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INSURANCE AND THE ECONOMIC CRISIS

Rama Warrier & Arun Kumar V

An analysis of the Impact of the crisis, Lessons Learnt from it, and the Change Initiatives emerging…

Abstract

The year 2008 witnessed the beginning of one of the worst recessions since the Great Depression. Credit crunch, low yield on government securities, low working capital, fall in equity price, and stricter lending terms ensued. The ripples spread to the emerging markets that were insulated from the misfortunes of the US and the advanced European markets. The recession resulted in unprecedented write-downs by banks and other financial institutions of a staggering amount of over $4 trillion. The life insurance

industry was affected in two primary ways – loss of premium income as a result of reduced customer spending in general, and the falling out of favour of unit-linked policies owing to the equity market collapse. Global non-life insurance premium fell by only 0.8% largely due to the remarkable growth of 7.1% registered by emerging markets. The reinsurance industry managed to honour its obligations while continuing to provide services at an expected level, which was highly commendable given the magnitude of the crisis. Customers and intermediaries felt the tremors of the crisis too. Regulators and the governments of various countries were in a quandary. The recession instigated knee-jerk reactions from both these parties. While insurance customers were insulated from any breach of contractual obligations by the insurers, the crisis brought out some aspects of the insurance market mechanism that needed immediate focus to ensure continuity of growth in the face of a similar or bigger crisis in the future. It also forced the insurers to look at innovation as an important tool for business sustenance.

1. Objectives, Methodology, and Findings

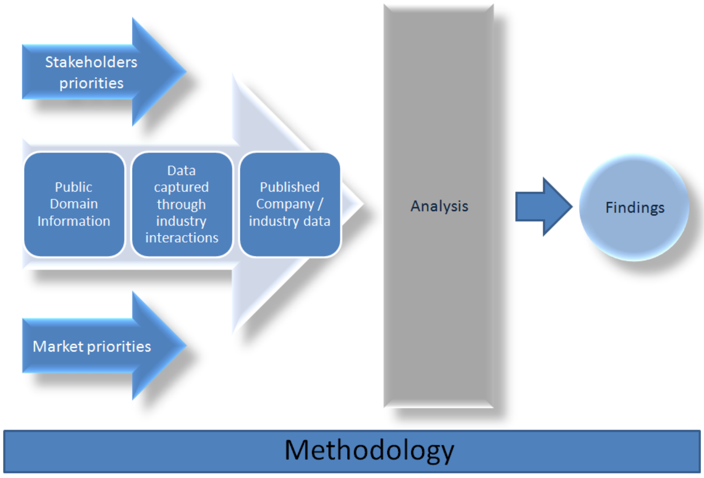
1.1. Objectives

The recent recession was a historic event and such occurrences throw open an opportunity to research students to analyse the turn of events to understand the industry in more detail and to anticipate potential behaviour in unexpected circumstances. The key objectives of this study are to:

- Understand the root causes of the recession
- Track its impact on the insurance industry
- Investigate how the industry responded to the crisis
- Analyse the events from the perspective of different stakeholders
- Understand the behavioural changes that happened
- Bring out possible change initiatives that could be considered to weather such events in future
- Ensure that recommendations are practical and can be considered for actual implementation

1.2. Methodology

Data collection: The base data required for this research have been collected from publically available sources as well as from an assimilation of various industry interactions. Further validation of data has not been done since the sources are recognized and well acknowledged.



Analysis: Brainstorming sessions for data analysis was used to identify the underlying patterns and to understand the nuances of behavioural changes in the key stakeholders.

Conclusion: The inferences and results of the analysis were viewed in the light of ground realities of the industry to arrive at a few possible options that would help equip the industry better to successfully tackle similar economic situations in the future.

1.3. Findings

The key findings of the study include the following:

- The observation that insurance industry put up a more resilient response than the other arms of the financial services industry
- Different stakeholders – insurers, reinsurers, intermediaries, customers, regulators, governments – have differing perspectives and expectations following the recession
- There are several steps that regulators, government, and industry bodies could take to counter similar difficulties in future
- Insurance companies may need to review their product offerings, distribution channels, and the other touch points with customers

Our findings are presented in the following sections, structured in this way: we first present a brief history of recession followed by an introduction of the economic crisis under study. Then we go on to examine the impact of the crisis on the financial services industry in general, followed by the impact on the three key insurance industry segments – Life, Non-Life, and Reinsurance. We then present a study of the perspectives of the other key insurance stakeholders namely the customer, the intermediary, the regulator, and the government. In our final section, we present our ideas and recommendations that we believe are practical and implementable solutions relating to insurance structure, and business strategies.

2. Introduction

2.1. Past economic downturns

History has witnessed many recessions. While some had lasted as less as six months, some had grown in magnitude to qualify for 'depressions'. The longest known depression had lasted for over four years. Prior to the latter half of the twentieth century most recessions had either preceded or succeeded a war. Most of these events had inevitably involved activities related to Great Britain or the United States or both. The other important elements leading to recession were predominantly factors affecting agriculture, like weather and natural catastrophes. It was only later that banking crises assumed greater prominence in that they featured at the very core of an economic crisis. While most countries have experienced economic crisis of varying magnitude, only those that affected the US, UK, Russia, France, Italy, Japan, and to an extent some Middle Eastern economies are well documented.

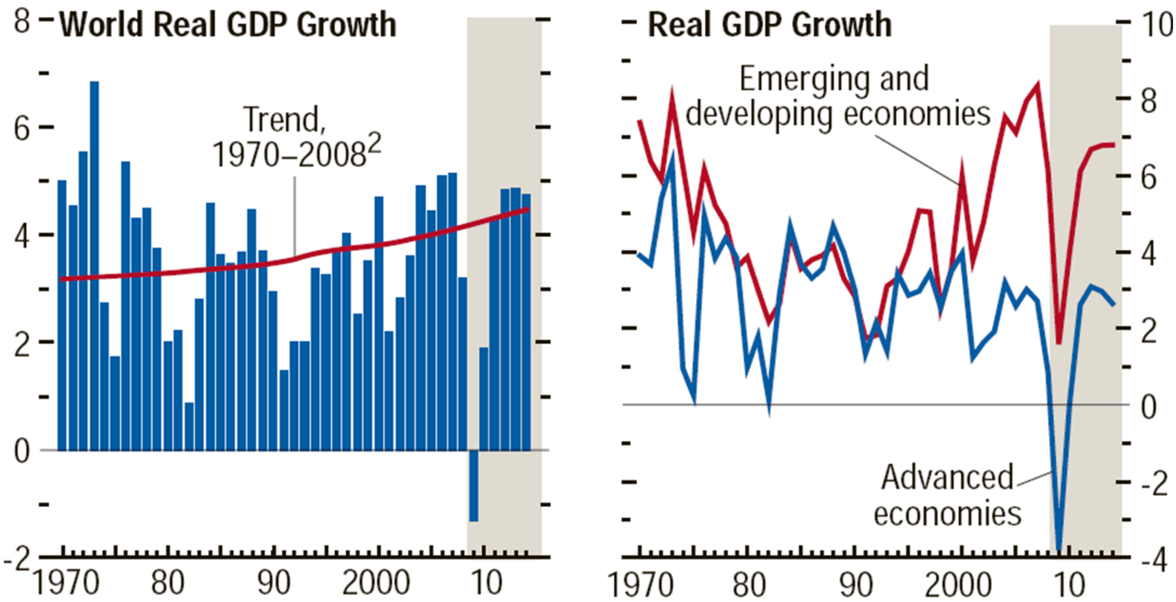
2.2. The 2008 recession

The year 2008 witnessed the beginning of one of the worst recessions since the Great Depression. While the 'Black Tuesday' event – the crash of the New York Stock Market in 1929 – is largely believed to have been the primary reason for the crisis that had lasted for over 4 years, the first hint of the recent crisis was felt in the latter half of 2007 during the outbreak of the US subprime crisis. Important events preceding the subprime crisis were high inflation, stock market excesses, real estate boom, and an unprecedented rise in oil prices. The US subprime crisis resulted in large corrections in the housing market leading to many banks writing down billions of dollars in holdings. This write-down had a cascading effect on the banking industry outside the US pushing up credit costs worldwide. Poor credit conditions, increasing concerns and distrust about the financial credibility of banks and other financial institutions were ominous signs of a financial catastrophe in the making. In less than a year's time, there were a series of dramatic upheavals led by the collapse of a large US investment bank, and the fall of the largest US insurance company that prompted federal intervention. Europe witnessed similar events signaling the onset of the economic crisis. Credit crunch, low yield on government securities, low working capital, fall in equity price, and stricter lending terms ensued. The recession spread to the emerging economies that were until then insulated from the misfortunes of the US and the European markets. The revelry of the emerging markets that were seeing healthy balance sheets across industries was brought to an abrupt halt following the global financial turmoil.

Mass layoffs, credit defaults, nationalization of financial institutions, bailouts, increased regulatory activity especially in the area of capital adequacy and liquidity, increased emphasis on corporate governance, reduced customer spending, reduced corporate spending on non-core functions, and most importantly low global morale were some of the consequences. Most economies woke up to the inherent vulnerabilities that were until then shielded by the euphoria triggered by unrealistic stock market indices. Risk management assumed greater prominence in the wake of the inadequacies brought to the fore by the global meltdown.

The world real GDP growth was down 1.3% [1] in 2008-09 (refer Exhibit 1), the worst in a long time. Whereas emerging markets displayed great resilience in the face of the crisis with a respectable growth margin.

EXHIBIT 1



Source: IMF

Table 1 shows the change in real GDP, consumer prices, and unemployment numbers of the advanced economies. It can be seen that the recession made a deep impact on the economic growth, and that recovery is expected to be at a gradual pace.

Table 1: Real GDP, Consumer Prices, and Unemployment
(Annual percent change and percent of labour force)

	Real GDP				Consumer Prices				Unemployment			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Advanced economies	**2.7**	**0.6**	**–3.4**	**1.3**	**2.2**	**3.4**	**0.1**	**1.1**	**5.4**	**5.8**	**8.2**	**9.3**
United States	2.1	0.4	–2.7	1.5	2.9	3.8	–0.4	1.7	4.6	5.8	9.3	10.1
Euro area[1]	2.7	0.7	–4.2	0.3	2.1	3.3	0.3	0.8	7.5	7.6	9.9	11.7
Germany	2.5	1.2	–5.3	0.3	2.3	2.8	0.1	0.2	8.4	7.4	8.0	10.7
France	2.3	0.3	–2.4	0.9	1.6	3.2	0.3	1.1	8.3	7.9	9.5	10.3
Italy	1.6	–1.0	–5.1	0.2	2.0	3.5	0.7	0.9	6.1	6.8	9.1	10.5
Spain	3.6	0.9	–3.8	–0.7	2.8	4.1	–0.3	0.9	8.3	11.3	18.2	20.2
Netherlands	3.6	2.0	–4.2	0.7	1.6	2.2	0.9	1.0	3.2	2.8	3.8	6.6
Belgium	2.6	1.0	–3.2	0.0	1.8	4.5	0.2	1.0	7.5	7.0	8.7	9.9
Greece	4.0	2.9	–0.8	–0.1	3.0	4.2	1.1	1.7	8.3	7.6	9.5	10.5
Austria	3.5	2.0	–3.8	0.3	2.2	3.2	0.5	1.0	4.4	3.9	5.3	6.4
Portugal	1.9	0.0	–3.0	0.4	2.4	2.7	–0.6	1.0	8.0	7.6	9.5	11.0
Finland	4.2	1.0	–6.4	0.9	1.6	3.9	1.0	1.1	6.8	6.4	8.7	9.8
Ireland	6.0	–3.0	–7.5	–2.5	2.9	3.1	–1.6	–0.3	4.5	6.1	12.0	15.5
Slovak Republic	10.4	6.4	–4.7	3.7	2.7	4.6	1.5	2.3	11.0	9.6	10.8	10.3
Slovenia	6.8	3.5	–4.7	0.6	3.6	5.7	0.5	1.5	4.9	4.4	6.2	6.1
Luxembourg	5.2	0.7	–4.8	–0.2	2.3	3.4	0.2	1.8	4.4	4.4	6.8	6.0
Cyprus	4.4	3.6	–0.5	0.8	2.2	4.4	0.4	1.2	3.9	3.7	5.6	5.9
Malta	3.7	2.1	–2.1	0.5	0.7	4.7	2.1	1.9	6.4	5.8	7.3	7.6
Japan	2.3	–0.7	–5.4	1.7	0.0	1.4	–1.1	–0.8	3.8	4.0	5.4	6.1
United Kingdom[1]	2.6	0.7	–4.4	0.9	2.3	3.6	1.9	1.5	5.4	5.5	7.6	9.3
Canada	2.5	0.4	–2.5	2.1	2.1	2.4	0.1	1.3	6.0	6.2	8.3	8.6
Korea	5.1	2.2	–1.0	3.6	2.5	4.7	2.6	2.5	3.3	3.2	3.8	3.6
Australia	4.0	2.4	0.7	2.0	2.3	4.4	1.6	1.5	4.4	4.2	6.0	7.0
Taiwan Province of China	5.7	0.1	–4.1	3.7	1.8	3.5	–0.5	1.5	3.9	4.1	6.1	5.9
Sweden	2.6	–0.2	–4.8	1.2	1.7	3.3	2.2	2.4	6.1	6.2	8.5	8.2
Switzerland	3.6	1.8	–2.0	0.5	0.7	2.4	–0.4	0.5	2.5	2.7	3.5	4.5
Hong Kong SAR	6.4	2.4	–3.6	3.5	2.0	4.3	–1.0	0.5	4.0	3.5	6.0	6.5
Czech Republic	6.1	2.7	–4.3	1.3	2.9	6.3	1.0	1.1	5.3	4.4	7.9	9.8
Norway	3.1	2.1	–1.9	1.3	0.7	3.8	2.3	1.8	2.5	2.6	3.3	3.8
Singapore	7.8	1.1	–3.3	4.1	2.1	6.5	–0.2	1.6	2.1	2.2	3.6	3.7
Denmark	1.6	–1.2	–2.4	0.9	1.7	3.4	1.7	2.0	2.7	1.7	3.5	4.2
Israel	5.2	4.0	–0.1	2.4	0.5	4.6	3.6	2.0	7.3	6.2	8.2	8.6
New Zealand	3.2	0.2	–2.2	2.2	2.4	4.0	1.5	1.0	3.7	4.2	5.9	7.9
Iceland	5.6	1.3	–8.5	–2.0	5.0	12.4	11.7	4.4	1.0	1.6	8.6	10.5
Memorandum												
Major advanced economies	2.2	0.3	–3.6	1.3	2.1	3.2	–0.1	1.1	5.5	5.9	8.2	9.4
Newly industrialized Asian economies	5.7	1.5	–2.4	3.6	2.2	4.5	1.0	1.9	3.4	3.4	4.5	4.4

[1]Based on Eurostat's harmonized index of consumer prices.

Source: IMF

3. Impact on Financial Services

The economic crisis of 2008 resulted in unprecedented write-downs by banks and other financial institutions of a staggering amount of over $4 trillion [2], according to IMF.

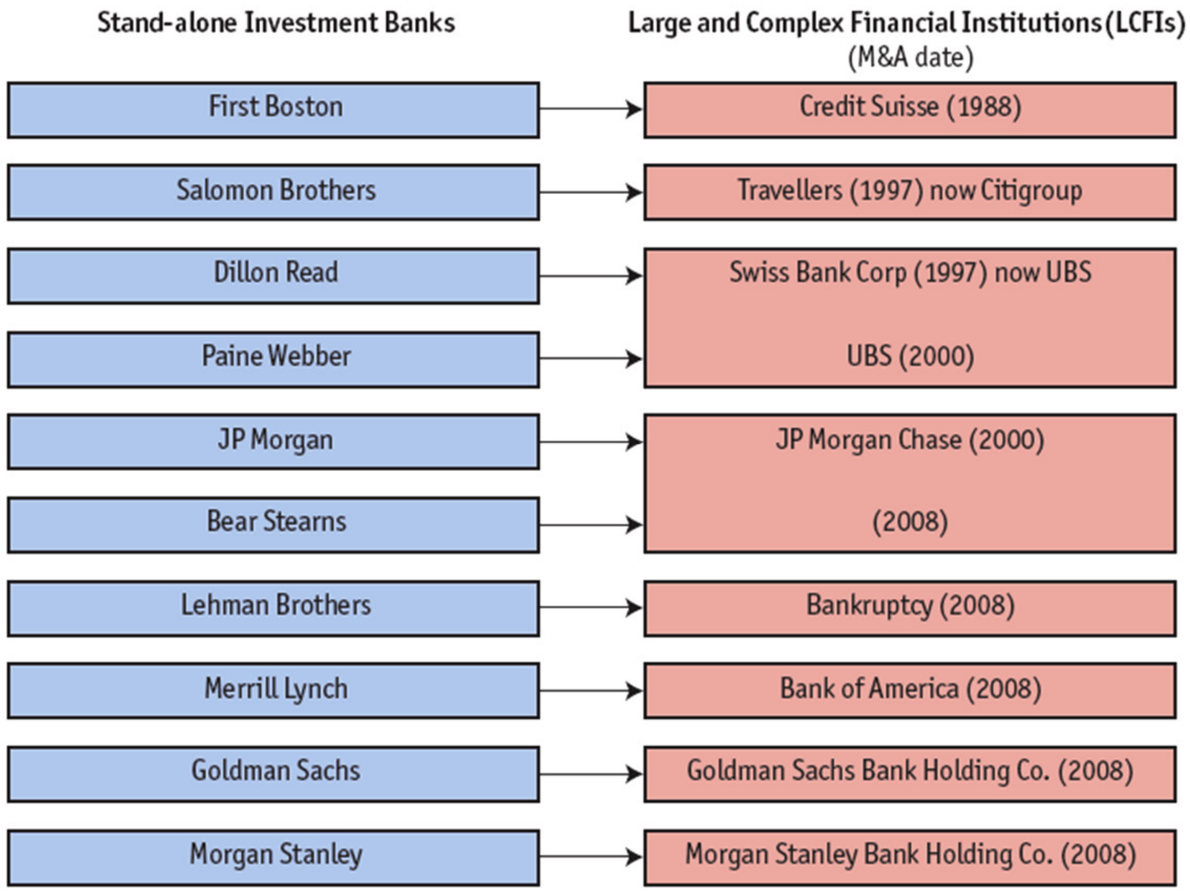
In 2009, over 140 banks had failed whereas in the 5 years preceding 2008, only 11 banks had failed…

The banking industry in advanced economies led by the United States bore the maximum brunt of the crisis. The US financial system witnessed its worst period in history with several banks filing for bankruptcy. According to Federal Deposit Insurance Company (FDIC) over 25 banks had failed in 2008. In 2009, over 140 banks had failed whereas in the 5 years preceding 2008, only 11 banks had failed [3]. Some of the largest banks in the country were forced to write-down loans to the tune of more than $1 trillion, while the combined capital injection for banks and other financial services institutions in the US totaled only just over $700 billion (IMF) [4].

In addition to banks, the Financial Risk Outlook 2009 report published by the Financial Services Authority (FSA) states that large stand-alone investment banks based in the US collapsed in the wake of the tremendous pressure exerted by the crisis. These institutions were stifled by the unrelenting market forces that deprived them of the luxury of an escape route – first, the risks that they had assumed rose drastically, then their attempts at getting rid of these risks by selling off portfolios proved futile, and then there was the issue with access to secured borrowing since these banks did not have the benefit of direct access to central bank liquidity facilities.

Exhibit 2 shows a list of some of the biggest stand-alone investment banks that were taken over by other Large Complex Financial Institutions (LCFIs) [7].

EXHIBIT 2

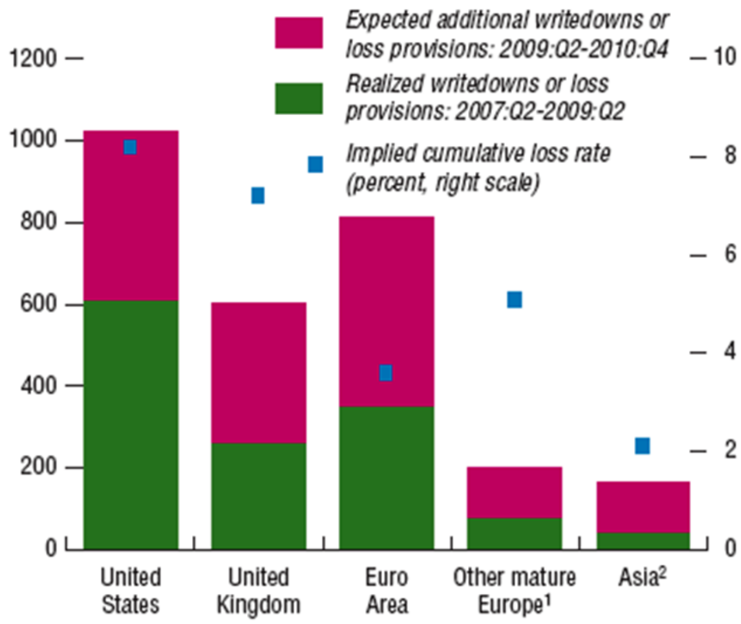


Source: FSA

The financial system in Europe suffered mainly due to their close linkage with the toxic assets of US banks. As a result these banks suffered from erosion of capital and profit accumulated over a period of time due to large write-downs on loans. The total write-downs by the financial institutions in the European markets, both the advanced and emerging markets, are expected to touch $US1 trillion [5].

In the UK, over a dozen banks were taken over by other banks. Her Majesty's Government also initiated a scheme to acquire stakes in three of the largest banks in UK. The total write-downs by the UK financial institutions are expected to touch $US600 billion [6] (*refer Exhibit 3*). In addition to the global crisis originating from the collapse of mortgage bonds in the US being the primary trigger, UK also suffered extensively as a result of the infamous Icelandic Banking Crisis. According to information available in public domain, close to GBP 840 million from over a hundred UK authorities [8] were invested in the three large Icelandic banks that collapsed.

EXHIBIT 3
Realised and Expected Writedowns or Loss Provisions for Banks by Region
(in billions of USD unless otherwise shown)



Source: IMF staff estimates.
[1]Includes Denmark, Iceland, Norway, Sweden, and Switzerland.
[2]Includes Australia, Hong Kong SAR, Japan, New Zealand, and Singapore.

The emerging markets felt the ripples of the crisis in installments. First there was tightening of financing conditions following loss of confidence. Then the markets experienced steep currency depreciations. The authorities responded with rate cuts and capital injections to salvage the situation at the onset of the crisis fearing that it may evolve into something too large to contend with. Some emerging market economies (EMEs) saw large financial stimulus packages being doled out. The financial systems recovered sooner than feared, exchange rates stabilized, and were concomitant with the recovery of the equity markets.

4. Impact on Insurance Industry

From an insurer's perspective, but for the bitter prospect of capital erosion accompanied by breach of customer's trust, the financial crisis played out just like a soft market cycle except that it wasn't one. This was more so when the insurer in question was a non-life insurer, and one that did not have toxic asset exposures. Refer Table 2 that lists the premium volume and growth by region. Markets with high exposure to toxic assets in most of the advanced economies registered significant drop in numbers.

While keeping a healthy solvency margin was of paramount concern, the crisis forced the insurers to take a closer look at their investment portfolio and product portfolio and ensure that there was no risk to either their own accumulated profits or to their commitment to customers. Ensuring compliance with applicable regulatory framework was another important aspect that insurers focused on.

From a strategy perspective, cutting down on operational cost, optimization of resources, and innovative business strategies were the need of the hour. While cost rationalization was important, insurers had to tread that fine line between blocking all possible cost leakage routes and making wise technology investments. Life insurers had to alter their revenue target to reflect the revised product mix, which laid more emphasis on traditional pure risk insurance coverage as against the more aggressively sold, but by-then-infamous, unit-linked products.

The crisis presented an opportunity to insurers to implement underwriting controls to ensure that high instances of insurance fraud were countered. Though the recession reduced the disposable income of customers preventing them from setting aside enough for their insurance needs, it also resulted in an increase in the number of insurance proposal submissions with irregularities. In addition to increased scrutiny in screening proposals, insurers had to exercise tight controls in claims processing.

Insurers also had the opportunity to capitalize on some specific needs of customers brought out by the crisis. Policies offering specialized coverage like protecting the receivables, protecting the balance sheet, protecting the directors and officers of a corporation from the negative fallouts of critical decisions, etc. were gaining in popularity. This did pose a question on capacity availability, and potential higher treaty renewal costs. The high claims resulting from products like D&O, and E&O is likely to make things difficult for the insurers in getting capacity at the desired price in the coming years. The claims anticipated from these policies sold during the downturn are likely to run into the billions, and continue to be reported in the coming few years.

Table 2
Total insurance growth, penetration and density by region

	Premiums (in USDmn) 2008	Real growth 2008	Share of world market (in %) 2008	Premiums in % of GDP 2008	Premiums per capita (in USD) 2008
America	1,450,749	-2.4	33.98	7.29	1,552.7
North America	1,345,816	-3.1	31.52	8.54	3,988.8
Latin America and Caribbean	104,933	8.4	2.46	2.53	175.8
Europe	1,753,200	-6.2	41.06	7.46	2,043.9
Western Europe	1,656,281	-6.9	38.79	8.33	3,209.2
Central and Eastern Europe	96,919	9.0	2.27	2.79	299.2
Asia	933,358	6.6	21.86	5.95	234.3
Japan and newly industrialised Asian economies	675,109	3.8	15.81	10.41	3,173.2
South and East Asia	229,036	16.3	5.36	3.20	65.5
Middle East and Central Asia	29,213	4.7	0.68	1.45	110.3
Oceania	77,716	8.6	1.82	7.02	2,271.9
Africa	54,713	4.9	1.28	3.57	55.6
World	**4,269,737**	**-2.0**	**100.00**	**7.07**	**633.9**
Industrialised countries	3,756,939	-3.4	87.99	8.81	3,655.4
Emerging markets	512,799	11.1	12.01	2.72	89.4
OECD	3,696,073	-3.2	86.56	8.32	3,015.2
G7	2,925,946	-4.4	68.53	8.96	3,930.2
EU, 27 countries	1,616,461	-6.7	37.86	8.28	3,061.3
NAFTA	1,364,839	-3.0	31.97	8.10	3,065.7
ASEAN	45,493	0.4	1.07	2.99	85.1

Source: Swiss Re, Economic Research & Consulting, sigma No. 3/2008

4.1. Life Insurance

The crisis affected the life insurance industry in two primary ways – loss of premium income as a result of reduced customer spending, and the falling out of favor of unit-linked insurance policies owing to the equity market collapse.

The former can be attributed to two factors. One is the financial strain affecting individuals and corporates alike, not to mention the widespread low morale typical of a recessionary atmosphere. The life insurance industry suffered directly as a result of both low individual spending, and reduced corporate spending on employee benefits. The second factor is the reduced scope for purchasing life insurance products by individuals to fulfill contractual obligations. Real estate slump, credit crunch, and other related causes had a direct bearing on not creating enough obligations on the individual for buying life insurance.

….the emerging markets seemed to be more or less oblivious to the happenings in the advanced economies by registering a growth of around 14.6 % compared to the previous year…

The US market, and the advanced European markets suffered revenue losses as a result of the failure of unit-linked policies. The drop in premium in the advanced economies is estimated at 5.3% which corresponds to a premium figure of over $2219 billion [9], mostly attributable to the equity linked products offered by life insurance companies. The steady performance, if not a significant growth in premium, of the other conventional life insurance products ensured that the impact of the fall was not destabilizing. Whereas, the emerging markets seemed to be more or less oblivious to the happenings in the advanced economies by registering a growth of around 14.6% [10] compared to the previous year.

Table 3 represents the growth in life insurance premium revenue across different geographies. The emerging economies have registered a remarkable growth in premium income nullifying the big dents made by the crisis in the revenues of advanced economies. This had ensured that the global drop in life insurance premium was limited to a respectable 3.5% given the magnitude of the crisis [11].

Table 3
Life insurance growth, penetration and density by region

	Premiums (in USDmn) 2008	Real growth 2008	Share of world market (in %) 2008	Premiums in % of GDP 2008	Premiums per capita (in USD) 2008
America	666,954	-2.8	26.78	3.35	713.8
North America	626,066	-3.4	25.14	3.97	1,855.6
Latin America and Caribbean	40,889	7.0	1.64	0.99	68.5
Europe	1,050,815	-11.1	42.19	4.54	1,244.1
Western Europe	1,025,260	-11.6	41.17	5.25	2,022.4
Central and Eastern Europe	25,554	18.7	1.03	0.74	78.9
Asia	690,951	8.2	27.74	4.42	173.9
Japan and newly industrialised Asian economies	519,046	5.2	20.84	8.03	2,447.8
South and East Asia	164,228	19.0	6.59	2.29	47.0
Middle East and Central Asia	7,677	9.3	0.31	0.38	29.0
Oceania	43,835	17.6	1.76	3.96	1,281.5
Africa	37,866	5.5	1.52	2.47	38.4
World	2,490,421	-3.5	100.00	4.13	369.7
Industrialised countries	2,218,523	-5.3	89.08	5.24	2,174.4
Emerging markets	271,898	14.6	10.92	1.44	47.4
OECD	2,147,210	-5.1	86.22	4.87	1,764.4
G7	1,710,983	-5.7	68.70	5.31	2,327.7
EU, 27 countries	998,452	-11.4	40.09	5.21	1,926.8
NAFTA	634,394	-3.3	25.47	3.76	1,425.0
ASEAN	29,329	-0.4	1.18	2.03	57.7

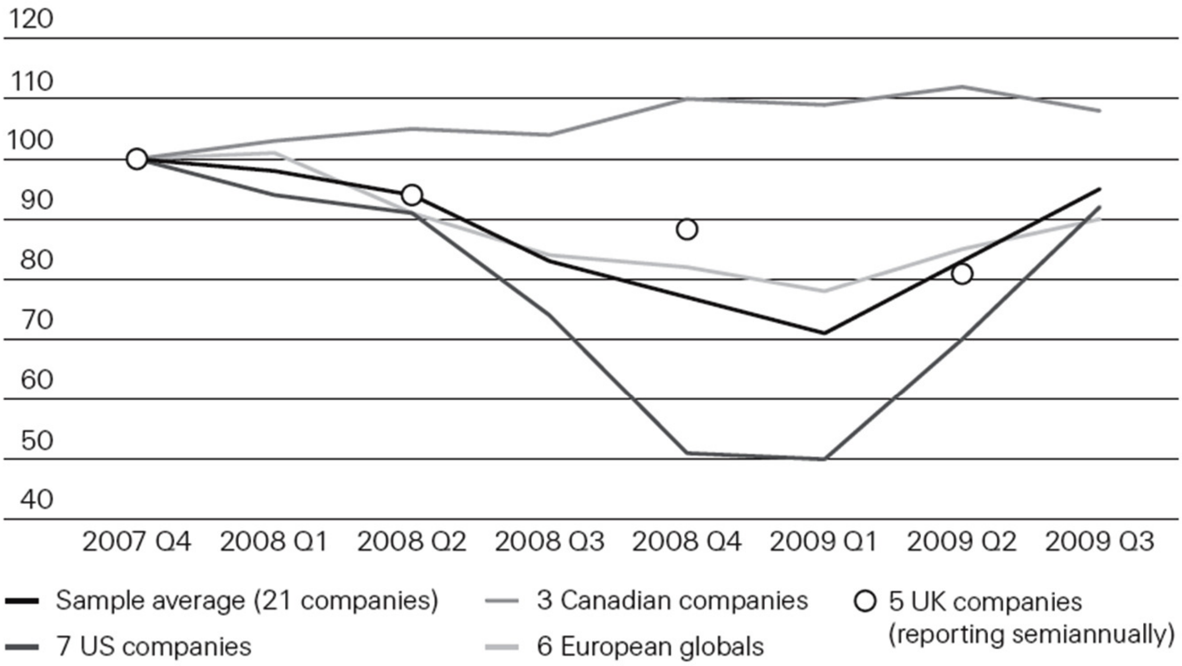
Source: Swiss Re, Economic Research & Consulting, sigma No. 3/2008

The crisis was indiscriminate in the way it affected assets and bonds irrespective of how they were rated and backed. This was an important factor that directly affected the profitability of life insurance companies due to low returns on investment.

The other critical consequence of the turmoil was the drop in shareholder capital on an average of around 30-40%, with some companies reported to have suffered a drop of nearly 70% [12]. This reinforces the fact that life insurance companies assume risks beyond the ones that relate to underwriting lives. Asset risks henceforth will assume a greater role as a critical constituent of a life insurer's risk profile.

In addition to these, the life insurance industry suffered losses as a result of dwindling intermediary strength. Insurance fraud by both customers and agents – the former by initiating

EXHIBIT 4



Sample: Allianz, AXA, Aviva, CNP, Friends Provident (PLC), Generali, Genworth Financial, Great-West Lifeco, Legal & General, Lincoln National, Manulife, Metlife Group, Old Mutual, Phoenix Companies, Principal Financial Group, Protective Life, Prudential (US), Standard Life, STOREBRAND ASA, Sun Life, Zurich

Source: Company reports, Bloomberg/Swiss Re Economic Research & Consulting

fraud claims, and the latter by concealment, misrepresentation, misleading the customer in the process of selling – was another major concern. While new business was on the decline, retaining existing customers was no pushover either. Rationalization of operations costs ensured that no new initiatives could be taken to improve the way in which business was conducted. Freeze on budgets for information technology related enhancements ensured that companies could not achieve any remarkable turnaround in their operational efficiency.

4.2. <u>P&C Insurance</u>

Compared to their Life Insurance counterparts, P&C insurers have sailed through the economic turmoil with relatively less damage. The downturn has not effected that big a dent in the coffers of P&C insurers as it has the players in other financial domains, primarily because of the lower asset leverage of P&C insurers. While there were widespread speculations about loss of premium as a result of reduced customer spending, premium leakage because of morale hazards like arson and other insurance frauds, the extent to which it affected the profitability of insurers is debatable. While on the other hand, it is a fact that the recession forced the insurers to center greater attention on preserving their capital, which meant more underwriting controls. Also, while it is only natural that a crisis of this scale will affect the top line of any insurer, a counter argument can be presented in terms of the potential increase in revenue because of the demand for specialty lines insurance products. It is possible that this demand for products like Trade Credit, Fiduciary Liability, and other liability policies may have helped offset any reduction in premium of the conventional products. Other similar arguments reinforcing the two-sides-of-the-same-coin nature of recessions are the saving in cost of worker compensation claims because of less number of workers due to downsizing, as against the increase in the number of employment practices claims because of wrongful termination; savings in cost due to operations rationalization, as against increase in pollution or product liability claims due to the use of substandard raw materials; savings in risk management cost, as against an increase in loss frequency or severity and so on.

Global non-life insurance premium fell by only 0.8% largely due to the remarkable growth of 7.1% registered by the emerging markets. Industrialized economies experienced a drop of 1.9%[13] (refer Table 4). In spite of natural catastrophes resulting in substantial claims volumes, underwriting results remained overall positive. Due to the claims from property losses, as well as liability losses reported and anticipated in the casualty lines of business, some markets witnessed rate increases.

In spite of its overall good health, the P&C industry did not manage to escape unscathed. The first casualty of a crisis of this magnitude is world trade. Almost all sectors of world trade were hit hard by the downturn and the line of insurance business directly affected was Ocean Marine Insurance. According to Conning, the international trade volume fell by nearly 9% during the recession. In US alone, ocean marine written premiums were down by a significant 5% [14].

While premium revenues have not stopped flowing, the number and magnitude of claims that have been reported or that are in the making are not far behind either. Claims from E&O and D&O policies are expected to exceed USD8 billion [15] in the coming years. In addition to eating into the reserves of the insurers, it is also likely to end up increasing the reinsurance rates in the years to follow.

Table 4
Non-life insurance growth, penetration and density by region

	Premiums (in USDmn) 2008	Real growth 2008	Share of world market (in %) 2008	Premiums in % of GDP 2008	Premiums per capita (in USD) 2008
America	783,795	-2.0	44.05	3.94	838.9
North America	719,751	-2.8	40.45	4.57	2,133.2
Latin America and Caribbean	64,044	9.5	3.60	1.55	107.3
Europe	702,386	-0.5	39.48	2.92	799.8
Western Europe	631,021	-1.1	35.46	3.08	1,186.8
Central and Eastern Europe	71,365	5.7	4.01	2.06	220.3
Asia	242,407	2.3	13.62	1.53	60.4
Japan and newly industrialised Asian economies	156,063	-0.4	8.77	2.38	725.4
South and East Asia	64,808	9.5	3.64	0.90	18.5
Middle East and Central Asia	21,536	3.1	1.21	1.07	81.3
Oceania	33,881	-1.0	1.90	3.06	990.5
Africa	16,847	3.0	0.95	1.10	17.1
World	**1,779,316**	**-0.8**	**100.00**	**2.95**	**264.2**
Industrialised countries	1,538,416	-1.9	86.46	3.57	1,481.0
Emerging markets	240,901	7.1	13.54	1.28	42.0
OECD	1,548,862	-1.8	87.05	3.45	1,250.8
G7	1,214,963	-2.5	68.28	3.65	1,602.6
EU, 27 countries	618,009	-1.0	34.73	3.07	1,134.5
NAFTA	730,445	-2.7	41.05	4.33	1,640.7
ASEAN	16,164	1.9	0.91	0.96	27.4

Source: Swiss Re, Economic Research & Consulting, sigma No. 3/2008

4.3. Reinsurance

Reinsurance is a low margin business and its susceptibility, hence, is much higher than direct insurance. When the global crisis was slowly unfolding, the biggest worry which the insurance industry had was about the possible shrinkage of capacity in the reinsurance market and a steep increase in the rates. Any observer would have to admit that the reinsurance industry performed much better than what was anticipated. This is a tremendous achievement looking at the pace at which about one fifth of their asset value vanished.

The worst possible scenario that could have occurred was a high natural catastrophe year during the recession. Nature, fortunately, was sympathetic and natural catastrophe events did not aggravate the crisis.

The capital market crisis had a heavy impact on several reinsurers. Swiss Re, the largest global player in the field of reinsurance, was severely affected. Other reinsurers, big and small, had varying degrees of impact. The key point, however, is the resilience which the industry displayed during probably the worst phase of the meltdown.

The rates of Property & Casualty markets are yet to move to acceptable levels. The crisis certainly helped in arresting the deterioration of the rate. With the financial market completely letting them down, the reinsurers had to take a hard look at the pricing of their products. The direct insurers, also under pressure from their customers, had to do the balancing-act of matching the customer, and the reinsurer expectations on pricing. One could observe that contrary to the anticipation of rates hardening quite fast, the reinsurers and direct insurers have managed to strike a level of rates agreeable to both. This is still perceived low by most industry analysts, from a long term perspective.

The market collapse impacted reinsurers in multiple ways. The more obvious one is the value erosion of assets and consequential capacity and other impacts. The less observed impact is the one on product offering. Reinsurance companies have increasingly looked at products which are built on the capital market mechanism – like catastrophe bonds. The recession severely crippled the ability of reinsurers to look at these possible product offerings to supplement the traditional reinsurance products.

The recovery sign shown by the markets towards the end of 2009 have raised the hopes of more stability for reinsurance companies. The rallying markets are expected to help the companies recover some of the lost value. At the same time it would also alleviate the concerns about capital inflow and writing capacity. When the markets improve further, reinsurers could think of securitization of risks once again.

Overall, the reinsurance industry has managed to honour its obligations to their business partners while continuing to provide the services at an expected level, during one of the most difficult times in recent years. If the recovery process goes on as expected, we will have to give credit to the reinsurance industry for its support to stabilize the finances of insurance providers.

5. Other Key Stakeholders Perspectives – Customer, Intermediary, Regulator, and Government

5.1. Customer

The crisis affected the two customer segments – individual and corporate in different ways. Each segment had its own priorities, concerns, and apprehensions. While insurance decisions for individual customers were driven mostly by their disposable income, corporate customers had to balance their cost-consciousness with judiciousness in risk management. Table 5 summarises the perspectives of the individual and the corporate customer with relation to five fundamental business aspects, i.e., affordability, need, caution, availability, and accessibility.

Table 5

Business Aspect	Individual Customer	Corporate Customer
Affordability	• Low disposable incomes affected affordability • Premium products substituted by cheaper alternative policies. E.g., in the UK, Private Medical Insurance (PMI) was rejected in favour of newer, cheaper, and innovative products like National Friendly's Healthcare Deposit Account that offered monetary incentives for favorable claims.	• Cost rationalization affected affordability • Corporate customers either cut down on employee benefits or got the employees to fund a portion of it
Need	High • Pure risk products like life, health and accident especially for the large number of retrenched employees	High • Specialty Lines products like Trade Credit Insurance • Liability policies like D&O, E&O, Fiduciary, Employment Practices, etc.
	Low • Travel, Motor, etc. • Marine insurance for traders • Insurance purchases to fulfill obligations towards mortgage, credit, etc.	Low • Employee benefits products • Workers Compensation • Ocean marine insurance, since trade was low

Caution	Cautious about investing in unit-linked insurance products that posed an asset risk threat.	Cautious about vulnerability to a wide range of liabilities like class action law suits on directors, wrongful termination lawsuits, pollution liability, fiduciary liability, and other risks like default on credit by customers, etc. As a result, demand for products that cater to the above needs was high.
Availability	Availability, or the lack of it, of some insurance products offering unemployment benefits, was a concern especially in emerging markets.	Availability or adequacy of specialized liability insurance coverage was a concern in the emerging markets.
Accessibility	• Need for better online channels • Distribution value chain still 'personal (and personnel) heavy' • Need for better aggregator services	Corporate customer did not seem to face accessibility issues

5.2. Intermediary

Individual agents in advanced economies saw a drop in insurance activities among their target customer segment due to the overall low sentiments prevailing in the market. The repertoire of products that an individual agent is likely to focus on experienced mixed reception during the downturn. Term life insurance policies continued to be a steady source of revenue whereas auto insurance products saw a significant drop in revenues. This is attributable to two factors – one, automobile purchases were down, and two, the number of individual customers embracing online channels for auto insurance purchase was on the rise, and even more so during times like the downturn when there was acute cost consciousness. An unhealthy outcome of the impact of the crisis was a rise in incidents of insurance fraud committed by agents.

Corporate agents and brokers are not likely to have experienced any remarkable deviation in their sales trend other than the one that mirrored the market trend. The area where well established and large broking firms are expected to have done better than the other intermediaries is in servicing large accounts. The recession reinforced the need for effective risk management in large accounts and enterprising brokers who assumed the role of a risk manager for a part of the risk port folio of their customers saw fruitful relationships being established. Even corporate agencies servicing mid-size accounts realized the need to be involved a lot more closely with their corporate customers than merely facilitating the terms of the insurance contracts.

The general trend seen during the crisis was that customers chose to pursue small claims, which in good times would have been overlooked with the foresight of future benefits. As a result, intermediaries in general are likely to have been kept a lot busier than usual.

In emerging markets which did not see as big an impact on their revenues as their counterparts in the advanced markets, insurance intermediaries did see their business affected because of factors that were in a way amplified by the crisis. Most emerging markets are still in a dynamic state when it comes to regulations and policies affecting the way in which business is carried out. Most of them opened out to foreign investors only recently, some of them are tightly controlled by regulatory bodies, some are experiencing the pandemonium that follows deregulation and drastic policy changes, and so on. The insurance customer's understanding of the role of, and the perceived need for, an insurance intermediary in such geographies is still evolving. Contrary to their economic status, most emerging markets are better equipped when it comes to deployment of technology for retail distribution. Cost consciousness is an important factor regardless of the prevailing state of the economy. Given this scenario, in a country like India which was in the initial stages of regrouping after the general insurance market was 'de-tariffed' in early 2007, the economic crisis only added to the complexities of the business. Brokers saw themselves being sidelined in the insurance distribution value chain. Individual agents suffered as a result of innovative distribution models followed by insurers, most of whom leveraged the resources of their conglomerate partners to the maximum extent.

5.3. Regulator

From a regulator's point of view, the economic crisis was a direct attack on its objectives. Protection of the policyholder's interest, which is the core objective of insurance regulation, was the primary challenge posed by the crisis. With customers of unit-linked insurance policies exposed to asset risks, insurance regulators had a major problem on their hands. To compound matters, large, well established global insurers experiencing declining solvency margins, having huge investments in toxic assets, and having mortgage bonds forming a sizable chunk of their product portfolio ensured that the regulators had a lot to answer for. There were questions being raised on the justification for the confidence placed on credit rating agencies that shifted focus once again towards the efficacy of the regulators.

In a market like the US, the crisis brought to a full circle the hundred and fifty year old debate about whether or not to have a federal regulator for insurance. With each state having its own regulation, and an average mid-size or large insurer having operations in more than one state, it was felt that the crisis brought out the inadequacies inherent in such a system. Questions over the accountability for capital erosion, and the inability to constantly monitor the activities of the interstate operations of large insurers, were some of the immediate concerns.

At the peak of the US sub-prime crisis the regulators' objective and need to address customers' concerns resulted in a massive bailout effort. The attempt at restoring the customer's confidence in the system cost over USD150 billion from public finances [16], accomplished by working in tandem with the federal government.

With the liberalization of economies in most emerging markets leading to the presence of marquee names in insurance across the globe, an event like the financial crisis has established the need for a global regulatory framework. This framework should ideally set standards for various aspects enabling and influencing an insurer's functioning ranging from solvency margins, guidance on investment of assets, reinsurance placements, compliance, and reporting. The International Association of Insurance Supervisors has recently approved the recommendations and plan for a global framework [17] that would provide for the development of approaches to better monitor global insurance group structures, group business mix and intra-group transactions. This would help in identifying risks and establishing safeguards where necessary. The framework will also ensure in setting out quantitative and qualitative requirements, provision of a platform for supervisory cooperation and interaction, and facilitating in wide implementation. In the US, the National Association of Insurance Commissioners (NAIC) proposed a new regulatory framework for reinsurers with a view to eliminate collateral requirements for foreign reinsurers operating in the US.

Regulatory framework for Takaful insurance, solvency ratio revisions in Japan, and other local regulatory bodies taking the initiative in addressing the immediate impacts of the economic crisis notwithstanding, Solvency II is still the buzzword in the world of insurance regulation. With the implementation likely to be completed in 2012, it is expected to make a remarkable change in the way insurers in the European Union function.

In addition to a global regulatory framework for insurers, a framework to regulate the functioning of credit rating agencies was felt to be an imminent need considering the number of highly rated financial institutions that either sparked the downturn or bit the dust in the wake of the crisis. Regulators also felt the need to controlling executive remuneration and incentives. It was felt that the hefty pay packets and bonuses were the driving factors behind the reckless investment initiatives that are the fundamental cause of the crisis.

5.4. Government

Government is the insurer of last resort, but that is not a role which it would love to play frequently. A crisis like the one we recently witnessed would test out the willingness and capability of Governments to play this role. The primary concern of Governments would be to avoid being in a situation where a 'bailout package' is essential to effectively intervene.
The biggest fall out of the financial crisis is the eroding of confidence in the system. Governments would need to closely work with the regulators to ensure that checks & balances and transparency in the system are adequate to maintain the confidence of customers.

Another aspect which the Governments in many countries are actively considering is the introduction of a common or integrated regulator for the financial services industry. FSA functioning in the United Kingdom works on this model. An integrated regulator would be much more effective than independent regulators for each element of the financial services segments, since the business segments are closely inter-connected.

The need to strengthen the arms of the regulator is also another aspect which Governments would be actively considering at the moment to ensure that the system provides adequate flexibility and at the same time the regulator has sufficient strength to pull up erring players.

Government would also be looking forward to more active interaction with industry forums to ensure that the decisions related to financial levers, like interest rate changes, which it made during difficult times, are taken with the buy-in of the industry.

6. Proposed Change in Structure and Adoption of Key Differentiators

While insurance customers were insulated from any negative influences of the market on the obligations owed to them by their insurers, the insurers themselves were at the receiving end of the crisis that checked their revenue growth. It brought out some aspects of the insurance market mechanism that needed immediate focus to ensure continuity of growth in the face of a similar or bigger crisis in the future. It also forced the insurers to look at innovation as an important tool for business sustenance.

Among the several possible measures and change initiatives that can be employed to fortify the insurance mechanism against the vagaries of the environment that they operate in, we propose the following practical and implementable solutions relating to insurance structure, and business strategies.

6.1. <u>An integrated Financial Services Regulator for an Integrated Approach</u>

There could always be multiple opinions about the way and extent to which regulators should take control of the market. If not carefully designed, the approach could quickly deteriorate into a *policing model* or on the other extreme may end up in *laissez faire*. The recent incidents, however, have highlighted the need to have a certain amount of regulatory control to ensure that the interests of all stakeholders, especially the policy holders, are protected. This is critical because the policyholders are usually not given visibility into the operational details and even if they are given that information, an average consumer may not be able to use that intelligently.

The typical approach adopted by markets is to have separate regulators for different arms of the financial services industry – banking, insurance etc. If you take India for example there are separate regulators for each industry: Reserve Bank of India (RBI) for banking, Securities and Exchange Board of India (SEBI) for capital markets, Insurance Regulatory and Development Authority (IRDA) for insurance, and Pension Fund Regulatory and Development Authority (PFRDA) for pensions. Having separate regulators do certainly help in allowing the regulators to concentrate on the individual industry and refine the regulatory framework in a more focused manner. The negative aspect is the lack of *big picture view*. At the same time if we have a single regulator like the FSA of UK care should be taken to see that the flexibility of regulating each industry is not compromised. A way out could be a hybrid model which will work on a federal system. Each regulator could focus on the macro aspects of the industry and would have jurisdiction on that. The central regulator would work on the macro aspects and would monitor the larger industry level elements.

The success of this model of regulation would be determined by:

- The tight integration of the structure determining how the macro-elements are regulated
- The flexibility provided to the individual regulators to manage industry level elements
- Ease of communication / information flow between the different arms
- Ability to act as a single regulator in case of major economic events like recession
- Clarity in the jurisdictions and areas of authority

6.2. <u>Self governance – industry bodies can play a key role</u>

Insurance markets have a large number of bodies working towards overall improvement of the industry. Though there have been discussions on self-governance at various levels, there are very few good examples that one could quote on this. One could criticise with the benefit of hindsight that some of the key causes of recession could have been easily avoided by a little bit of effective self-governance. To cite an example, if there were self-governance guidelines designed by insurance associations, on investment options, the industry would have been impacted to a much lesser extent. On a futuristic note, the industry associations could collaborate across financial services the same way as regulators could.

6.3. <u>Embracing e-Commerce</u>

During tough times when disposable income is limited-to-nonexistent, like in a recessionary economy, retaining existing corporate customers is one of the problems faced by insurers. The bigger challenge however, is in attracting individual customers, and penetrating the market to widen the customer base as well as to understand the dynamics of unexplored, unexploited customer segments. Addressing the change in the customer psyche and tailoring products and distribution approaches accordingly is an important facet of a successful insurer. While market experts have acknowledged cost consciousness among individual customers as an important factor, not much has been done to address it. The government, the insurance regulators, and other stakeholders with a vested interest in the promotion of insurance as the best risk transfer mechanism have a lot to catch up with when compared to their counterparts in the retail industry. While the retail industry is not far from the day when virtually all aspects of the business will be carried out online, insurance still remains a predominantly personal affair. Though the general idea was that insurance, being a non-tangible product, required some tangible element in the distribution value chain, having to linearly grow the size of the distribution force to cater to a larger customer base is not practicable. Customer information security and financial integrity are important tenets of the philosophy of insurance, but so it is in Banking. The insurance stakeholders concerned, especially insurers, regulators, and the government, should consider learning a trick or two from the enormous success of online share trading services, which are also governed by similar operating principles. e-Commerce was the tour de force of the retail industry in the last decade. Many research reports suggest that even during the crisis, online sales of retail and financial services products clocked impressive numbers. Among insurance products sold online, it is only motor insurance policies that seem to have some patronage. It is about time the insurance industry helped its customers embrace its complete service offerings online.

6.4. *e*-Insurance – the next generation insurance

An *e-Insurer* is a zero-paper insurer. *e-Insurance** extends beyond hosting web portals to market insurance products and accept proposal submissions, issue quotes and policy contracts. It is a business philosophy that every insurer aspiring for success in a shrinking world – literally and figuratively – should espouse in their vision and mission statements and promulgate in their day-to-day business affairs. An e-insurance business transaction would be a seamless process involving only two parties – insurer-customer, insurer-intermediary, or intermediary-customer. Since one of these parties is always in the virtual web world, for all practical purposes there is only one participant in an e-insurance business transaction. The only likely instance when a personal element would be introduced in the proceedings is in the event of a claim. e-Insurance activities are not limited to customer interactions alone. It extends to every transaction in each element of the insurance value chain viz. reinsurance placements, accounting, regulatory compliance, etc.

An insurer certified as an *e-insurer* would have certain obligations to fulfill in order to retain its 'e' tag, which would be subject to renewal at regular intervals. The governing body, which can be the regulator, or the government, or an environmental agency for that matter, will certify an insurer on various factors including its carbon foot print. Insurance company rating agencies will incorporate an

** The idea that we are proposing under section 6.4 may as well be called Green Insurance or Paper-less Insurance or by any other name. e-Insurance was the name that best captured the essence of what we wanted to convey. To the best of our knowledge, and based on the resources at our disposal, we can confidently say that this idea has no similarities whatsoever with any description of the term 'e-Insurance' available in the public domain.*

insurer's online readiness, online proficiency, online success, online customer growth, and carbon foot print as important attributes in determining their annual ratings. Championing the cause of the environment, intentionally or in the process of achieving one's business objectives, does not seem like a bad idea. From a philosophical stance, perhaps the answer to the frequent natural disaster claims lies in the environmental sensitivity of the group most affected by it.

6.5. Insurance Aggregators

Insurance aggregator services are fairly well established in some advanced economies and have seen reasonable success in recent times, and mainly for personal insurance products like motor, and accident policies. The acceptance of online channel by the insurance customers in advanced economies especially during the recession can see the number of aggregator services go up. With a little more thought and enterprise, insurance aggregator services can be extended to cover the entire gamut of products in the personal lines offerings as compared to the limited range of products that are available at the moment.

Aggregators however, are yet to make their presence felt in the emerging economies like India, which is a paradox considering it is an information technology hub. Emerging markets may see a spurt in insurance aggregators given the success seen by aggregator services for retail products, airline services, tourism, etc. Both in times of recession and otherwise, there is a large untapped market in a country like India where aggregator services can make a big impression. Given the prudence of the customers combined with a growing knowledge of insurance, and exceptional technology advancements, aggregator services are likely to create an important place for themselves in the insurance value chain.

6.6. Software-as-a-Service (SaaS): Making inroads

Mature insurance markets like the US have a problem of legacy applications that prevents them from responding to market dynamics as much as, or as quickly as they would like to. They have made large investments in their information technology systems over a period of time with various insurance vendors and applications. As a result they are faced with problems of disparate systems that deprive them of tactical advantages.

The insurance mechanism in emerging markets on the other hand has undergone significant changes in the last decade or so. Most of them have broken the shackles of monopoly by the government or the public sector and opened up to foreign investments. These insurance companies do not face any legacy system issues. Their problems are more to do with choosing from among the wide range of alternatives available in addressing their near and future objectives. While the need for an enterprise-wide robust core business application is a critical step in the direction of their long-term objectives, the flexibility to respond to market needs using cheaper alternative solutions is essential in addressing tactical needs.

Insurers can fulfill this need using a wide range of point solutions addressing different areas of an insurer's operation from new business underwriting to post-sales customer service. As a consequence of the crisis, it is likely that software-as-a-service (SaaS) business model will find wider acceptance both in the mature markets as well as in the emerging markets due to the tremendous advantages it offers in terms of cost and maintenance efforts. SaaS involves the IT vendor hosting the application using their own infrastructure and charging the insurers based on the number of transactions. Apart from saving on infrastructure costs, insurers benefit from paying only for the extent of use, which is a great benefit especially during a time like the crisis when there is low activity. The speculations about its viability in insurance notwithstanding, SaaS has been making inroads in the IT landscape of insurance companies in the last few years. Restricted earlier to peripheral solutions involving low-to-zero customer confidential data, SaaS has seen itself assuming a more prominent role in larger applications like core life insurance administration systems. If anything, the crisis has only underscored its importance.

7. Conclusion

7.1. Market Revival – Restoring confidence

Fifteen months after the fiasco of September 2008, the world at large has come to terms with the uncertainties prevalent in the economy. At the same time, the impressive recovery and the record time in which the turnaround happened has left anyone associated with and / or affected by the economy stronger and wiser. While it was always expected that the unrealistic highs preceding the crisis would be short-lived, witnessing it all come crashing down with a resounding thump in a matter of such a short time was disquieting. It is true that some sectors are still limping, and some have just begun to see the light at the end of the tunnel. The majority has however come back to normalcy, only enriched by the experience and strengthened by the collective resolve displayed by the global economy in face of the adversities.

7.2. <u>Insurance Industry – Standing Tall Amidst the Ruins</u>

The insurance industry globally withstood the onslaught of the recession with relative poise and sturdiness. The fall of one of the largest insurers in the world that sparked off wide unrest and speculation notwithstanding, the impact on insurance customers in terms of fulfilling the promises committed in pure insurance contracts was minimal. On the contrary, the crisis only vindicated the role of the insurance industry in sustaining the lives and establishments of individuals and businesses. The significance of hitherto undersold and under promoted insurance products like Trade Credit, D&O, E&O, and Employment Practices policies was soundly established during the crisis.

7.3. <u>Winning in the Downturns</u>

There have been many recessions in the past, and there will be many in the future. They may be bigger and meaner than the recent one. It is high time that the insurance industry extends to its own functioning some of the philosophies it thrives on – that the future is uncertain, and that the first step towards conquering the uncertainties is to be prepared for it. It is important that the insurers and the key stakeholders concerned fortify the insurance mechanism to counter the volatility inherent in the environment that it operates in. It would serve the best interests of the insurance world to look at the current crisis as a sign of bigger things to come. In fact, the insurance fraternity should be thankful that the crisis exposed the chinks in its armour without making it pay dearly for it. Not capitalizing on this rare display of magnanimity can be expensive.

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Exhibits

- Exhibit 1: Figure 1.1. Global Indicators, Crisis and Recovery, World Economic Outlook, IMF, April' 09
- Exhibit 2: What happened to the Wall Street Investment Banks? - Financial Risk Outlook 2009 – FSA
- Exhibit 3: Figure 1.9, Global Financial Stability Report, Oct' 09, IMF
- Exhibit 4: Development of Shareholder's equity of mainly life and global companies (part of the Dec' 09 Insights Report, Swiss Re)

Tables

- Table 1: Table 2.1. Advanced Economies: Real GDP, Consumer Prices, and Unemployment 1, Crisis and Recovery, World Economic Outlook, IMF, April' 09
- Table 2: Swiss Re, Economic Research and Consulting, sigma No. 3/2008 (Insurance)
- Table 3: Swiss Re, Economic Research and Consulting, sigma No. 3/2008 (Life)
- Table 4: Swiss Re, Economic Research and Consulting, sigma No. 3/2008 (Non-Life)

Authors

Arun Kumar V is a Senior Associate with Infosys Consulting. He focuses on business consulting and technology driven business transformation. Arun is a CPCU and a Chartered ACII. He also holds the Fellowship of Insurance Institute of India. He could be reached on arun_kumar15@infosys.com

Rama Warrier runs an independent management consulting practice (www.conzulting.in). His areas of interest include business & process consulting, technology initiatives and eLearning. Warrier is a Fellow of the Institute of Risk Management, London and a Chartered ACII. He is also a Fellow of Insurance Institute of India. He could be reached on warrier@conzulting.in .