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## THE CHANGING NATURE OF THE REINSURANCE INDUSTRY - A CALL FOR AN ETHICAL APPROACH

### INTRODUCTION

Business Ethics has increasingly become a concern among companies in the financial services industry. No insurance without reinsurance. Although it is traditionally assumed that insurance has a wider role in society, the ethical debate has mainly developed over the last decade. It is even emerging in the reinsurance industry. This dissertation aims at providing a useful piece of research to the development of ethics in reinsurance.

Initial consideration of the reinsurance industry reveals that the shareholder theory has established as the core business theory. This forms mainly the 'return on equity' predominant approach in the vast majority of companies.

Having developed a research using a variety of qualitative methods, including secondary data collection (literature review) and semi-structured interviews in the field of reinsurance, the I observed and was convinced that ethics should play a larger role than that of the restricted return on equity approach.

The literature review reveals limited exploration of a link between ethics and reinsurance. Therefore it is reasonable to propose that there are links between the financial thinking of the industry and its approach to ethics.

The literature review and the primary findings have revealed that trust remains at the heart of the reinsurance industry but seeks to reconcile the short-term and the long-term, and that the strong links between ethics and trust call for a larger ethics beyond the restricted shareholders' theory in the long run.

No reinsurance without trust, no trust without ethics.

Furthermore, I found that existing literature on reinsurance limits the ethical debate to the shareholders or stakeholders theory, and fails to explore links between societal ethics and this industry.

Consequently, the dissertation has made a contribution to research in an area where there was a notable gap.

Finally, this dissertation proposes a number of recommendations to the reinsurance industry to integrate societal focus and develop 'geo-ethics' (via the concept and implementation of societal insurance and reinsurance pools against natural catastrophes for instance), to reconcile short-term financial thinking and long-term partnership, and to regain the necessary public trust.

### ETHICAL CHALLENGES IN REINSURANCE

Basically, reinsurance consists in insuring insurers. Insurers use reinsurance to transfer all or part of the risks they themselves have underwritten onto reinsurance companies.

Trust has long been at the heart of the reinsurance industry and reflected the well-established legal principle of *uberrima fides*.

According to Baligni (1996), 'in the long run, insurance cannot work without trust'.

Why has the principle of trust been overlooked? 'Perhaps it is because trust was always assumed in the past, when values such as honesty, integrity, fairness, respect, responsibility, and caring were emphasized by families, churches, and schools. Presently, extreme competitive pressures and short-term thinking often overshadow these time-tested values that create an environment of trust' (Nierhaus, 1998, p. 3)

However, the ethical image of reinsurance has always had its peaks and troughs.

The first traceable reinsurance treaty of an obligatory character was arranged between a French and a Belgian company in the year 1821; in England reinsurance was forbidden by a law passed in 1764 under George II and this ban was not lifted until 1864 in the reign of Queen Victoria.

Until the last twenty-five years, trust was analysed *a contrario* with reference to "blind" treaties which were marginal in the early days of reinsurance but have always been a historical constant fact, thus showing that 'uberrima fides' has moved to 'caveat emptor' (let the buyer beware) in an increasing number of cases.

The weak ethical image of the reinsurance industry did not have until recently devastating effects on the market, but recent huge financial losses put into light the

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accumulation of 'blind' treaties at an incommensurable level and raised legitimate ethical concerns.

The debate between long-term financial and short-term financial thinking, between trust and distrust, is raising key ethical considerations.

Adopting an analysis by analogy, we could argue like Barrett (1998) that these changes are induced by the erosion of 'the old paradigm of business' and by a greater corporate concern for 'the new theories'.

The former refers to philosophical theories supporting enlightened self-interest, the latter to altruism, both leading to opposite ethical outcomes.

Western Enlightenment philosophies (such as Locke) focused on the need for personal autonomy and emphasized the ethics of moral self-determination leading to egoism and ethical relativism.

The shareholder paradigm is the corollary adopted by organizations (minimum legal compliance, shareholder responsibility), viewing the maximization of profit as the primary objective (Friedman/Cooke) or the lack of obligation to society and a lower set of moral standards (Carr).

The incoherent conceptual order created by the classical strategic choice theory, based on the autonomous individual and on systems thinking, has resulted in a disconnection between values and facts (Heller's Catch 22): in particular, the lack of practical ethical framework and the increasing complexity of western society leads to chaos readily exploited by 'control-freaks' whose personal insecurity leads them to manipulate and abuse the trust of others, justified in terms of scientific rationality and selfish-individualism.

## THEORETICAL PERSPECTIVE

### Gerathewohl's School

Gerathewohl (1980-1982) is most likely to be considered the father of the classical school of trust and continuity. This doctrine developed the traditional approach of personal and long-term reinsurance relationship (Michaels, 1997), with a strong emphasis on the core 'follow-the-fortunes' principle and corollary 'follow-the-actions'.

According to a well-established definition of Gerathewohl, following-the-fortunes means 'a proportional risk distribution between the underwriting and non-underwriting results of the insurer and the reinsurer'.

### Weaknesses of The Classical School / Predominance of The Shareholder Theory

The modern school of ethical relativism has built on the weaknesses of the static classical school.

The doctrine is mainly descriptive of the virtues of the presumed intangible 'follow-the-fortunes' principle in a period in which the environment was more stable, less competitive and long-term minded (Hagopian, 1991; Gerathewohl, 1976).

The 'return on equity' approach emphasises profitability at all costs, holds pressures on shareholders' rewarding dividends and sustains non-continuity or increased suspicion/control embedded in short-term financial thinking in a fast-changing business world.

The vast majority of reinsurance professionals (Lepine, 1973; Nierhaus, 1998; Kann, 1984) sustains that the reinsurance industry is facing unique challenges. It needs to face them with sound, responsible reinsurance techniques with risk-commensurate terms and conditions. In a heavily loss-suffering trend, reinsurers must, above all, pursue a policy to ensure that they earn the full margins that are needed to pay losses, irrespective of whether the original rates charged by their reinsured clients actually provide these margins.

Consequently, these changes in the environment have strengthened the profile of the defendants of the shareholder theory, which seems to be a sufficient condition for:

- The switch from proportional to non-proportional treaties (XL):

As sustained very recently for instance by the world largest reinsurer, Munich Re (Nierhaus, 1998): 'In proportional reinsurance exposed to large single losses or catastrophes, reinsurers have to do their own pricing - following the methods they use in non-proportional business - to arrive at the margins that they require'.

- For developing more financial and less traditional reinsurance / insurance products

- For re-focusing strategy on core business:

Leonard (2003) provides an appropriate illustration with the suddenly revised reinsurance strategy of Axa Re in the USA after the World Trade Center loss in 2001

- For continuously searching for the most favourable tax environment (Schroders' statement, 1998)

- For absorbing business ethics within the shareholder theory:

The influence of the McKinsey School of trust in financial services, establishing a strong link between

ethics and corporate governance, has been notable in the reinsurance industry in terms of organisational management and ethical standards.

The relativist doctrine (Newell, 2002; Wilson, 2002) reports that 'substantial progress has recently been made in US corporate governance, not least because of the new Sarbanes-Oxley Act. Yet investors and directors are clearly calling for more – and deeper – reforms. Boards that embrace them may well reap a trust premium, while those that continue to ignore the call for change serve neither management nor the shareholders well'.

### Limits of The Shareholder Theory

A minority of the doctrine has tried to highlight the limits of the 'return on equity' approach identified with the shareholder theory in reinsurance (Ballantine, 1997; Punter, 2001; Wanf, 2003).

For instance, Ballantine (1997) identifies two setbacks concerning:

- **Security (financial strength and correlated rating):** 'High returns may endear reinsurance companies to investors but over-zealous pursuit of the goal could obviously be prejudicial to the security of ceding clients. There is a natural temptation to enlarge distributable profits at the expense of reserves. To act as a restraint against such temptation is the function of regulators and rating agencies' (p 22)
- **Cultural Differences:** 'There is the question whether the numbers used to make a calculation are accurate. This is a particular problem when such Anglo-Saxon concepts as rate of return are applied to German accounts', i.e. when short-term financial thinking and long-term financial thinking come up against significantly different accounting practices, still hampering their owners' attempts to discover how well they are performing (see the recent example of Munich Re: the recurrent undervaluation of its assets has been compensated with its ability to raise share capital with successful rights issues).

These considerations have paved the way for a recognition of global and 'polycentric' ethics for filling the gaps of financial and cultural relativism (Challis, 1998, O' Connor, 1994). In practice, the major reinsurers have reacted to the shareholder theory using a two-pronged attack, technically and theoretically.

Technically, the second largest worldwide reinsurer, Swiss Re, is counter-attacking the defendants

on the return on equity approach on the grounds that the return on the full cost of capital is technically contentious and calls for greater transparency.

At the theoretical level, Kann (1984) defines an ethical concept of profitability, which has the merit to develop a stakeholders' approach of ethical profitability overtaking the influential shareholders' theory: 'What is the meaning of profitability? The concept of profitability covers more than a system of figures. It includes at the same time a behaviour pattern of people acting in our insurance industry. Therefore the meaning of profitability embraces in addition to the economical definitions moral categories like confidence, courage and honesty. Those categories are hard to measure and for the same reason it is so difficult to measure the profitability of the insurance industry. I mentioned various critical aspects having an impact on our profitability and I would like to remind you at the end that the most important one is a competitive, but fair co-operation between direct insurer and their reinsurer.' (p. 16)

However, one should note that the opponents of the shareholder theory have not reacted by developing an ethical framework (principles, codes) but rather by disputing concepts, originally found in the shareholder theory, or by enlarging them to wider dimensions (such as the stakeholders' interests). Therefore ethics in reinsurance is mainly descriptive, fragmented and less conceptual (McPerson's five-tier ethical programme, 1996).

In this restricted approach, relativist ethical guidelines are developed 'inside' for improving financial performance and increasing management efficiency, and not for suggesting an ethical approach coherent between the individual, the organisation and the society in open systems.

### Benefits of a Societal Ethical Approach

#### Non-Financial Benefits

##### a) Concept

In a recent influential article, Andrews (HBR, 2003) concedes that the choice of ethics larger than ethical relativism (shareholders) means that 'it is possible to carve out of our pluralistic, multicultural society a coherent community with a strategy that defines both its economic purposes and the standards of competence, quality, and humanity that govern its activities.' (p 75).

For Giarini (1995), the switch from classical economic study (protecting the capital value / sharehold-

ers' or stakeholders' interests) is linked to greater emphasis on ethical considerations (the society's interests) and the setting up of an ethical framework to cover the global interests of the society.

Applied to reinsurance, Nierhaus (1998) considers a similar 'flight to quality' is needed for this industry to promote the interests of the society *in fine*.

### Moving to a Societal Ethics

The wider dimension of societal ethics calls for 'new theories' (Barrett, 1998) beyond the stakeholder and shareholder paradigms at the theoretical level (a), and requires b).

#### (a) Searching For a New Theoretical Paradigm

The societal focus is the fundamental stage of transformational ethics and determines that 'organizations are responsible to society as a whole, of which they are an integral part. They operate by public consent in order to serve the needs of society, to the satisfaction of society' (Van Marrewijk, 2002).

The societal approach therefore requires:

- **Integration of corporate sustainability and social responsibility:** as pointed out by Barrett (1998), corporate sustainability needs to integrate a societal approach ('good global citizens') and is inseparable from social responsibility 'responsible members of the community' to avoid the danger of continuation of the 'old paradigm' in another form. To that extent, corporate sustainability is, like CSR, 'vital to improve labour and environmental standards and human rights worldwide' (Jackson, 2003)

- **Proactive approach to corporate sustainability:** in contrast with cognitivist theories based on the primacy on the autonomous individual and directed towards egoism and self-interest, complex responsive process theory encourages companies to be proactive in creating new realities through the involvement of their staff in civic participation and personal and social transformation.

- **Necessity for businesses to work on open systems for successfully continuous learning of societal ethics.** This fits with Hertz's emphasis on the need to re-connect the economic and social dimensions of corporate life. Moreover, meeting customers' social needs facilitates long-term trust and loyal commitments for achieving the organizational goals (win-win relationships, Aijo's value marketing concept) provided that the alignment of corporate sustainability to the marketing or advertising function is not

purely superficial and motivated by self-interest (Hertz, 2001).

#### b) The Global Challenges of Societal Ethics are Consistent with the Reinsurance Industry

Under these circumstances, societal ethics is consistent with

- **Economic growth and competition:** as Barrett (1998) further states, 'in a world of growing competition, it is clear that organizations with a strong sense of community will be the ones who will best survive.'

- **Environmental ethics by taking a holistic and biocentric view of the relationship between humans and the environment:** for instance, McEwan (2001) claims that 'for industrial development to be sustainable over the long-term, the quality of development, particularly in industrialized countries, would have to change radically but without imposing a quantitative limit on economic growth in developing countries' in order to respect the conditions of sustainable development, defined by the Bruntland Report (1987), that 'meets the needs of the present without compromising the ability of future generations to meet their needs.'

- **The organization and the society twofold:**

- Businesses that do not accept or understand their social responsibilities are far more likely to fail to fulfill their economic and legal responsibilities (Carroll, 2001) as this approach of 'the new theories' requires organizations to fundamentally rethink their strategic position for long-run survival and act in terms of the complex societal context of which they are a part (Van Marrewijk's comments on the case study of Nestle, 2002)

- Businesses which do not internalize the values and principles of good corporate citizenship will not be seen as credible contributors to trendy increasing corporate social investment or sustainable projects, like the SRI outlined by the UNCED in 1991

An established body of research demonstrates the links between trust-based ethics and corporate financial performance (Cranfield Management School study on SRIs, 2003).

Equally, BNP Paribas noted in 2003: 'Investment portfolios involved in SRI grew by more than 240 percent from 1995 to 2003, compared with the 174 percent growth of the overall universe of assets under professional management over the same time period.'

I am very supportive of what we would modestly call 'geo-ethics', especially for reinsurance brokers

in the future. As noted by Kriz (1995), 'Looking at geographic markets there is plenty of opportunity for entrepreneurial brokers in the Far East and Latin America. Regions of populations and natural resources would need solutions to risk transfer problems' (p. 684).

Based on my research I strongly believe that a reinsurance pool is not just about the catastrophe peril and involves:

- A multilateral ('polycentric') approach embracing economics, politics, society, culture and religion, and
- A commitment at government level to make the pool work

Reinsurers are also increasingly committed with environmental responsibilities and societal ethical guidelines (*Munich Re's Environmental Guidelines, 2002*)

In developing countries facing a high concentration of risk (earthquake, windstorm, flood) and having a low penetration of insurance, the recent and successful implementations of the Turkish Pool or the Algerian Pool, after the devastating earthquakes hit by these countries, are paving the way for further 'geo-ethical' realisations.

### The Suggested Framework

I suggest a two-pronged framework integrating and conciling ethics between the organization (a) and the environment (b)

#### a) 'Inside'

Ethics must come from within the organization.

I very much support ethical training, learning and management and believes that ethical entrepreneurship should be encouraged and recognised by organisations.

This approach is consistent with the Ethics and Compliance Group recently set up in the reinsurance industry (Mitchell, *Ethical Entrepreneur*, Institutional Investor, July 2004, p.8).

#### b) 'Outside'

Importance of the environment in assessing ethics based on trust needs to be pointed out. After 2001, the need to improve premium payment provisions or cash flow has become an issue.

The shareholder theory sustains that immediate improvement should follow the excesses of a soft

market cycle, irrespective of the buyers' or society's interests.

Using a BCG Matrix, the enclosed framework rejects an isolated scenario and adopts an interactive approach of the markets (hard, soft), which impact on the level of morale and ethical interests.

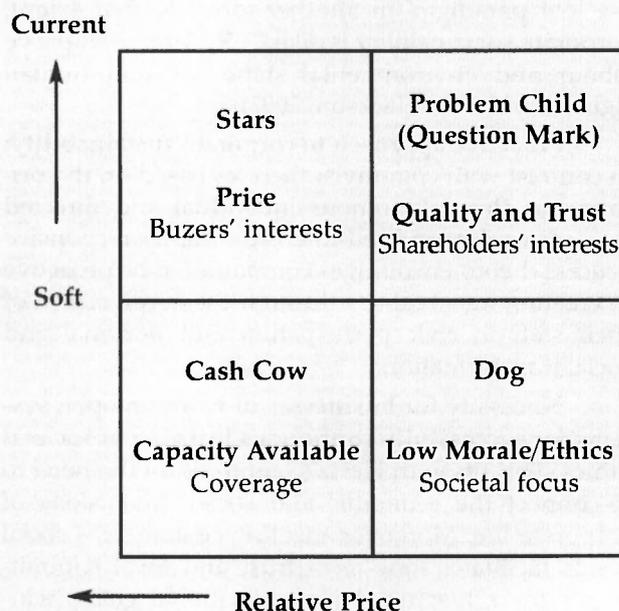
For instance, when the market becomes soft again, premium payment morale is low again, the market suffers cash flow problems and pushed towards a hardening trend (not cycle).

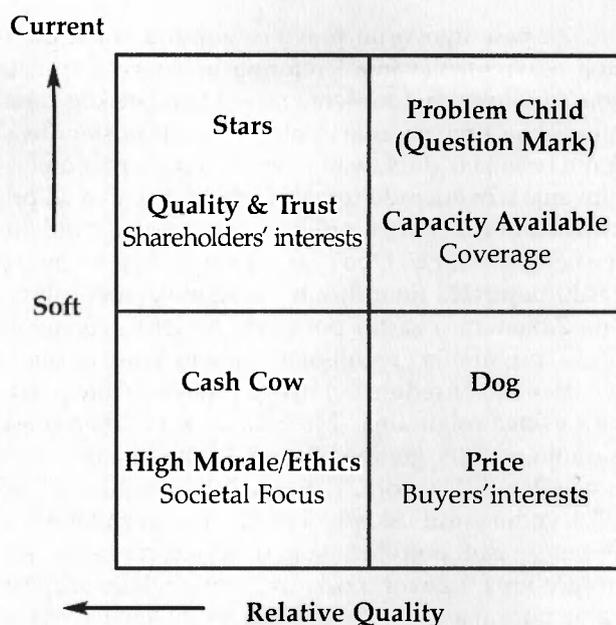
**Observation 1: soft market > low morale/ethics > emphasis on (cheap) price and on capacity > shareholders' interests and societal focus are affected**

**Observation 2: hard market > higher morale/ethics > emphasis on return on equity and shareholders' price and best allocation of capacity > societal focus is integrated (see the creation of reinsurance pools after major natural catastrophes or threats)**

Therefore the this framework demonstrates that the view of long-term and client/society profitable partnership is not incompatible with the requirements of capital remuneration. This is consistent with Lutke-Bornefeld (1996) and Golden (2002), but their views reflect predominantly stakeholders interests.

### THE SUGGESTED FRAMEWORK





## CONCLUSION

The research has also established that both the existing literature on reinsurance and the semi-interviews limit the ethical debate to the shareholders and stakeholders theory, and fails to explore links between societal ethics and the reinsurance industry.

Switch from proportional to non-proportional reinsurance, or from large trust-based ethics to restricted shareholder-based ethics, has significantly altered the nature of the relationship between cedant and reinsurer in which short-term financial interests may prevail only.

However, the shareholder perspective is not without contradictions.

Punter (2001) highlights the conflicts of interests that may affect the society: "Policyholders, insurance regulators, credit rating agencies all, in principle, want a re/insurer to have as much capital as possible for greatest security; shareholders want a re/insurer to have as little capital as possible for greatest return on capital." (p 74)

The shareholder theory is not without ethical deficiencies.

As Neave already noted in 1982, the issues facing the control of the reinsurance industry concern both the ultimate consumer and more transparency, which calls for larger ethics (regulation, implementation) and demonstrate that the "short-term financial thinking" is in contradiction with the confidence needed

for any financial services industry.

Moving toward societal ethics propels insurers and reinsurers toward public trust and transparency meanwhile allowing them to achieve management efficiency (including profitability, long-term sustainable growth, quality of relationship) and improve their weak image through the satisfaction of the interests of the society.

In light of the above, following recommendations may be made to the reinsurance industry:

1. Integrating a societal focus and developing "geo-ethics" for addressing the issues of inadequate or missing catastrophe models: "it is time for reinsurers and insurers to share expertise, establish agreed levels of uncertainty in the outcomes and work with the scientific and academic communities for real and tangible improvement." (Golden, 2002)

2. Reconciling short-term financial thinking and long-term partnership requires a prior understanding, learning and implementation of business ethics within the organisation.

3. Re-focusing the reinsurance activities to include society's interests in both developed and developing countries, to regain the public trust and ensuring profitable and sustainable long-term partnerships.

4. Societal ethics is not incompatible with stronger financial performance, increased tangible value, enhanced intangible assets and, more importantly, organisational motivation and personal achievement.

The success of the Reinsurance Industry of Tomorrow will not be only the result of strong shareholders' interests in the marketplace, but also of sharing project goals between the capital providers and the society's interests. Societal ethics in reinsurance? *Fluctuat nec mergitur.*