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EXCLUSIVE INSIGHT AND ANALYSIS FROM INSURANCETIMES, STRATEGICRISK & GLOBALREINSURANCE

Michael Faulkner ■ Editor

Welcome to the first issue of Insurance Agenda. Each month we will be looking at key insurance, reinsurance and risk management issues, bringing insight, fresh perspectives and analysis on topical matters. This month has been a rollercoaster ride for the financial services sector, as the sub-prime crisis took a further twist, bringing down investment bank Lehman Brothers and taking insurance giant AIG to the brink of collapse.

Insurers appear to have emerged relatively unscathed from Lehman's demise. Had AIG gone bust, the view from analysts is that it would have been a credit event on a similar scale to Lehman.

Yet AIG's troubles could be other insurers' gain. AIG's new chief executive is in the process of drawing up a list of business units to sell, which could provide some prize assets for rival insurance groups to snap up – if they can raise the money to bid for them (page 2).

The root of the problems at AIG and the wider financial crisis were complex financial instruments such as credit default swaps. With the spotlight turning on such products, will investors become wary of cat bonds? Global Re editor David Sandham says not (page 3).

Meanwhile, the worsening economic climate coupled with the financial turmoil will lead risk managers to review their buying strategies. Insurers will need up their game or risk losing business (page 6).

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Michael Faulkner • Editor • Insurance Agenda

AIG crisis is good news for insurers

Insurance giant needs to sell off its profitable parts quickly.

Wall Street is in turmoil but amid the collapses and government bail-outs is some good news for the industry. The nationalisation of AIG will create a wealth of opportunities for insurers.

The near-collapse of the insurance giant as it struggled to raise collateral to support its derivatives obligations has not caused wider panic among investors in insurance stocks. It appears investors have seen the distinction between AIG's business model, under which it insured financial instruments for the banking industry, and the strategies of other insurers.

With the exception of a few credit default swaps at Swiss Re, European insurers have not been engaged in this type of activity. Indeed, Citigroup notes that as AIG struggled for survival, European insurance stocks were down only 4% against a broader market decline of 3%, while US property and casualty stocks actually rose 6%.

Investors are already beginning to look ahead to the shape of the insurance market after the AIG crisis. Meanwhile, insurers are circling, looking for opportunities to win business from AIG. Global corporate business could move as buyers assess their risk concentration and key underwriting partners. Zurich in particular could benefit from this. Investment bank Keefe, Bruyette & Woods has estimated that Zurich could raise its group operating profits by about 3% on the back of business won from AIG. RSA is also a potential benefactor from the movement of any large UK commercial risks from AIG.

Lloyd's insurers could be even bigger winners from the crisis, particularly those operating in higher-risk markets, such as the US excess and surplus lines business.

High-hazard clients are particularly sensitive to an insurer's rating, so AIG's downgrade will have a disproportionate effect on these clients, which may look for a more sound insurer. The Lloyd's market, which enjoys an A+ rating from S&P and is the second-largest writer of US excess and surplus lines business after AIG, is reportedly seeing an upturn in requests for quotes.

"There are a lot of fantastic opportunities in terms of people and business," notes one senior insurance executive.

Beyond the potential to win business from AIG, insurers will also be eyeing up the embattled insurer's business units for purchase. Edward Liddy, AIG's new chief executive, is looking to repay the government's loan as quickly as possible through asset sales. The break-up value of AIG could be well over $150bn (£85bn), according to analysts.

AIG's Asia business units are seen as particularly attractive and would appeal to the likes of RSA and Aviva. Munich Re and Allianz could make a move for AIG's reinsurance operations. What is on the block has yet to be confirmed, although the noises coming from AIG indicate the insurance businesses are "core" and will not be disposed of. Some suggest that the magnitude of AIG's liabilities mean that some insurance assets will need to be sold.

One issue for potential buyers is how to pay for any acquisition. The US government wants to be paid in cash not shares, so suitors will need to raise large amounts of money to buy the most valuable assets in AIG's portfolio, which may be beyond many companies in the current climate.

More generally, the AIG crisis could precipitate a hardening of rates and boost industry profitability. AIG was also a tough competitor and the movement of clients to other markets could see rates edge up. Big-ticket UK commercial insurers could well benefit in this regard. The movement of capacity through the sale of assets could also help lift rates although the market is overcapitalised, which would tend to limit this.

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Key points

- Insurance stocks have not been tarnished by the AIG crisis as investors can distinguish its business model from that of other insurers.
- There will be opportunities for insurers to win business from AIG. Zurich, RSA and Lloyd's insurers could be major winners in the UK.
- Insurers could have the opportunity to buy valuable AIG assets, but there are question marks over whether they can raise the money to do so.
- Rates could harden in some lines as competition from AIG is reduced.

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➔ AIG UK boss breaks silence
23 September 2008

➔ Brokers poised to pull out of AIG as it fights for life
18 September 2008

➔ Fed steps in to rescue AIG
17 September 2008

➔ AIG to raise $12.5bn after record loss
9 May 2008

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David Sandham • Editor • Global Reinsurance

Cat in a storm

The global financial turmoil should not trouble the cat bond market.

The financial crisis, which spread like wildfire because of the securitisation and repackaging of debt based on subprime mortgages, shows no sign of abating. Will cat bonds, themselves a form of securitisation, suffer in the backlash?

In fact, cat bonds have proved resilient and a relatively safe haven in the financial storm. There are very few sections of structured finance that have remained open to new issues (among the few are US auto loans, student loans and credit cards). But cat bonds have remained open and 2008 could be the second-highest year in history for new issuance.

The use of capital markets as a tool for insurance companies has grown massively since its inception more than a decade ago. Although cat bond activity has slowed in 2008, a longer perspective reveals that cat bond activity is still high.

There are reasons for the boom in cat bonds over the past few years. After hurricane Katrina (the most expensive natural disaster ever to strike the US), there was a surge in demand for reinsurance and not enough capacity. Traditional reinsurance, when it was available, was highly priced. Cat bonds filled a need and brought, in addition, the advantages of full collateralisation and the important idea of insurers being able to access the world's capital markets.

Equally, there are reasons for cat bonds' recent comparative slowdown in 2008. Today, there is sufficient capacity in the reinsurance market and prices for reinsurance are cheaper. With cat bonds still positioned as providing surplus capacity, it is no wonder that cat new issues have slowed.

As for the effects of the credit crunch, the uncorrelated nature of cat bonds has made them relatively free of contagion. Cat bonds cover hurricane or earthquake risks: the wind and the earth do not care what the capital markets are doing.

But the cat bond sector had one strike against it. On 19 September, a few days after Lehman Brothers filed for protection under Chapter 11 of the US Bankruptcy Code, ratings agency AM Best placed the debt ratings of a number of Lehman-related cat bonds under review with negative implications. This was because Lehman is the swap counterparty on each of these bonds and there is some doubt as to whether Lehman will be able to meet its obligation under the swap agreement. The affected cats are: Newton Re, whose sponsor was Catlin, Willow Re (sponsor Allstate) and Ajax Re (sponsor Aspen Re).

The impact of the early termination of the swap agreement is unclear at the time of writing. It is possible that the swap counterparty could be replaced.

A sign of health in the insurance linked securities sector is that secondary market trading volume has increased. Trading in already issued bonds is more than $3bn (£1.6bn) in the year to date. This figure is higher than the total number of new issues in 2008 to date. Trading exceeds issuance for the first time ever.

Part of the reason for the increased trading volume is the exit of some hedge funds from the sector, with trading volume up because they are selling their cat positions, often to cover losses in other sectors. This is actually a sign of health in the sector, whose investor base has been supported by the formation of several new specialist funds, and by new capital inflows.

Cat bonds offer a form of uncorrelated risk that should prove attractive for investors seeking a safe haven in a financial storm.

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Key points

- Cat bond new issuance has slowed in 2008.
- Secondary trading volumes are high.
- The investor base is growing with new funds formed.
- The uncorrelated nature of cat bonds means they have largely avoided the subprime contagion.

Archive

➔ Cat bonds are here to stay
9 September 2008

➔ $5bn new cat bonds for 2008?
6 September 2008

➔ ILS sector slows
7 July 2008

➔ Platinum closes cat bond
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➔ Benfield invests $50m in ILS firm
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A fraud catastrophe?

As the UK edges towards recession, suspicious claims are rising. Can the industry cope?

Doom-mongering, perhaps, but there are already signs of a surge in fraudulent claims as the economic outlook worsens. Insurers and loss adjusters are reporting more suspicious claims. AXA has already surpassed its target for fraud detection this year, with detected fraud up 80% year-on-year.

It is no surprise that the incidence of fraud increases during economic downturns. During the last recession in the early 1990s, the number of fraudulent arson claims rose as cash-strapped firms looked to their insurance policies to keep them afloat.

Insurers are now preparing to tackle another upsurge in fraudulent claims. The industry has changed since the last recession and is implementing new systems, processes and technologies. There are clearer metrics and measures across the industry. Data is shared. Insurers as a whole are less naïve when it comes to the problem.

But some question the extent to which insurers are fully prepared for the wave of fraud that could engulf them. In the past few years, the industry has taken on the organised fraud gangs. Indeed, the Insurance Fraud Bureau appears to be enjoying some success. But how well placed are insurers to tackle opportunistic fraud?

Research in recent months suggests consumers are increasingly willing to exaggerate claims and make false statements in order to obtain a cheaper premium. Many of these will be low-risk customers, who have been driven to lie because of economic pressures.

How many of these claims will be identified? It is likely that many will fall through the net. Insurers will have to take some of the blame for this. Claim handlers' targets are based on speed, process and customer service. Some argue there is simply not enough resistance in the system to pick out low-value frauds, despite the investment in new detection systems.

Others point to the decline over the years of skilled and experienced senior fraud specialist staff, arguing that it is now less likely that fraudulent claims, particularly large, complicated commercial losses, will be identified.

One area that insurers have yet failed to address is the perception that insurance fraud is a victimless crime. A recent survey conducted for ITV1 found one in seven Britons believed it was acceptable to exaggerate a claim.

Last year the insurance industry, through the ABI, was poised to begin a campaign to raise consumer awareness of the cost of fraudulent claims. That plan fell apart because of lack of support from some insurers.

While individual insurers have their own strategies for raising awareness of the cost of fraud, the industry is lacking a coordinated strategy for changing consumers' misconceptions about fraud. Until individuals really understand its financial cost and the risks they face in committing it, then the problem will not go away.

As the economy moves ever closer to recession, insurers cannot afford to be complacent about fraud.

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Key points

- As the economy slows previously low-risk customers will make fraudulent claims.
- Insurers must look at their systems to ensure opportunistic fraud is identified.
- Targets for claims staff should be reviewed.
- Processes should add sufficient "resistance" without compromising customer service.
- Greater investment is needed to educate consumers about the cost of fraud.

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➔ Adjusters report rise in fraud probes
11 September 2008

➔ Industry fears broker fraud
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➔ Fighting fraud
24 July 2008

➔ A changing attitude to a growing problem
26 July 2008

➔ ABI shelves plans for anti-fraud ad campaign
29 March 2007

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Subprime: a mountain of claims

We have yet to reach the peak on cases related to the mortgage crisis.

In the midst of a crisis, it is not always easy to get one's bearings. By any measure, the subprime crisis rates as a financial disaster on an epic scale. Insurers are bracing themselves for billions of dollars of claims relating to subprime, as investors who lost money look for redress. The final cost to the insurance industry can only be guessed.

One gauge of the potential impact is the number of legal cases filed. Previously, the high watermark for the number of filings in the US was 559, as a result of the savings and loans crisis of the 1980s. Then 747 savings and loan associations failed, largely as a result of imprudent lending and scams during a housing bubble (déjà-vu anyone?). The savings and loans crisis probably contributed to the 1990-1991 recession. By 1991, the number of new homes constructed per year in the USA had slumped to the lowest rate since the second world war.

This time, it is worse: by 30 June 2008, the number of subprime mortgage and related US legal filings totalled 607. But there is what may seem at first glance to be a silver lining in these figures. There has been a slowdown in filings through the months of this year. January was the biggest month and May the smallest, with June picking up a little.

But we should not be too cheery about this reduction in velocity. Experts say the slowdown is happening merely because subprime mortgages are receding into history, as lenders curtail their involvement or exit the field entirely. Worryingly, securities-related and contract-related disputes have held steady or even increased.

The subprime crisis appears to be still fluid. We could see episodic bursts of new activity and new areas of litigation may be tunnelled out.

There is other evidence that we are still on the uphill climb of this legal mountain. In the second quarter of 2008, only 36 cases were disposed, compared to 121 new cases filed: a ratio of approximately 1:3. Although this ratio is less steep than in the first quarter of the year (about 1:5) it indicates that the downhill portion of the mountain is still some way off.

The consequences of subprime for insurance claims under directors' and officers' (D&O) and errors and omissions (E&O) policies are incalculable. In the savings and loans crisis, the legal payout was $4bn (£2.2bn). Given that more cases have to date been filed in connection with the subprime meltdown than for the savings and loans crisis, we can infer that the legal pay-out is likely to be more than $4bn.

Thomas Hess, Swiss Re's chief economist, has estimated the D&O and E&O losses at between $3bn and $9bn, roughly equivalent to a medium-sized natural catastrophe. But we should be wary. The total cost of the subprime crisis has been estimated at $1 trillion, much bigger than the $160bn estimated for the savings and loans crisis.

We will not know the answer tomorrow. It could be a decade before all the subprime cases are resolved.

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Key points

- Subprime filings have recently topped the previous high watermark
- Slowdown in overall filings, but not for some classes of filings
- Impact on D&O and E&O likely to be more than $4bn

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➔ Subprime-related legal cases pile up
12 September 2008

➔ 'New type of catastrophe' – Zaffino
6 September 2008

➔ Financial and other storms
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➔ Financial nat cat
18 September 2008

➔ AIG to be biggest run-off in history?
18 September 2008

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Andrew Leslie • Deputy Editor • Strategic Risk

New world for risk management

Insurance buyers will be asking tough questions of insurers following the AIG crisis.

Like a man waking to find that the Earth is flat after all, the risk management profession must be calling into question some of its dearest held beliefs. The financial services sector, that most lovingly regulated of machines, surfeited with risk committees and swaddled in governance, has come close to collapse.

Back in June, as Lehman's troubles started to become apparent, one blog contributer to *The New York Times* wrote: "The disciplined risk management that they are known for? Those risk managers must have been out to lunch … for the past four years or so."

That neatly sums up the continuing incredulity that risk management could fail so badly. The profession's image has taken a severe knock.

So will companies show "risk management" the door and return to the days of the "insurance buyer", upping their spend in the process? Not necessarily – for part of risk management's existential nightmare is the fate of AIG. If AIG has to be salvaged by the US taxpayer because of a crazed love affair with credit default swaps, who else may have been playing equally risky games? We have now heard too many "business as usual" statements followed by revelations of massive write-downs for such assurances to be trusted.

Risk managers will be asking their brokers the kind of "what if" questions that would not have crossed their minds a year ago. Even where they can be reassured that their policies will ultimately be honoured, questions over delays in claims handling and worries about the administrative nightmares that would follow a big insurance failure must weigh heavily.

Add to this the fact that a severe economic downturn is moving from a possibility to a probability and companies are likely to be drawing in their horns. First to go will be the spending on emerging risks. Insuring against the fallout from an avian flu pandemic at some uncertain time in the future will seem something of a frippery if the business may not survive to witness it.

The same goes for terrorism and almost certainly for anything to do with the environment if companies reckon their exposure to environmental liability is less than life-threatening. The balance between those risks that can be retained in-house and those that must be transferred will be reassessed – and probably not in favour of upping spend on insurance.

The reaction is likely to be overdone – and wrong. You do not cure cancer by getting more rest. Sensible businesses even now should be clearing a space in the boardroom for risk management and strengthening, not weakening, its hand. Buyers of insurance should be actively looking for reliability and efficiency rather than cheapness and the insurance industry in turn should be upping its game in providing top-class service, notably in contract certainty and claims handling.

The purgative of the current turmoil may have beneficial long-term effects. But don't expect to have a happy time meanwhile.

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Key points

- Insurance buyers will question the financial stability of insurers
- Spending on peripheral insurance products will be cut
- Risk retention will increase
- Insurers must focus on service

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→ Marsh warns of rising D&O demand
22 September 2008

→ Subprime leads to growth in class actions
14 August 2008

→ Has risk management failed?
22 September 2008

→ Benchmarking claims
30 June 2008

→ Shifting relationship between buyers and brokers
30 April 2008

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Personal injury: it's not over

Insurers face major challenges if claims reform is to take place.

The government published its long-awaited proposals for reform of the personal injury claims process in the summer. Yet the issue of claims reform is far from over. The government's reforms themselves raise serious challenges for the insurance industry. There is also the question of how to improve the efficiency of the claims process for claims falling outside the government's reforms.

Despite promising a radical overhaul of the personal injury system, the government's final report offered little in the way of true reform: only low-value road traffic accident claims would get a new fast-track process, with the process for other personal injury claims left largely untouched.

The new process for motor claims under £10,000 sets a 15-day time limit for insurers to make a decision on liability. The proposals will also bring in a fixed recoverable legal costs regime, the details of which have yet to be determined.

Yet the proposed system is troubling some insurers who are concerned about their ability to meet the deadline set for low-value motor claims. The uncertainty around the fixed-cost regime is also an issue. Some top claims executives express fears that compensation costs may not even drop.

Insurers are therefore working hard to make their own processes more efficient, for both low-value motor claims and other personal injury claims. Over the past few years, major liability insurers such as AXA, RSA and Zurich have been doing this, with a range of initiatives. These have included agreeing working practice protocols with major claimant law firms to speed up the settlement process. Insurers, such as Zurich, are also becoming more aggressive in tackling excessive legal costs.

Insurers are looking to circumvent lawyers, cutting costs and getting claimants into rehabilitation quickly. This direct dealing with claimants – so-called third-party capture – is becoming a major focus for insurers.

There are calls from sections of the insurance industry, such as AXA, for some form of coordinated approach between insurers for dealing with personal injury claims falling outside the government's reforms – within the bounds of competition law, of course. This will not be easy to achieve.

The challenge is to persuade claimants to deal direct with insurers. The insurance industry will refer to research commissioned by the ABI that found unrepresented claimants received more money from insurers than those with legal representation and their claims took on average three months less time to settle.

Nonetheless it will require a lot of PR work to make claimants feel comfortable without legal representation. The claimant lawyer association will fight hard against moves to cut its members out of the equation.

Political lobbying is vital. The industry is looking to get the Conservative party on side, given that it seems likely to win the next general election, in order to achieve wider reform. Demonstrating that the government's reforms work for motor claims will also provide a powerful argument for expanding the new system to other types of personal injury claim.

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Key points

- Direct dealing with claimants in order to circumvent lawyers will grow in importance.
- An industry-wide solution for handling non-motor claims should be explored.
- Continued lobbying of the government and opposition is vital.
- Demonstrating that the government's proposals work will provide a powerful argument for wider reform

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→ Insurers to seek market solution to injury claims
18 September 2008

→ Bearing the brunt of the personal injury reforms
14 August 2008

→ Insurers vow to return to court after government U-turn on reform
24 July 2008

→ Personal injury claims under the microscope
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