insurance AGENDA

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EXCLUSIVE INSIGHT AND ANALYSIS FROM INSURANCETIMES, STRATEGICRISK & GLOBALREINSURANCE

Ellen Bennett ■ Executive editor

Welcome to the final Insurance Agenda of 2009. I expect most of us will be glad to see the back of a year that has seen economic misery across the globe, a massive slowdown in mergers and acquisitions, a dearth of debt funding and of course that lingering soft market.

The good news is things are looking up in 2010. Insurance – and particularly reinsurance – has remained comparatively insulated from the banking meltdown, and is set to reap the rewards of its more cautionary approach to risk. From reinsurers such as PartnerRe, which recently acquired Paris Re, right down to the UK regional brokers, all sectors of the market are getting ready for action next year.

But 2010 will be about more than deals. The impact of the credit crunch will continue to be felt as politicians radically alter the regulatory landscape. The insurance sector will have to lobby the government hard as it gets ready to implement the long-awaited Solvency II, to make sure that insurers are not treated as harshly as the banks. The industry will also continue to push back on encroaching taxes and the crackdown on tax havens.

All this and more will be making headlines next year. Until then, have a great Christmas.

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in this issue

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Hitting the January sales

Will the new year herald a return to the broker buyout activity of 2007/08?

Remember the heady days of March 2008? In the weeks before a drastic change to capital gains tax, dozens of entrepreneurs rushed to complete the sales of their businesses to various consolidators and insurers, eager to pocket the money and plan for a comfortable retirement. A glance at the news archive brings back memories of AXA buying SBJ, IAG buying Barnett & Barnett, and CCV snapping up Protectagroup, to name but a few of the deals that went through in the space of three weeks.

They were the lucky ones. Those who held out those few extra months, whether through reluctance, indecision or greed for an even bigger prize, quickly discovered that the M&A landscape had changed forever. Thanks to US subprime followed quickly by the meltdown of financial institutions on both sides of the Atlantic, the back end of 2008 and 2009 were the antithesis of 2007/08. Figures published in *Insurance Times* in October show deal-making at its lowest level since 2002.

But with the first tentative signs of economic recovery, the question now is: will 2010 herald a return to the glory days of dizzying multiples and headline-grabbing deals?

The answer hinges on two factors: who's buying, and who's paying.

The buyers are the usual suspects, bar a couple of names from last time round. Towergate can be expected to announce a number of deals in the early part of next year, though none on a transformational scale. Its little sister CCV will also continue to buy, probably making smaller acquisitions at a faster rate. Announcements from Oval are to be expected early in the year, though these are deals that have been in the pipeline for some time. Bluefin chief executive Stuart Reid is on record saying the broker is "open for business" and looking for opportunities. Finally, Giles still has money to spend and remains on the hunt for that transformational deal. Crucially, all these players will be looking to buy at far, far lower multiples than those seen in the halcyon days of 2007/08.

So where's the money coming from? Towergate's debt finance continues to come from the major banks, led by Lloyds TSB, following this year's long-winded renegotiation of its covenants, backed up by substantial investments from its major shareholders (Peter Cullum, Andy Homer et al). Giles meanwhile also has a debt facility with Lloyds, though its acquisition war chest comes mainly from private equity paymasters Charterhouse.

Oval and Bluefin are arguably the more interesting examples. In both cases, their acquisitions will be at least part-funded by insurers. For Bluefin, parent AXA will be stumping up the cash, and for Oval, RSA, as well as other shareholders, has provided a loan.

Lloyds TSB currently appears to be the only major bank willing to put any substantial investment into insurance intermediaries – and it is already heavily committed in the consolidator sector. Meanwhile, private equity is looking to safer investments; 3i for example is thought to be looking to sell out of Jelf. So that leaves insurers.

While their days of buying brokers outright are probably over, as their investment returns come back, expect to see insurers looking at alternative models of putting money into brokers. Perhaps, like RSA, they will call it a loan. Maybe, like AXA and Groupama, they will provide acquisition funding to the brokers they already own. Or perhaps, like Aviva, they will make cash available outright to smaller players.

Either way, the chances are that, as the good times return to the broker M&A market, the UK's biggest insurers will be lining up to take a share of the action.

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Key points

- M&A has been at lowest level since 2002
- The major consolidators will buy again in 2010 – but at lower multiples
- Insurers will be looking to invest in acquisitions again, though not as outright purchasers

Archive

➔ Deals round-up: debt market pick-up signals new dawn, 22 October 2009

➔ Consolidators mull merging, floating, refinancing, 1 October 2009

➔ RSA loans Oval millions, 29 September 2009

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Nathan Skinner • Associate Editor • Strategic Risk

Out with the old

Solvency II is on its way and, despite its challenges, the effort should be worth it

The deadline for Solvency II is less than three years away, and represents a major overhaul of the existing supervisory system. There are concerns that in the current climate insurers could do without another layer of regulation – particularly considering that Basel II, a similar set of rules for the banks, failed to prevent financial catastrophe. Nevertheless, Solvency II is going ahead, so the best companies will get on board early and design programmes that deliver business benefits, not just compliance.

Challenges
One of the main challenges is that insurers are required to develop their plans while the details of the new framework are still being ironed out. The high-level principles have been agreed, but there are over a thousand pages of consultation that need to be factored into planning.

Solvency II seeks to embed risk management into the culture of the organisation by including measures to ensure that companies are using risk information in the day-to-day management of their business. Solvency II delivery teams will probably have to overcome significant resistance to change internally. Do not underestimate the cultural challenge.

Designing Solvency II internal models is a huge undertaking. After the models are built, they need to be consistently re-evaluated as the business and markets evolve. To do so, the modelling team may have to grow. With a limited pool of talent out there, some companies will face problems locking in the required risk management and actuarial resources, as well as training management on the implications of the new regime.

Opportunities
Risk-based solvency requirements are at the heart of Solvency II. Insurers are required to hold capital commensurate with a range of risks. If a company's risk management controls are good enough, they may be able to convince the regulator that they don't need to hold onto as much capital as their competitors. Companies are expected to report on the efficacy of their internal systems and controls. Insurers can win the confidence of the authorities if they convince them that they understand the strengths and limitations of their own risk systems.

Companies should update business processes and make sure data is complete, accurate and appropriate. They have to demonstrate good documentation and a clear understanding of their own internal models. With accurate data, insurers will be able to calculate capital requirements and price their products more competitively. Compared with their European counterparts, UK insurers are generally a step further down the Solvency II road as most of them already use internal capital assessment models. UK companies may be able to steal a march on their continental competitors, who will have more work to do to overhaul their internal models.

The opportunity to improve professionalism, make business processes cleaner, faster and manage risks better should be warmly welcomed. Further, demonstrating risk management robustness will become increasingly important for insurers as credit ratings become more tightly linked to the sophistication and effectiveness of their risk management capabilities.

So will it be worth the effort? One of the main problems with Basel II was that banks went into it with the wrong attitude. Instead of asking how it could help improve their business, many of them simply looked for ways to reduce their capital requirements. Solvency II is about better risk management and, while the transition will be painful, ultimately it should help raise standards across the industry.

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Key points

- Do not underestimate the time and resources it takes to overhaul internal models and embed a culture of risk management
- Companies that have good risk management controls and the confidence of the regulator, will have less stringent capital requirements
- Most UK insurers, which already use internal capital assessment models, may have the advantage over their European counterparts
- We should welcome the opportunity to improve professionalism and make business processes cleaner and faster

Archive

→ Munich Re has high hopes for Solvency II, 24 November 2009

→ Hire specialist Solvency II staff now or miss out, warns IBM, 26 October 2009

→ EU timetable starts countdown to Solvency II, 20 October 2009

→ Expect higher prices under Solvency II, says insurer, 8 October 2009

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David Banks • Deputy Editor • Global Reinsurance

Whatever you do, don't panic

The ECJ's ruling that Swiss Re is liable for VAT on a portfolio transfer has the industry worried

Swiss Re appears to have shot the reinsurance industry in the foot by picking a fight with German tax authorities.

The case, about whether VAT was liable on a portfolio transfer, went all the way to the European Court of Justice in Luxembourg and ended on 22 October with judges upholding the lower court's decision. Swiss Re, they said, could not recoup the money it paid the Munich tax office in 2002 on the transfer of 195 life reinsurance contracts from its German subsidiary.

Few reinsurers will have taken any pleasure in the ruling, as the fear is that it could now apply to reinsurance contracts in every EU member state.

While Swiss Re believes no new liabilities arise from the decision, other reinsurers are worried. The court decision spread quickly among delegates at the annual reinsurance gathering at Baden-Baden and was greeted with startled expressions.

No one quite knows what the repercussions will be. Reinsurance executives, who until now have had their noses firmly lodged in books about Solvency II, have spent the last few weeks making feverish calls to their tax experts and lawyers to discover what the ruling could mean to them, their balance sheets and their bonuses.

While the German tax office involved in the case, Finanzamt München für Körperschaften, has every right to gloat, there has been an eerie silence from other tax bodies across the Continent. There is so much silence, in fact, that reinsurers might actually think it wise to remain silent themselves, rather than stir a hornets' nest.

But let's be realistic, we are talking about money. If anyone, not least government authorities, believes they can get their hands on more of the stuff, they will make every effort to do so. We can safely assume tax offices from London to Ljubljana are studiously eyeing reinsurance tax returns at this very moment to find financial gain for their political masters. Silence, therefore, could be something to worry about.

However, Swiss Re, which has had longest to weigh up the case, believes the industry as a whole should not panic. The firm says that many portfolio transfers may qualify for country-specific VAT exemptions under 'transfer of going concern' rules.

And we can be reassured that case law has already established the meaning of the expression 'insurance transaction', namely that the insurer undertakes, in return for the payment of a premium, to provide the insured with the service agreed under the contract agreed between the parties. This point remains unchanged, Swiss Re says, meaning that routine insurance and reinsurance transactions are not affected by this ruling. "We do not believe that the ECJ's decision fundamentally threatens the basis of reinsurance business as a whole. Some of the commentary in recent days appears therefore somewhat alarmist," a Swiss Re spokesman says.

But as TMF VAT & IPT Services managing director Richard Asquith poiints out, the case still poses questions about redomiciliations in the last few years. "I think the companies that are worrying the most are those that are moving portfolios: companies with interests in Europe moving portfolios between Europe, Bermuda and Switzerland. They will be the ones trawling through documents to see if they are exposed. The portfolios might be millions or billions, and any tax on that would be a huge chunk."

Will the authorities dredge up outstanding tax on transfers from years ago? Retrospective cases are unusual, Asquith says, but they can happen. "Tax authorities are capable of anything, especially at the moment because tax officials are all looking for revenues."

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Key points

- The ECJ has ruled that Swiss Re cannot recoup the VAT it paid on 195 life reinsurance contracts transferred from its German subsidiary
- With tax authorities more keen than ever to capture revenue, insurers are concerned what the judgment will mean for future tax bills
- Routine insurance and reinsurance transactions are not believed to be affected by the ruling, but the case still poses questions for redomiciled companies moving portfolios

Archive

➔ Baden-Baden: Swiss Re appeals for continuity, 27 October 2009

➔ Voting with your feet, October 2009

➔ Global reinsurers will fight US tax plans, 9 September 2009

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A painful time for PI

With 2009's rates hikes and four-fold rise in claims, the PI market faces a cautious new year

For seven years, the professional indemnity (PI) market was relatively quiet, as the UK enjoyed an era of unprecedented growth. The economic downturn has completely changed that landscape, however, with insurers facing rising claims as clients are hit with professional negligence lawsuits. This has had an significant effect on rates and capacity, with further change expected for 2010.

Rates

The professions that have faced the greatest rate rises this year are surveyors and solicitors, and they will continue to do so. Marsh believes there will be rates increases of anywhere between 10% and 100% over the next 12 months, as insurers adjust to a four-fold rise in claims in 2009 compared with the previous year.

Meanwhile, the annual battle to find cover for solicitors before the October deadline was well-publicised. Small law firms specialising in conveyancing were hardest hit, with some premiums rising by 400%. The trend of targeting small law firms with premium hikes will continue in 2010, as underwriters seek to protect themselves from the greatest risks.

What is noticeable is that the rest of the PI market has remained stable. The general consensus is that professionals in IT, estate agency and media have escaped largely unscathed from rate increase. Despite the recession, the risk level still remains low for those groups.

Capacity

At first glance, it might seem that PI market is flush with capacity for 2010. The share of PI for solicitors in 2009 rose from £217m to £241m, according to the Solicitors Regulation Authority (SRA).

However, although there are no other official statistics for PI capacity in the UK, general consensus sways towards the view that capacity has shrunk. There are three reasons for this. First, insurers have scaled back and become more selective on the risks they write, having undergone an increase in claims. Secondly, reinsurers have also pulled back capacity, which is having a knock-on effect on primary insurers that have less capital. Finally, there is a feeling that we are heading for a 'W' shaped recession, rather than a more optimistic 'V'.

Despite this shrinkage in capacity, there have been two major new entrants into the market. Allianz, which signed up a team from AIG at the beginning of 2009 and started writing in April, and also AXA. AXA will be one to watch in 2010. The insurer has offered to create D&O and P&I products, and aims to write £50m premium by 2013. In the solicitors market, there was a late entry from Ukranian insurer Lemma, while Lloyd's-based syndicate Pembroke Underwriting dipped its toe into the sector for the first time.

As the PI market heads into the new year, insurers will be wary of their PI book. Now more than ever, what is needed is careful risk selection and sensitive pricing to see them through choppy waters.

Key points

- The recession has fuelled a four-fold rise in professional indemnity (PI) claims during 2009, with surveyors and solicitors hit hardest
- Insurers are seeking to protect themselves by scaling back capacity or increasing rates – by as much as 400% for small conveyancing firms
- Overall capacity within the PI market is believed to have shrunk as a result, despite some new entrants into the market
- Rates are likely to continue rising in 2010, with insurers needing to ensure careful risk selection and sensitive pricing

Archive

➔ Solicitors' PI costs £15m more, 23 November 2009

➔ AIG takes the largest slice of solicitors' PI, 19 November 2009

➔ Surveyors' PI rates could double as claims keep rising, 5 November 2009

➔ Surveyors in PI rate crush, says insurer, 30 October 2009

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