

insurance

A G E N D A



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Christmas is coming and with it some much needed good news for the punch-drunk global financial services industry. As the economic gloom deepens, certain businesses can start to look for opportunities. Among insurers, those with strong balance sheets such as RSA, Amlin and Hiscox can expect to benefit from the troubles of their rivals (page 2). And the whole market will be rubbing its hands in glee at the growing consensus that reinsurance rates are about to harden, prompting a turn in the cycle at last (page 5). Insurers will escape from the kind of harsh regulatory intervention that banks now face, reckons Michael Faulkner (page 3), and risk managers can step forward to take their place in the limelight (page 6). Finally, whatever your political colours, there can be no doubt that Barack Obama's historic victory is going to shake things up. David Sandham asks what it means for (re)insurance (page 4). So take a tip from wartime Britain: batten down the hatches for the festive season, hope the worst of the economic storms have passed and look forward to making the best of things in the new year.

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How to have a happy new year

It's not all bad news. The recession of 2009 will create opportunities for some insurers.

The economic slowdown has hit some insurers hard, but others stand to gain. Insurers' financial strength is under the spotlight after the banking crisis and the near collapse of AIG. Those with the strongest balance sheets will be at an advantage, with investors and buyers preferring the most secure companies.

While the industry's capital levels have been squeezed by mark-to-market losses on investment portfolios and catastrophe losses, it has avoided the worst of the toxic assets that bedevilled the banks. A re-rating of the sector appears unlikely at present; individual performances vary and some insurers – RSA, Amlin and Hiscox – are particularly strong.

The AIG effect

Business is likely to migrate to other carriers, given AIG's rating issues and the general perception of risk associated with the company. The insurer is the largest writer of excess and surplus lines and had been aggressively writing US and European property and casualty, airline, UK commercial and motor fleet insurance.

A recent survey of risk managers by Advisen found that 71% of AIG commercial-lines policyholders planned to get quotes from AIG's rivals when their policies were due for renewal. Lloyd's insurers, major insurance groups and specialist carriers are likely to benefit from any migration of business. Hiscox, for instance, is planning to increase its 2009 capacity for its Syndicate 33 and launch a new syndicate to capitalise on these opportunities such as this. Insurers will also be able to pick up experienced staff from AIG.

Market cycle

The rating environment is widely expected to change next year, as depressed investment returns, an active hurricane season and AIG's difficulties combine to end the soft cycle.

Insurers are already reporting a hardening of rates in areas such as reinsurance, especially property reinsurance lines, offshore energy and large property risks. Munich Re said recently that it was aiming to increase rates across its book by an average of 10% in 2009. RSA has reported positive rates movement year-on-year in the third quarter across the whole of its UK general insurance portfolio.

Insurers should position themselves to take full advantage of rating movements.

New products and acquisitions

As the previous points demonstrate, there is potential for insurers to reallocate capacity and launch new products, whether to target lines of business that are beginning to harden or to exploit the perceived weakness of other carriers. Expect insurers to push into sectors such as excess of loss, professional lines and large property risks.

Good-quality businesses are likely to go on the block in the coming months. Some of AIG's non-core operations are already on the market and it may still need to sell core general insurance assets in order to repay its government loan. HSBC is looking to sell part of its underwriter business and other banks could look to dispose of capital-intensive insurance businesses. Royal Bank of Scotland continues its search for a buyer for its insurance arm.

Bolt-on acquisitions and large strategic buys could be a useful way to position a company for growth in anticipation of hardening rates. Major acquisitions will be difficult to complete in this market, however. Sale prices will be suppressed.

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Key points

- Insurers with the strongest balance sheets will be at an advantage.
- There will be opportunities to win business and staff from AIG.
- The market will begin to turn in 2009.
- Insurers will move into new lines of business.
- Attractive acquisitions opportunities are likely to arise.

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→ AIG 'close' to asset sales
7 November 2008

→ Reinsurance set to boom
30 October 2008

→ Hiscox adds £210m to syndicates' capital
30 October 2008

→ RBSI tipped to float if CVC sale gets go-ahead
23 October 2008

→ HSBC tipped to sell off underwriting arm
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Capital, but no punishment

The banks needed huge recapitalisation programmes, but insurers aren't like them.

The insurance industry's capital level is under close scrutiny. Investors have become concerned that insurers, like banks, will be forced into massive recapitalisation programmes as falling equity markets and widening corporate bond spreads have eaten away at insurers' capital base. Citigroup says the major European insurance groups have, in aggregate, no surplus capital benchmarked against the level required for an A rating.

Although capital levels are being squeezed, the industry is not facing the same threat of meltdown as the banking sector did a few months ago. It is important to distinguish between insurance companies and banks when judging the health of the sector:

- The banks' problems were caused in part by a crisis of liquidity – ie, the ability of a bank or business to convert its assets into ready cash. Banks' highest quality assets suddenly became impossible to sell in the markets, even though their default risks had not gone up at all. Liquidity is not an issue for insurers; claims, for instance, cannot be accelerated.
- Insurers are also unlikely to face the vicious circle of declining confidence and inability to raise money that caused some major banks to implode. The question of confidence is far less important to insurers than it is for banks. Insurers' need to access short-term lending facilities is limited too. As Citigroup notes, this means it is much more difficult for investors to "force" a recapitalisation.
- The insurance industry is in a much better position now than it was in 2002/2003, the last time the sector had to undergo significant capital raising. Then it was generating a very low return on capital from operating earnings and there were material deficiencies in general insurance reserves.
- Insurers are still operating at a fair margin above regulatory capital levels. Aviva, for instance, had a regulatory surplus of £1.3bn at 24 October, despite £600m being wiped off that figure in the preceding three weeks. RSA's insurance group directive surplus increased between 30 September and 5 November.

Where does this leave the insurance industry? A major recapitalisation of the sector is unlikely. Insurers, particularly the pure-play general insurers, will be able to trade through the current financial difficulties, but some companies will undoubtedly have to raise fresh capital. Credit Suisse said recently: "Despite recent market falls, [European insurers'] capital levels remain robust, with no particular player standing out as particularly exposed relative to the peer group as of today."

The Lloyd's insurers appear to be in a particularly strong position. They have largely avoided exposure to toxic assets and are awash with cash. And while weak equity and bond markets have hit investment performance, much of the pain has related to mark-to-market adjustments on short duration bond portfolios, which will reverse over the next year to two years as the bonds redeem at par. "This leaves the sector with no requirement for new capital and potentially able to return surplus capital to shareholders," according to analysis by investment bank Noble Group.

The FSA and ratings agencies are likely to give the sector some slack in terms of stress testing capital models. Insurers will need to consider how they will rebuild their capital in the next 18 months if they can avoid having to issue new equity. Share buyback programmes are likely to be postponed until 2010 and more reinsurance is likely to be purchased to provide a solvency boost.

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Key points

- European insurers have no surplus capital benchmarked against the level required for A rating.
- Insurers do not face the same threat as banks.
- Insurers should be able to trade through capital crisis.
- Some insurers may have to recapitalise.
- Lloyd's insurers look generally strong.

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- Aviva shares up 15% as it unveils £1.3bn surplus
30 October 2008
- Marsh gathers 200 clients for credit crunch summit
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- Aviva and Prudential shares plunge amid solvency fears
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- FSA relaxes rules for life insurers
16 October 2008
- Industry 'must grapple with Solvency II soon'
2 October 2008

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Obama and the offshore insurers

He has made lots of noise about closing tax loopholes. Does that mean Bermuda?

Barack Obama has a lot on his economic to-do list, but do the president-elect's plans include raising taxes on offshore insurers? During his election campaign, Obama frequently mentioned closing corporate tax loopholes and ensuring that companies pay their fair share. His campaign ran a television advertisement that said: "John McCain went to Bermuda and, while he was there, pledged to protect tax breaks for American corporations that hide their profits offshore." The US government is running the largest deficit since the second world war – a great incentive to increase tax revenues – and the increased Democratic majority in both houses of Congress will make it easier for the White House to push through change.

A bill that seeks to end the perceived advantage of offshore reinsurers over American companies is already before the House, introduced by Richard Neal, a Democratic congressman from Massachusetts, in September. The Neal bill, which would disallow deductions for premiums above an industry average paid to insurance companies not subject to US tax, is backed by a coalition of US-based insurers including WR Berkeley, Chubb and the Travelers Companies. These companies claim foreign-based insurers, such as ACE and XL Capital, avoid taxes on their US business by reinsuring policies written in the USA to Bermuda-based affiliates. This, they claim, gives the companies an unfair advantage.

Bermuda insurers see the Neal bill as protectionist. They reply that they already pay a 1% US federal excise tax on reinsurance transactions and a 35% tax on ceding commissions to the US affiliate for reimbursement of expenses. They also point out that any increase in tax would be passed on to customers in the US. Over the past six years, the Bermudian insurance industry paid \$25bn (£16.9bn) in US property catastrophe claims, the largest share of any non-US market. While they do not pay tax in Bermuda, Bermudian reinsurers also cannot deduct losses. That results in the export from the US of losses that would otherwise be deductible against US tax. Bermuda insurers are privately hoping Obama isn't too keen to move on this issue quickly.

Some are fearful that the topic provides an easy way for congressmen to score political points. Although the Bermudian insurance industry has grown because of the island's fiscal policy, it is now a thriving market and a centre of expertise. For it to be damaged would be a loss for the worldwide insurance industry.

It would be a mistake to think Obama's only concern about the insurance industry is how to extract more tax from it. He also supports a greater federal government role in disaster financing. The Homeowners' Defense Act – proposed by two Democratic congressmen from Florida, Ron Klein and Tim Mahoney – would create a US national pool to fight high costs of insurance for homeowners in hurricane-exposed areas. The idea of a federal backstop is opposed by many US insurers, who want a market-based solution, but supported by some, such as Allstate. Another idea Obama has backed is a tax on large corporations that do not offer health insurance to their employees.

It would be another mistake to think the Obama administration will be the only government looking hard for ways to increase tax revenue. European governments will be doing the same. And many of them will have the insurance industry in their sights.

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Key points

- Offshore insurance could be targeted by the Obama administration.
- Clumsy measures could damage the reinsurance industry.
- Time will tell how high the topic is on the president's busy agenda.

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→ The tax world tour
30 October 2008

→ A heavier touch
21 October 2008

→ Brit: 'We might quit the UK'
27 August 2008

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Coming soon: the hard market

Hurricane and investment losses are tipped to push up reinsurance rates.

The reinsurance market is close to a turning point. Ahead of the 1 January 2009 renewals, it is too early to be certain, but the soft market could soon be replaced by a hard market. And that means reinsurance premium rates will rise.

The reinsurance market typically expects an upturn in rates following a major disaster, such as an especially bad series of hurricanes or the terrorist attacks of 9/11. The last market turn was in 2005, when Katrina and other hurricanes caused massive losses and reinsurance rates rose. Today, severe losses caused by hurricanes are also significant.

The losses from hurricane Ike, which struck in September, were underestimated. Initial estimates by Risk Management Solutions, a natural catastrophe modelling firm, were for \$7bn (£4.7bn) to \$12bn, but it now expects Ike to cost \$13bn to \$21bn. The revised estimate makes Ike the third most costly US hurricane, after Katrina and Andrew.

Ike, even when combined with hurricane Gustav, would probably not be enough to turn this market. But in 2008 there is a second factor: the financial crisis. Insurers have suffered losses on both sides of their balance sheets – on assets as well as liabilities. The credit crunch and the bear stock market have eroded insurers' investments. With weaker balance sheets, insurers are keener to transfer risk to reinsurers. There is, therefore, more demand for reinsurance, which combined with the hurricane losses could drive up rates. In total, hurricanes and the credit crunch are estimated to have cost the insurance industry more than \$50bn. This could well be enough to turn the market.

The general reduction in economic confidence and expectations of a recession will also have an impact. In a recession, claims tend to increase: policyholders are cash hungry and claim more often and more aggressively. This too will tend to drive up rates.

The credit crunch is blamed on a fundamental mispricing of risk. Investors, in their insatiable hunger for higher yields, drove down the price of riskier investments to unsustainable levels in the bull market. That is, they undervalued risk. The current bear market has experienced a reversal: risk is now being valued more highly. This attitude could easily spread to the insurance market, causing risk to be priced more highly there too. Again, this will tend to push up rates.

Just a few weeks ago, market participants thought the soft market would continue. Now they are saying it will harden. How much it will harden is unknown, though it could be between 1% and 10%. Different lines of business will harden by varying degrees. Offshore energy rates, for example, will climb much more steeply than the market average.

The reinsurance market tends to be cyclical. The soft market has been long sustained. A turn may well be due. A confluence of factors may have brought the reinsurance market close to a tipping point. Renewals on 1 January will be studied closely.

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Key points

- The soft reinsurance market may be due to turn.
- The two main factors behind the change are severe hurricane losses and investment losses.
- Additional factors are the recession and a belief that risk was previously priced too low.
- The turn is predicted to happen at the 1 January 2009 renewals.

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→ ACE says soft rates are over
29 October 2008

→ Rates: the market starts to turn
2 September 2008

→ Ratings outlooks could turn after Jan
9 September 2008

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Lessons from the financial apocalypse

Never think risk management is done and dusted. You must reassess it regularly.

The credit crisis has unearthed serious problems with risk management in some financial institutions. Ironically, the crisis has spread from the very industry that created many of the risk management controls subsequently adopted by other organisations. How is it that they managed to get things so wrong? Does it reveal fundamental flaws in the discipline? And what can the rest of us learn from these mistakes?

Many financial institutions that got into trouble were just not getting the basics right. The Société Générale fraud in January was an early warning that something was wrong with the way banks managed their traders. They may have had large and highly professional credit and market risk departments, but clearly their operational risk management wasn't up to much if a single rogue trader could wipe \$7bn off the balance sheet.

These problems came to a head during the credit crisis. Risk management departments were too siloed – and that meant there was no single picture of the total exposure to bad debt. Enterprise risk management (ERM) was meant to bring it all together and instil a culture of risk management throughout the organisation. Despite the fact that rating models had been affirming these programmes for a number of years, some of them clearly weren't working properly.

Why not? The banks had ERM frameworks in place – compliance told them as much – but they weren't properly embedded. These gaps meant the exposures were able to escalate as the market for traded credit products grew. No one, not the regulators, rating agencies or the banks themselves, properly understood the complex debt structures. So what hope was there for the chief risk officer to get a handle on the overall strategic risk they posed?

Instilling a culture of risk management – which means everyone becomes a risk manager – was hard to achieve in banks, particularly as it didn't sit well with the bonus culture that allowed them to make such massive profits during the good times. The money-making traders were often at odds with the nay-saying risk managers. But by absolving responsibility for risk to another department and putting pressure on it to approve transactions, the traders went about their business unhindered, with terrible consequences.

Perhaps this is the most important lesson from the financial apocalypse. Never become complacent and think risk management is done and dusted. It requires regular reassessment. Some of the bankers may have thought the risk was outsourced into the hands of the chief risk officer and therefore it must have been managed. That wasn't the case.

The banks also trusted the ratings agencies too much. They blindly believed the investments were worth what the ratings agencies said they were worth. The lesson here is not to assume ratings are always correct and remember they can change very quickly.

In the future, it might be worth considering an employee's risk management credentials as part of his or her assessment and remuneration. It is a performance criterion that some businesses have begun to include in annual reviews.

Now is the time for reappraising ERM. Financial businesses have shown that even the most mature programmes cannot prevent disaster. But a properly embedded programme allows companies to realise benefits – and they're probably less likely to get into serious trouble. An important lesson is not to rely too much on systems and models, particularly if the underlying information is flawed. Organisations should strive for continuous improvement with their programmes and remember that a culture of risk awareness is vital. In many ways, ERM is more important now than ever.

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Key points

- The firms that got into trouble were not getting basic risk management right.
- ERM was in place but it wasn't properly embedded.
- ERM was meant to instil a culture of risk awareness, but this didn't sit easy with big bonus-driven bankers.
- Risk management requires regular reassessment.
- Now is not the time to give up on ERM.

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- Downturn focuses attention on risk management
11 November, 2008
- ERM still not fit for purpose: PwC
1 July, 2008
- ERM for insurers
11 November, 2008
- ERM in ratings
10 October, 2008

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