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Résumé de l'article

La pression pour la réalisation de profits dans le secteur des services financiers provoque un phénomène de convergence des services et des produits. Tentant d'obtenir des économies d'échelle et recherchant la satisfaction du plus grand nombre de besoins de leur clientèle, les sociétés d'assurances, les banques et les marchés de capitaux tentent toutes de traverser leurs frontières respectives et de pénétrer les sphères d'activités de chacune.

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CONVERGING OF THE INSURANCE, BANKING AND CAPITAL MARKETS

by Ken Hague

ABSTRACT

The pressure for profits in the financial services sector is causing a convergence of services and products. Striving to achieve economies of scale and seeking to satisfy as many of their clients' needs as possible, the insureers, banks and capital markets are all crossing the boundaries into each other's sphere of operation.

RÉSUMÉ

La pression pour la réalisation de profits dans le secteur des services financiers provoque un phénomène de convergence des services et des produits. Tentant d'obtenir des économies d'échelle et recherchant la satisfaction du plus grand nombre de besoins de leur clientèle, les sociétés d'assurances, les banques et les marchés de capitaux tentent toutes de traverser leurs frontières respectives et de pénétrer les sphères d'activités de chacune.

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On June 15th I delivered a presentation on "Convergence" to the Royal Bank's 24th Annual Financial Management Conference for Insurance Companies. It is summarized in the following paragraphs.

Webster's Dictionary defines this word as "the act of moving toward union" or "the independent development of similar characteristics". The first is more akin to "consolidation", which saw a great surge in the past five years, while the second better describes the focus of this article.

It is not an exaggeration to say that "convergence" is happening everywhere; you cannot read a newspaper or magazine without seeing reference to it as regards one industry or another. Scientists have even convinced themselves (Economist- May 22, 1999) that parallel but independent universes are likely developing alongside our own! Let's stay in our own and concentrate on the world inhabited by banks, insurers, reinsurers, and capital markets. Each has its own different, perspective as to the direction in which "convergence" is taking them, as we shall see. We could also, but won't at this time, examine the perspective of other, inter-connected parties i.e. the accountants, lawyers, actuaries, management consultants, regulators, and, most importantly, the consumer.

■ BANKS

The banks are being called upon to produce increased profits. In the past, this usually meant increasing revenues by lending to worse borrowers. Not surprisingly, this produced unsatisfactory results so the banks worked assiduously at improving their efficiency ratios (cost to revenue), which have dropped from 68% to 57% in the last 15 years. Not much more can be achieved there so the banks are looking for new businesses e.g. insurance, reinsurance, and investment banking. As far as the latter is concerned, a recent observation (Economist- April 17, 1999) was that "...some follow clients into the capital markets i.e. investment banking. Though this is a rock on which many have foundered, numerous are the banks that still set sail." Can the same be said about insurance? The banks have made a tentative foray into Canadian insurance but have been stymied to some extent by the federal government. An advertisement appearing in the summer issue of the Canadian Association of Financial Institutions in Insurance newsletter shows where the banks would like to be ("...the market in Canada remains

underserved by traditional insurance providers... We deserve a system of insurance distribution that is accessible and fair to all.") and how they are lobbying to get there ("low income households and those headed by women are less likely to have access to insurance.").

INSURERS

The insurers are also expected to lower costs and deliver more profit; however competition and the use of technology are forcing some fundamental changes in the business of insurance. The traditional insurers are eyeing the banks, and everyone else encroaching on their terrain, and planning their "defense", which actually resembles more of an attack. In purchasing investment managers and creating other non-insurance centers of expertise, selling mutual funds with built-in dynamic capital hedges, launching lines of credit, and taking down the wall between the Life and P&C sectors, they are broadening and simplifying the interface with their customers. At the same time, the insurers are responding to the increasingly sophisticated needs of their clientele and offering such services as Mergers and Acquisition Services (AIG) or three dimensional survivability modeling (Aon's Impact Forecasting), to name but two. They perceive that the battle will be intense, complicated, and waged with enormous resources. The June 10, 1999 headline in the Globe and Mail (CIBC in talks to sell insurance operations to GM's finance arm) is a perfect example. General Motors Acceptance Corp. (GMAC), the largest commercial lender in the US, has a mandate to grow and has been seeking to broaden its array of financial products and services. Only two days prior, it had announced the purchase of BNY Financial Corp., the Bank of New York's asset based lending unit. Now it was pursuing CIBC, whom it was speculated wanted to get out of underwriting insurance and simply become a distributor. So, we have a bank in insurance potentially allying itself with a non-bank which is already big in lending and insurance and wants to get bigger!

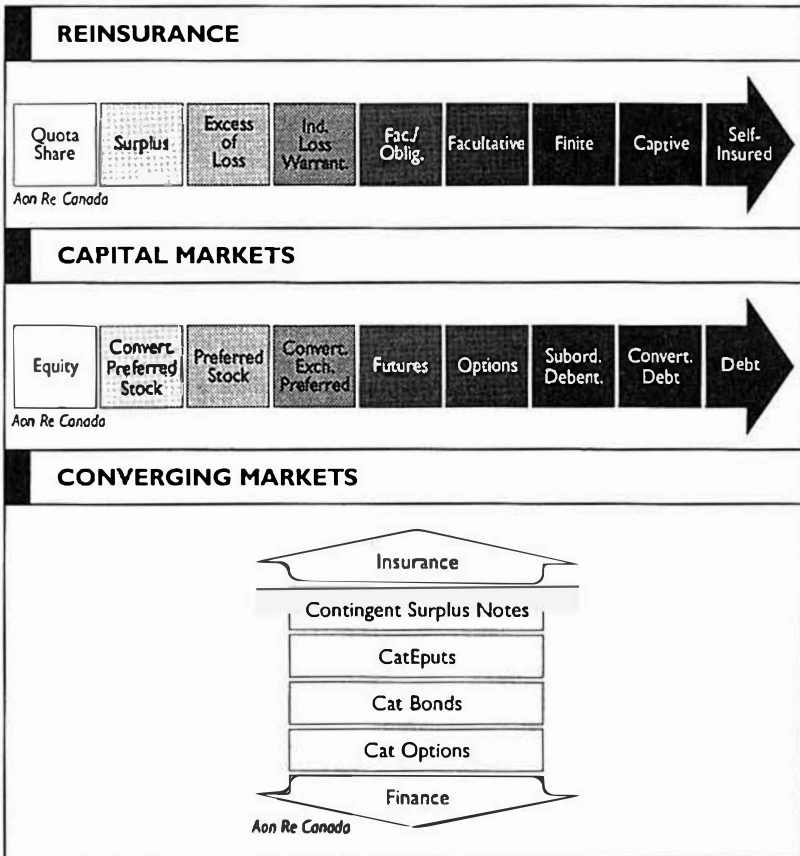
REINSURERS

Yes, profit and revenue growth are very much a concern to the reinsurers. Competition has led to consolidation and the need to offer a much broader product line. The reinsurers have had to follow

their clients (usually the insurers but occasionally the insureds) into sometimes uncharted territory. As the final repository for increasingly large and complex risks, this world has less room for smaller players and a greater need for highly educated (across a broad range of subjects) human resources along with the expensive and often developmental tools for analysis required to map their exposures. As the reinsurance community has come more and more into contact with the capital markets, a new "language" has evolved to enable the two to converge with some semblance of mutual comprehension.

REINSURANCE

The first image shows a spectrum of risk transfer vehicles with some familiar terms from the reinsurance world. The second uses terms that the investment bankers deal in but also describes a



range of risk transfer methods which resemble the reinsurance process in the degree to which the investor takes on risk. The third image shows some of the expressions that straddle the boundary. Reinsurers are taking definite aim at the asset side of the insurers' balance sheet, once the exclusive domain of the capital markets. This is reflected in their advertising, a good example of which is General & Cologne Re's "Working with you to manage your assets, liabilities, risks, and returns". Other reinsurers convey the same message, although perhaps not as succinctly. The brokers have been arguably even more venturesome, as they also have to contend with the spectre of "disintermediation", and their position is aptly described in a May 1999 article in Reactions entitled "Who's Afraid Of The Capital Markets?". This article largely consists of an interview with Kevin Callahan, the head of Aon Capital Markets, who made "a massive personal bet" in leaving Goldman Sachs that insuers/reinsurers could combine their greater appetite for risk with new ways of reducing their clients' cost of capital to meet the challenge of the capital markets.

■ CAPITAL MARKETS

The capital markets are no different than the other protagonists; they have to build revenues in order to increase profits. What is different about them is their size ($20 trillion plus) and their truly voracious appetite for anything new connected to finances. They are always seeking new investment vehicles and the goal to service the liability side of insurers' balance sheets began with the catastrophe futures at the Chicago Board of Trade in 1992, progressed to equity positions in the Bermuda catastrophe reinsurers starting in 1994, underwent a metamorphosis at the Bermuda Commodities Exchange (insurance related derivatives) in 1997, and added a new dimension in 1998 with the creation of Arrow Reinsurance Co. and Lehman Re, wholly owned subsidiaries of Goldman Sachs and Lehman Bros. respectively. These two could now claim to be not only investment bankers but also insurance/ reinsurance underwriters and brokers. Paribas, Citibank, First Boston, Merrill Lynch, and J.P. Morgan are others that have taken on the mantle of insurance/reinsurance intermediary. Catastrophe bonds have thus far provided them with the quickest route to fee generation and, although Canada's catastrophe profile doesn't lend itself to these types of bonds due to their cost and the availability of traditional reinsurance, Canadian investment reporters have monitored their

progress. Investment Executive reported on this concept under an insurance byline in August 1998 while the National Post's March 9, 1999 headline in FP Investing was "A taste for catastrophe" and described the visit by Goldman Sachs representatives to Toronto to sell cat bonds to institutional investors.

The foregoing provides at least four perspectives on "convergence". The impact of "convergence" on the insurance/reinsurance industry is substantial and every key element of the operations of an insurer or reinsurer, namely products, distribution, marketing, client profile, finances, mission/vision, human resources, and regulatory compliance are affected. The remainder of this article will deal with the first item only i.e. products.

■ PRODUCTS

Following are just a few examples of recent developments in the insurance/reinsurance product line that are manifestations of "convergence".

☐ Credit

There are at least two broad categories where some movement is taking place, namely trade finance and credit enhancement. The first is a $125 million market in which the Export Development Corp. has a near monopoly. A January 11, 1999 article in the Financial Post stated that: "EDC claims to be financially self-sustaining and not to cost taxpayers money. But if it couldn't borrow money at preferential rates; if it paid taxes, earned a return for its shareholders, and lived by financial regulations governing the private sector, it would be out of business tomorrow. Over the past eight years, the federal government transferred to EDC nearly $600 million from its consolidated revenue fund to let it quietly write off an equal amount in bad debts from Third World and Eastern European countries." The Insurance Bureau of Canada and certain insurers have set plans in motion to seek a greater privatization of this sector.

Less publicized is the activity related to the credit enhancement required on current Canadian securitizations, which total approximately $45 billion and which are generated primarily by the major Canadian banks. Roughly $2.5 billion of credit enhancement is provided on these securitizations. Until now the credit enhancers have been primarily foreign banks such as Société Générale or

Credit Suisse; however, for a variety of reasons, they are withdrawing this service from Canada. This is an opportunity for insurers and reinsurers to use their AAA security to replace the departing banks on current business and on new asset classes.

☐ Insurance Linked Securities

The press has given wide coverage to cat bonds but it is less widely known that insurance securitizations have been concluded with respect to at least four other categories of risk.

a) In the field of trade credit, Swiss Re New Markets has been active in pooling receivables and selling them to investors.

b) The residual market value of vehicles leased from Toyota Motor was covered in the Grammercy Place transaction.

c) Gerling Credit securitized credit risk using Namur Re.

d) Tokyo Disneyland has obtained both property damage and business interruption protection with the Concentirc/Circle Maihama bonds.

Until recently, all of the insurance securitizations were done using offshore special purpose vehicles. In the U.S., various bodies have said that if securitization is the wave of the future, it should be brought into their jurisdiction on a competitive basis. In November 1998, the Illinois Department of Insurance approved Regulation 27 allowing insurers/reinsurers to form special purpose syndicates at Inex (formerly the Illinois Insurance Exchange) for the purpose of securitizing insurance risk. The first Inex insurance securitization was completed by Aon Capital Markets in April when Kemper issued securities to provide $100 million of Midwest earthquake coverage. Separately, Illinois and Rhode Island have introduced legislation allowing insurers to establish bankruptcy remote protected cell companies that would be used to issue insurance linked notes to the capital markets. Working groups are trying to eliminate legal, tax, and regulatory uncertainty that presently favour offshore setups.

Much thought is also being given to the question as to whether securitizations can be done for traditional P&C, high frequency, low severity exposures.

For comparative purposes, it is useful to look at the mechanics of an asset backed securitization done by a bank on credit card receivables or mortgages. Essentially the bank is achieving a cost efficiency in the range of 100 b.p. by lowering the cost of its debt financing and reducing the cost of allocated equity. Through the

process of securitization and credit enhancement, the bank bundles and converts lower grade debt to AAA, which costs less to finance, and shifts some exposure from cost of equity to the less expensive cost of escrow accounting.

For an insurance company to contemplate something similar, it must look at the only assets on its balance sheet that are not invested i.e. the receivables. On average, these amount to 12% of assets, of which approximately 2/3 rds (8%) consist of balances due from agents, brokers, and policyholders. If a saving of 50 b.p. can be achieved, i.e. an improvement of 4 b.p. on the yield from the total assets, is a securitization worthwhile? It likely is for the larger companies. In fact, the first such transaction by a Canadian insurer was reported in September 1998, with Co-operators securitizing $90 million though the Royal Bank and PURE Trust.

In the realm of theoretical speculation, it has been suggested that the capital markets might create virtual insurers, charging consumers a premium that would cover administration costs and profit only, with the stipulation that any claims would be repaid through increased premiums. The risk of loss would be passed on to investors though securitization, the capital markets would provide short-term cash flow to pay claims, and traditional reinsurance would be purchased for high severity losses. Although this may seem like a novel approach to some, others might say that this is simply a variation on a mutual reciprocal insurer.

☐ Weather

- energy
- agriculture
- manufacturing
- tourism
- recreation
- construction
- clothing
- retail food

In all of these industries, the weather can have a fairly profound and usually predictable impact on earnings. Traditional property insurance can stabilize earnings in certain scenarios but it can't, for instance, help the ski centre whose revenues drop because of lack of snow.

A new range of derivative products is being developed that will change this. Since August 1997, there have been an estimated 2,000 trades related to weather with a notional value of $2.5 billion. These trades have been primarily temperature based (heating/cooling degree-days) and largely confined to the energy utility sector. They have been negotiated on the basis of monthly, seasonal or

multi-year periods and have taken the form of caps (calls), floors (puts), collars (call/put combination), or swaps (an exchange of one outcome for another), with or without premium.

This field is in its infancy but holds enormous potential as a form of earnings insurance. There are 1,200 weather stations across the U.S., 50% of which are automated, so the necessary infrastructure already exists in that country. In fact, the Chicago Mercantile Exchange will be introducing degree-day futures for eight U.S. cities later this year.

Reinsurers are already actively involved in this market outside Canada and have reasonably predicted that Canada's climate has sufficient volatility to justify its presence here.

☐ Earnings

Insurance is only one risk management tool that allows a company to protect its bottom line. To an increasing extent, chief financial officers are being given responsibility for overall corporate risk management. They are an important force behind the movement towards holistic or enterprise risk management, an offshoot of which is earnings insurance. The CFOs are beginning to use sophisticated value-at-risk software to measure the volatility of asset portfolios, which is leading them to explore the viability of measuring and protecting all operational risk. This has given rise to the concept of "insuratization", meaning the bundling of risks that were hitherto hedged in the capital markets (or mitigated in some other fashion than insurance) under an insurance policy.

There are two prominent examples of the foregoing that have made the news recently. Mead Corp, Dayton, has purchased a single insurance policy from AIG that covers P&C, foreign exchange translation, interest rates, and various commodity prices including pulp, old corrugated cardboard, natural gas, fuel oil, and coal. United Grain Growers, Winnipeg, began its process by identifying thirty-two risks outside of customary insurable risks and choosing six (credit, weather, environmental, counterparty exposures, inventory, grain commodities) to add to its P&C insurance. A number of carriers have expressed interest.

☐ Deposits

The Canada Deposit Insurance Corp. (CDIC) insures all deposit taking institutions (except credit unions) for the first $60,000 of an individual's deposits in insured accounts. Credit union deposit insurance is provided by provincial crown corpora-

tions and ranges from $60,000 to $100,000 per account or depositor with RRSPs insured separately. Collectively they represent a large block of insurance premium that has not, until now, been the subject of much scrutiny by private sector insurers and reinsurers.

☐ Mutual Funds

Life insurers have been selling segregated mutual for years. A relatively new development is that the maturity guarantee (principal plus annual management expense ratio) offered by some companies has increased from 75% to 100% and, in at least one case, the qualifying period has dropped from the usual ten years to five years. In addition, OSFI is considering a "marked to market" assessment of the guarantee and possibly an on-balance-sheet recognition of the liability. Life reinsurers have for the most part placed a moratorium on the unrestricted transfer of this exposure to them, so life insurers are considering dynamic capital markets hedges or, as we have suggested placements in the P&C reinsurance marketplace. Once again "convergence" is in full play.

■ CONCLUSION

"Convergence" has many implications that will penetrate every aspect of the insurance and reinsurance industry, as we now know it. No one entity of the converging services providers will dominate or be replaced by the others; however, no one will be unaffected!