulators will view the use of big data and how they will treat start-ups and non-traditional competitors. One participant noted, *"Start-ups want to be regulated. The challenge is a lot of regulations never imagined the iPhone or the sharing economy. Most start-ups think you do right by doing right by the customer. I'd also say that start-ups have a different risk-reward*

profile with less to lose. They will move fast to break things to get to the scale where they can engage with regulators." One executive suggested, *"The industry needs to have a very active dialogue with regulators on what is possible and what is desirable. We need to work with regulators in a spirit of common purpose. We are all interested in a sustainable insurance industry using innovation to reduce fear."*

⋆ ⋆ ⋆

As the world becomes more digital, disruption and the opportunities for innovation have arrived hand-in-hand in the insurance industry. Whether and how insurers harness innovation and convert it to growth remains to be seen. In just the last several years, the conversation within the IGLN, as within the industry, has changed from one focused on digital technologies to one that considers talent, culture, risk, and regulation as important elements of innovation. Nurturing innovation inside and outside the traditional walls of the sector is a growing strategic priority for boards and top management.

Board-shareholder engagement in an era of increasing activism

> "A dose of direct information may be the ounce of prevention that smart boards use to avoid a pound of cure in the form of derivative lawsuits, messy proxy fights, and activist battles."[30]

Active shareholders are fundamentally reshaping the corporate governance landscape. One way this has manifested is in calls for greater direct engagement with directors. Recent letters from large institutional investors demonstrate a clear expectation of regular investor-director communications.[31] The IGLN and BGLN represent institutions and sectors in transition, with much to communicate to the investment community regarding institutional health, strategy, and the implications of changing regulations. Although management has historically been the locus of shareholder communication, the fact that board directors are viewed as guardians of long-term strategy means that directors, including those in the financial sector, are under new pressure to engage with a wide range of investors. These investors are focused not only governance issues, but increasingly on corporate strategy, risk oversight, and improving financial returns. Over lunch on October 1, participants in the BGLN and IGLN Summits met jointly, along with subject matter experts and investors, to discuss emerging investor expectations.

Pressure from investors is increasing

While activist investors tend to grab the headlines, institutional investors are also focusing more attention on large banking and insurance groups. Furthermore, increasingly these two types of investors are finding common cause.

Financial services companies are attracting more attention from activist groups

To date, activist investors have not waged as public battles with financial services companies as they have with companies in other sectors. However, one participant warned, *"We cannot expect [that restraint] any longer. There is a massive wave of activists coming, and their influence is meaningful. As financial services companies, we haven't seen them show up in the boardroom, but that is changing. The traditional view is we are protected by regulations, but the world is changing. More activity is coming our way."* A recent letter from activist investor Carl Icahn to AIG calling for it to split into three companies demonstrates change may have already arrived.[32]

> *"There is a massive wave of activists coming, and their influence is meaningful."*
> -Participant

Institutional investors are becoming more active

There has been a tectonic shift in the shareholder base of large companies over the last two decades. In the United States, index funds are now over 20% of the market and growing in size. As a consequence, major asset managers own an array of large companies, whether they would have chosen them independently or not. For instance, BlackRock's $2.9 trillion in passive investments (i.e., holdings in index funds and ETFs), means that the firm owns, frequently on a long-term basis, an average 4%–6% of an indexed company.[33] Since these passive hold companies are shareholders through the good and bad, they view engagement as a way to enhance performance. In addition, one participant argued that many of these managers also compete against ETFs, and deeper engagement can demonstrate the value of their own pricing spreads for their clients. This is causing

managers to seek more direct engagement with firms to press for improvements that will drive returns.

An emerging approach is partnering with activists. One participant described this new trend: *"These investors are turning to activists and even submitting a RFA: a 'request for activists.'"* One director said, *"No company is immune. [Activist and institutional investors] are now acting in groups. I've been surprised by the long-term managers getting caught up with activists."* A recent *Wall Street Journal* article highlighted activist investors' increasing successes when supported by large institutional investors.[34] Institutional investors say that these new partnerships are valuable in improving corporate governance and performance, and that there is a growing trend toward "constructive activists rather than destructive activists."[35] JPMorgan bankers recently cautioned, however, "In contrast to the situation of just a few years ago, companies must examine their long-only shareholders with a critical eye … There are no 'management friendly' investors."[36]

"These new investors are turning to activists and even submitting a RFA: a 'request for activists."
-Participant

Many directors expressed fears that short-term activism would harm the long-term interests of their company. However, money is flowing to activists because of their perceived success in generating returns for their investors. One participant argued, *"There is a preponderance of academic data that suggests there is a sustainable performance improvement at a firm after an activist gets involved."* A *Wall Street Journal* report that studied the impact of an activist's arrival on large US companies concluded that shares of large companies confronted by activists are more likely to outperform those of their company peers, but the differential is minimal.[37] On other criteria, such as growth in earnings and profit margins, the results were inconclusive, demonstrating an overall mixed bag on activist impact.[38]

"The governance fight was won by institutional investors. The next battle is they want to tell people where to drive."
-Participant

Governance issues remain important, but the focus is increasingly on financial performance and strategy

One participant commented, *"At the end of the day, governance is interesting, but ultimately what attracts activism is the underlying share price and performance."* This participant continued, *"For the activist class, the governance stuff is in large part window dressing for an economic agenda. Activists use governance as a lever to get the institutional investors of the world riled up."*

Participants continue to see pressure from investors on governance issues, including compensation and board composition. One participant claimed, *"Some activists use compensation concerns as a screen to see if there are problems at the company."* Others concurred, by citing recent debates regarding splitting the CEO and chairman role. The general consensus, however, was that the battle is heading in a new direction. One participant argued, *"The governance fight was won by institutional investors. The next battle is they want to tell people where to drive."* Despite concerns about short-termism among activists, another participant noted increasing pressure for significant strategic changes: *"The safety net is no longer to buy back your stock. Activists are no longer asking for that. They want you to break up your company, to sell assets, or to sell yourself. It is becoming a strategic agenda, not a capital optimization agenda. That by definition is a long-term discussion."*

"They safety net is no longer to buy back your stock. Activists are no longer asking for that. They want you to break up your company, to sell assets, or to sell yourself."
-Participant

Proxy access: a rising tide

This year, more than 100 US companies received shareholder proposals on proxy access or decided unilaterally to implement it.[39] Much attention is focused on proposals to allow shareowners with 3% of the company's stock, held continuously for three years, to nominate up to 25% of the board and to place those nominees on the company's proxy. Scott Stringer, New York City Comptroller and a leading advocate for proxy access, recently stated, "This fight is about giving us the opportunity to have a say in the companies we invest. Boards that are unaccountable should feel… that they have competition at the ballot box."[40] One participant said, *"The issue is whether to get out in front of this parade, and set proxy access up on your own, or wait for an active shareholder to propose it."*

Boards are exploring how best to respond to investor demands

Participants acknowledged that views on engagement differ depending on country, board structure, and the level of activism among investors. As more investors actively press their agendas, boards will be called upon to engage directly on a broader range of issues.

"In today's environment, with more active shareholders, poor engagement strategies are a risk."
-Participant

Boards have been hesitant to engage directly with investors

Some directors continue to express reservations regarding direct and independent board interaction with investors. One participant observed, *"Board-shareholder engagement is the hottest topic in corporate governance and the one that has evolved the most in the last 20 years. It simply did not happen 20 years ago. When investors asked, doors were shut … In today's environment, with more active shareholders, poor engagement strategies are a risk."* Historically, senior management, particularly the CEO, CFO, and head of investor relations, handled most company-investor engagement. In discussions in advance of the summit, some participants expressed skepticism about increasing board-shareholder engagement. One director argued, *"Management's role is to talk to shareholders in all cases. I would only agree to direct board engagement if it is absolutely necessary."* Others highlighted potential regulatory concerns, especially fears of violating Regulation Fair Disclosure or related disclosure rules that would subject the company and/or director to liability.[41] Essentially, directors are fearful of accidently providing investors with information that is not available to the public. Still, critics argue these fears are overblown. In a June speech, Vanguard's CEO commented, "Companies individually have to decide how best to manage the risk, but it shouldn't be by shutting out the shareholders completely."[42]

"If you have people on your board who don't know your strategy [and how to communicate it], then they shouldn't be on your board."
-Director

Another common critique of direct engagement is that engagement will become sticky. Many directors believe they already have insufficient time to focus on core duties without adding additional ones. As well, not all board members are prepared to engage. *"You need trained people talking to investors,"* said one director. Furthermore, selecting one or more board representatives to speak publically raises concerns about what messages will be shared with the markets, especially if there are issues on which the board is not yet fully aligned. Yet some felt strongly that all directors should be capable of engagement, with

one director arguing, *"If you have people on your board who don't know your strategy [and how to communicate it], then they shouldn't be on your board."*

Boards are deploying an array of strategic and tactical responses

As requests for interaction increase, boards will need to develop strategies for meaningful and productive engagement and should take advantage of opportunities to get in front of potential investor concerns. Despite the reservations about engagement, most participants seemed to agree with one who said, *"The genie is out of the bottle. I don't see us returning to less conversation with shareholders in the future."* Accepting this reality, the discussion at the summit turned to strategic and tactical responses to investor pressure for communication:

- **Be proactive in articulating your strategy to improve returns.** Boards and management need to be able to crisply articulate the institution's multiyear path to greater value. *"It is about getting ahead of the strategic agenda before someone else does,"* said one participant.
- **Use various methods to tell your story.** One participant observed, *"We are all required to do disclosures. This should be viewed as a communication opportunity and not just a compliance exercise."* More holistically, directors were encouraged to use all available communication tools, including websites, to communicate with the broader investment community and offer a compelling narrative about the strategy and prospects of the firm.
- **Create board structures to handle shareholder engagement.** Participants asked how to strike the right balance in seeking out engagement. Some feared that without a reason to engage, direct interaction could do more harm than good. One possible solution offered was to create a dedicated committee to manage this delicate decision. *"An emerging practice is to create a committee on the board to deal directly with shareholders. It is a standing committee that is available to meet with shareholders for a standard review,"* one director explained.
- **Discuss with investors changes they would like to see.** Many directors argued that they gain the outside perspectives needed through meeting with analysts. Others claimed you need to go much further. *"Everyone should have a meaningful shareholder come talk to your board. What you hear from bankers is not necessarily the same as hearing directly from shareholders,"* said one participant. Some participants emphasized the influence of governance leaders at large institutional investors, with one describing the head of governance at a large institutional investor as being like *"the Ohio, Florida, and Pennsylvania of the electoral college."* Understanding the key investor groups, and people within those investors who are most influential, is critically important.
- **Consider including an investor on the board.** Some participants argued for bringing a major investor onto the board. Even those who have dealt directly with activists found value in this approach. One participant observed, *"When these activists join your board, you can have a different conversation because they are wearing the same jersey."* A director described the potential benefits: *"The activist*

"Everyone should have a meaningful shareholder come talk to your board. What you hear from bankers is not necessarily the same as hearing directly from shareholders."
-Participant

"When these activists join your board, you can have a different conversation because they are wearing the same jersey."
-Director

> *board member is just as willing to take our data and change his mind [as to pressure us for change]."* However, some were concerned that inviting investors to the board could open the floodgates. One director commented, *"The problem is every day a new guy emerges. Once it starts, it doesn't stop."*

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Increasing activism from large institutional investors doesn't have to be a concern. Leading corporate expert Ram Charan recently observed,

> As the biggest asset managers gain more power and exercise it more freely, they bear a heavy responsibility. They may influence employment, national competitiveness, and economic policy for better or for worse. They can ensure a balance between short-term and long-term corporate goals, and between value creation and societal needs. They can keep succession planning near the top of every company's agenda. How they will discharge their responsibility remains to be seen.[43]

If appropriate steps are taken to actively shape and communicate a compelling strategic vision to the market and ensure investor expectations are understood and managed, greater engagement can be a constructive way to improve governance. It does, however, place a new responsibility on board directors already handling significant engagement with regulators and spending ever more time on core board responsibilities. The challenge for directors will be to balance these increased responsibilities and demands on their time.

About the Insurance Governance Leadership Network (IGLN)

The IGLN addresses key issues facing complex global insurers. Its primary focus is the non-executive director, but it also engages members of senior management, policymakers, supervisors, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy insurance institutions. The IGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the IGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of senior management, advisers, and stakeholders who become engaged in this leading-edge dialogue, the more value will be created for all.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multistakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the insurance industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients, and for its communities. EY supports the IGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

Appendix 1: Insuretech and the digital disruptors

Industry outsiders and insiders are increasingly harnessing technology to provide better products, improve customer interaction, and develop new markets. Insuretech, like its older brother, fintech, is growing rapidly. By one estimate, since 2010, insurance start-ups have raised $2.12 billion, with about two-thirds of that in the last 18 months alone.[44] Prominent disruptors include the following:

- **Zenefits (United States).** Zenefits provides free cloud-based human resources management to companies with fewer than 1,000 employees. The company makes money on commissions on insurance sold through its software. Zenefits is known for its simple platform, targeting underserved market segments, high-profile litigation involving an incumbent, and a $4.5 billion valuation.
- **Friendsurance (Germany).** Like Guevara (United Kingdom) and InsPeer (France), Friendsurance facilitates online peer-to-peer insurance by combining social networks and insurance companies. Smaller claims, which would typically be part of a deductible, are shared across a circle of friends, and large claims are covered by insurers. Part of the premium can be returned at the end of the year.
- **Metromile (United States).** Metromile offers information on driving behavior, mileage, and expenses, as well as car diagnostics and parking and commute optimization for free. For a fee, it offers by-the-mile auto insurance, aimed at low-mileage drivers. More recently, it has begun to offer gap coverage for Uber drivers.

Appendix 2: Examples of innovative insurance partnerships

Insurers are entering into an increasing number of industry and cross-sector partnerships:

- **Blue Marble Microinsurance.** Blue Marble is part product-and-platform innovation and part market-building effort. It is a consortium of eight insurance and reinsurance organizations whose goal is to increase consumer access to insurance and create shared-service and technology solutions for developing economies' emerging middle classes. A participant affiliated with Blue Marble noted, *"Insurers will need new distribution systems for small-sum distribution. Why should individual companies compete on technology? Why not create a shared system and use it to sell different products? Differentiate yourself in the market based on products."* Such ventures may also provide opportunities for reverse innovation (i.e., the import of less expensive models, created for developing markets, into developed markets).

- **Discovery Vitality.** Discovery provides a range of products, including life, health, wellness, and short-term insurance, in South Africa and the United Kingdom. It has also partnered with leading insurers, including John Hancock, AIA, and Ping An, to provide services in other countries. Discovery offers incentive-based plans designed to improve wellness. It also offers return-of-premium and loyalty programs. Discovery gathers a mix of user data through health assessments, wristbands that record fitness levels, and other means, and uses advanced analytics to improve underwriting and change customer behavior.

- **ABR Re.** In April 2015, BlackRock and ACE raised $800 million to form ABR Re, an independent reinsurance company.[45] ACE is the sole source of risks ceded to ABR Re, and BlackRock is the investment manager. This partnership continues to blur the lines between reinsurance and capital-markets activity and offers both groups the opportunity to leverage core capabilities.

- **XL Innovate.** A number of insurers, including XL Catlin, AXA, MassMutual, Mitsui Sumitomo, Munich Re/Hartford Steam Boiler, and Aegon/Transamerica, have established VC funds with a strategic focus on developing technologies for the insurance industry. Created in April 2015, XL Innovate is focused on growing business that targets underserved risk markets, provides new approaches to risk underwriting and client access, and improves technology related to risk underwriting.[46]

Appendix 3: Insurance & Banking Summit Participants

Aegon
- Rob Routs, Chair

AIG
- John Fitzpatrick, Risk & Capital Chair
- Peter Hancock, Chief Executive Officer
- Doug Steenland, Chair
- Theresa Stone, Regulatory & Public Policy Chair

Andreessen Horowitz
- Mike Paulus, Partner

Blue Marble Microinsurance
- Joan Lamm-Tennant, Chief Executive Officer

BNY Mellon
- Nick Donofrio, Technology Committee Chair

Cambridge Associates
- George Hasiotis, Managing Director

CIBC
- John Manley, Chair
- Kate Stevenson, Non-Executive Director

Citigroup Global Markets
- Peter Babej, Managing Director, Global Co-Head Financial Institutions
- Gautam Chawla, Managing Director, Financial Institutions

Conning
- Woody Bradford, Chief Executive Officer

Credit Suisse
- John Tiner, Audit Committee Chair

Deutsche Bank
- Dina Dublon, Risk Committee Chair
- Stuart Lewis, Chief Risk Officer

Federal Reserve Bank of New York
- Bruce Richards, Senior Vice President, Division of Banking Supervision and Regulation

Hudson Executive Capital
- Doug Braunstein, Founder and Managing Partner

ICBC
- Callum McCarthy, Strategy Committee Vice Chair

JPMorgan Chase
- Labe Jackson, Audit Committee Chair

MetLife
- Catherine Kinney, Non-Executive Director
- Stan Talbi, Chief Risk Officer

Missouri Department of Insurance
- John Huff, Director, NAIC President Elect

Moody's
- Simon Harris, Managing Director, Global Head of Insurance

Morgan Stanley
- Bob Herz, Audit Committee Chair

Nationwide Building Society
- Tim Tookey, Risk Committee Chair

NN Group
- Doug Caldwell, Chief Risk Officer

NYU/Sanford C. Bernstein
- Brad Hintz, Adjunct Professor of Finance, former SVP Equity Research Analyst

Prudential Financial
- Michael Lillard, Chief Investment Officer, Fixed Income
- Nicholas Silitch, Chief Risk Officer

QBE Insurane Group Limited
- John Green, Deputy Chairman

RBC
- Katie Taylor, Chair

Société Générale
- Nathalie Rachou, Risk Committee Chair
- Alexandra Schaapveld, Audit and Internal Control Committee Chair

Sompo Japan Nipponkoa

- Jan Carendi, Senior Adviser to CEO

State Farm

- Paul Smith, Chief Financial Officer

Sun Life

- Sara Grootwassink Lewis, Non-Executive Director

UniCredit

- Alessandro Decio, Chief Risk Officer

USAA

- Herman Bulls, Risk Committee Chair

XL Group plc

- Mike McGavick, Chief Executive Officer

Zurich

- Joan Amble, Non-executive Director

EY

- Ian Baggs, Global Banking & Capital Markets, Deputy Leader
- Martin Bradley, Global Insurance Finance, Risk, & Actuarial Leader
- Shaun Crawford, Global Insurance Sector Leader
- Dave Hollander, Global Insurance Advisory Leader
- Mike Lee, Global Asset Management Leader
- Chris O'Hehir, Partner, Advisory
- Ted Price, Advisor, Risk Governance
- Marc Saidenberg, Principal, Financial Services
- Isabelle Santenac, EMEIA FSO Assurance Managing Partner
- Bill Schlich, Global Banking and Capital Markets Leader
- Ann Yerger, Executive Director, Center for Board Matters

Tapestry Networks

- Dennis Andrade, Principal
- Leah Daly, Principal
- Jonathan Day, Vice Chairman
- Colin Erhardt, Associate
- Peter Fisher, Partner
- Jason Watkins, Principal

Endnotes

[1] V*iewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

[2] Sidecars are limited-purpose structures that work in tandem with insurance or reinsurance companies. They reduce the underwriter's liability and allow for additional risk-bearing opportunities. Sidecars will purchase a portion or all of a book of business to share in the profits and risks. If the underwritten policies have low claim rates while in possession of the sidecar, the investors will make higher returns.

[3] Phil LeBeau, "Car-Sharing a Growing Threat to Auto Sales: Study," *CNBC,* February 4, 2014.

[4] For further discussion of this topic, see Christian Hott and Benno Keller, "Big Data, Insurance and the Expulsion from the Garden of Eden," *Insurance Economics*, no. 27 (2015).

[5] Sarah Jones, "Reinsurers See Further Price Declines for 2016 in Wake of Mergers," *Insurance Journal,* October 19, 2015.

[6] A sample of recent M&A activity includes the mergers of XL and Catlin, Ace and Chubb, Ironshore and Fosun, PartnerRe and Exor, Endurance and Montpelier, Tokio Marine and HCC, Renaissance Re and Platinum, Sompo and Canopius, Fairfax and Brit, Validus and Western World, Tokio Marine and Safety National, and Mitsui Sumitomo and Amlin.

[7] See Bank Governance Leadership Network, *Top and Emerging Risks: Improving Identification and Oversight of Key Risks Facing Large Banks*, ViewPoints (Waltham, MA: Tapestry Networks, 2015), and Insurance Governance Leadership Network, *Navigating Amongst Icebergs: Leading Insurers Address Emerging Risk*, ViewPoints (Waltham, MA: Tapestry Networks, 2015).

[8] William C. Dudley, "Regulation and Liquidity Provision" (speech, SIFMA Liquidity Forum, New York, September 30, 2015).

[9] Stephen A. Schwarzman, "How the Next Financial Crisis Will Happen," *Wall Street Journal,* June 9, 2015, and "Fed's Tarullo, BlackRock's Fink Cite Bond Market Liquidity Concerns," *Today,* June 5, 2015.

[10] Bank Governance Leadership Network, *Top and Emerging Risks: Improving Identification and Oversight of Key Risks Facing Large Banks*.

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