

# insurance

A G E N D A



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Just as people have been seizing on positive economic data to call an upturn in the country's fortunes, the insurance industry has been looking for signs that rates are beginning to harden.

Although catastrophe-exposed sectors have seen rates increasing, in other lines of business the picture has been different, with rates continuing to fall.

Recently there have been some positive signs that the market is starting to bottom out, however, and that average premiums are beginning to rise. But, as we discuss on page 2, there are reasons to be cautious: insurers still need to work hard to increase rates to the right level.

Meanwhile, the half-year results season is drawing to a close, and on page 3 we take a look at what the numbers reveal.

Remember contingent commissions? After the 2004 Spitzer enquiry in the US, these remuneration deals were abandoned by the world's major brokers. But they could be about to make a return following an American legal ruling. Nathan Skinner looks at the implications of this development on page 4.

Finally, David Sandham has compiled his top-10 issues facing the reinsurance sector over the coming months.

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## Don't count your green shoots too early

Despite some positive rises in premiums, not all business classes are bouncing back

Is the market beginning to harden? There have been some encouraging signs in recent weeks that premiums are starting to rise.

A recent analysis of commercial lines trading data by software house Acturis reveals that average premiums are beginning to increase in some classes for the first time in months.

In commercial combined, for instance, the year-on-year average premium is now 99% of the value in 2007, up from 96% in 2008. Additionally, the year-on-year comparative by quarter shows the average premium in the second quarter of 2009 to be 5% more than in the same period last year.

Meanwhile, according to Acturis, average premiums in property owners business were up 6% in the second quarter of 2009 compared with the same period last year. This is in stark contrast to the 17% fall in average premiums in the first quarter of 2009 compared with a year earlier.

These are positive signs. But there remain reasons to be cautious. Looking at the Acturis data, other classes of business are not showing the same spring as commercial combined and property owners. The average premium for package business is still declining, with the average renewal premium down by nearly 5% year-on-year (tempered by a near 3% year-on-year increase in new business rates).

Indeed, judging by some of the comments made by the chief executives of the UK's largest insurers during the recent interim results season, there is still serious concern that rates are not rising as much as expected, which does not bode well for this year's and next year's full-year results.

Take AXA chief executive Philippe Maso, for instance. He noted: "We have been expecting rates to increase on commercial lines for more than 18 months. It has not happened as expected."

Allianz UK chief executive Andrew Torrance commented: "While there have been some positive signs in that direction, I am somewhat disappointed that, in the second quarter, the market did not push on from the rate rises applied during Q1 of this year."

He added: "Rate momentum must be regained as we progress through the remainder of the year if insurers are to make acceptable underwriting profits in 2010."

But fundamental market and economic issues are making consistent rate increases difficult. A glut of spare capacity as insurers dump unprofitable business, coupled with fierce competition for new business, are acting to suppress rate increases. New entrants have added to the pressure in certain classes, such as fleet.

Rate increases have also been tempered by a declining demand for insurance – the result of the recession – and by the prevalence of large, powerful brokers and networks.

So while it appears we are at – or approaching – the bottom of the premium cycle, a return to a hard market could still be some way off.

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### Key points

- Average premiums are rising year-on-year in some classes
- But there are still weaknesses in pricing in others
- Insurer chief executives have warned that rates are not increasing as fast as expected and that this will hit profits if not rectified
- Spare capacity, fierce competition between insurers, and depressed demand for cover are tempering efforts to raise rates

### Archive

- AXA pledges to turn its back on poor commercial business, 13 August 2009
- Motor rates set to rise, 13 August 2009
- RSA promises to take action on rates as premium income slides 3%, 13 August 2009
- Green shoots, 6 August 2009
- Dual pricing must end, Insurance Agenda June 2009

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## Number crunching

The major insurers have been reporting their interim results. So what do the figures show?

### Premiums

Business volumes declined for many companies during the first six months of the year.

Revenues fell 4% compared with the same period last year for AXA's UK business; Aviva reported a 21% decline in UK general insurance net written premiums, and RSA's UK net written premiums were down 3%.

Average UK gross written premium (GWP) of European insurers decreased by approximately 2% in the first half of 2009 compared with the first half of 2008, according to analysts.

This decline in premiums is not surprising, and can be attributed to a mix of factors, including lower demand for insurance as a result of the economic downturn, the steps taken by insurers to reduce their exposure to unprofitable business, and lower premium rates.

The economic downturn cost RSA £85m in revenues, says its UK chief. Aviva attributes its notably large decline in premiums primarily to its exiting of poor performing business.

Yet some insurers have bucked this trend. Brit, for instance, increased GWP by 38% in the UK, which it attributes to its "focused distribution strategy". Allianz UK reported a 2.9% jump in GWP.

### Claims

So far, the recession appears to have had a limited impact on claims. What appears to be emerging is a trend towards a more normal claims environment, in contrast to an abnormally benign period that has been evident in recent years.

This transition in the claims environment has resulted in loss ratios generally declining significantly, not just in the UK but across Europe.

Several groups (including AXA and Allianz) reported increases in frequency and severity of loss events when looking at the whole of the group.

Analysis by Citigroup found that the average UK loss ratio for European insurers deteriorated by four percentage points, from 62.8% to 66.8%.

AXA's UK general insurance loss ratio increased to 68.9% in the first half of the year from 62.5% last year; RSA's rose slightly from 62.9% to 63.2% and Aviva's increased to 65.8% from 60.2% according to Citigroup. Of the major European insurance groups, only Zurich improved its UK loss ratio, cutting it slightly to 69.8% from 70.0%.

### Reserves

A comparison of the claims incurred (or booked) by insurers in the first half of the year and the claims paid during the period suggests that reserves are being paid down more quickly than in the past.

For a number of insurers, the claims paid in the period increased more than claims incurred; for instance, Allianz's current-year claims paid increased by 10.6% but the claims incurred (booked) only increased by 1.0%, according to Citigroup.

Citigroup suggests that one reason is that some insurers are now reserving very thinly compared to previous years. The implication of this is that insurers will not be able to rely on reserve releases to boost future earnings – something that has happened in recent years.

Indeed, it notes that reserve release contribution to first-half results has been lower than in the preceding half year. Insurers may only have a reserve cushion of another 18 months in order to bolster results.

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### Key points

- Average UK gross written premium of European insurers declined by approximately 2% in the first half of 2009
- The recession appears to have had a limited impact on claims
- Average UK loss ratio for European insurers deteriorated by four percentage points, from 62.8% to 66.8%
- Indications suggest that insurers are now reserving very thinly compared with previous years

### Archive

- Allianz reports 2.9% jump in GWP, despite retail suffering, 20 August 2009
- Aviva moves into profit after half-year loss in 2008, 13 August 2009
- RSA promises to take action on rates as premium income slides 3%, 13 August 2009
- Brit sees profits wiped out, 30 July 2009

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## Back to the bad old days?

Buyers fear implications of a US ruling that a broker can accept contingent commissions

A legal ruling in the American state of Illinois has raised serious concerns with risk managers on both sides of the Atlantic that controversial contingent commissions may resurface.

After a great deal of lobbying, the Illinois insurance regulator and Attorney-General resolved to allow US insurance broker Arthur J Gallagher (AJG) to accept “retail contingent commissions across all lines of its business”.

The decision has startled risk managers. Buyers had hoped that the spectre of contingent commissions had long been buried. In the past, these payments were made by insurers to brokers on the understanding that the broker would steer a certain amount of business their way. They are not actually unlawful, but following former New York Attorney-General Eliot Spitzer’s inquiry in 2004, most of the big brokers decided to voluntarily give them up.

This new development is a dangerous sign that these payments may start to creep back into the industry. There’s an obvious incentive for brokers to start receiving them again: they could add millions to their revenues. AJG estimated that, by accepting contingent commissions once more, it could add on \$10m in revenue on an annualised basis by 2011.

Buyers are thoroughly against the commissions, however, saying it represents “an inherent conflict of interest”. How can a broker claim to be working on behalf of the client if they are receiving large sums of money on the basis that they steer that business in a certain direction?

The US Risk and Insurance Management Society (RIMS) was the first to give its verdict on the new ruling. It said that contingent commissions can be, and were in the past, “manipulated to the detriment of the insurance consumer”.

And it’s not just American insurance customers who are peeved. The Federation of European Risk Management Associations quickly stepped in and gave its view. It stood by RIMS and said it was “disappointed” with the decision.

The fear is that the ruling could have implications across the industry, in that insurance regulators elsewhere could consider allowing similar practices. Once one big broker decides to accept contingent commissions, the fear is that others will have to follow suit.

Buyers are right to worry. Spitzer was not able to close the book on contingent commissions altogether, and a great deal of smaller brokers continue to receive them. By falling short of an outright ban, many believe that Spitzer left the job unfinished.

The right thing for the industry would have been to ban all types of broker from receiving contingent commissions. But the door was left open for these types of payment to creep back in.

There are positive signs from the big brokers, however. At a recent New York hearing on the issue, Don Bailey, chief executive of Willis North America, said: “If we are truly serious about raising standards in our industry, a formal ban of contingent compensation agreements is the right thing to do.” And, last year, Aon decided that any broker that it bought would have to phase out contingent commissions within three years.

If there’s any hope of an end to the contingent commissions saga, the regulation must be uniform across the industry. But regulators have failed to take a tough stance on the issue. The FSA, for example, recently fell short of even demanding mandatory commission disclosure, which suggests it is a long way off from banning contingent commissions.

Clearly, the biggest worry is that the Illinois ruling opens the door for brokers to amend their contingent commission arrangements. The industry has made some positive moves since 2005 – many of which driven by the big brokers – and this gives hope that, with the right tone at the top, these developments can continue. Full broker transparency in all aspects of remuneration is an essential prerequisite for a healthy and competitive insurance marketplace.

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### Key points

- After heavy lobbying, Illinois regulators said Arthur J Gallagher could accept contingent commissions
- The ruling could have implications elsewhere as other brokers demand similar arrangements
- A return to the bad old days is not a good idea. Contingent commissions represent an inherent conflict of interest
- Full broker transparency in all aspects of remuneration is an essential prerequisite for a healthy and competitive insurance marketplace

### Archive

- US ruling raises spectre of contingent commissions, 17 August 2009
- Buyers demand answers to conflicts of interest, 2 October 2008
- Willis blasts rivals over contingent commissions, 28 July 2008
- Aon seals deal on contingent commissions, 4 June 2008

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## Reinsurance review

The 10 most important developments affecting the reinsurance industry this year and next

### 1. Rates are up – but modestly

Main renewals so far this year have shown a consistent picture, with property catastrophe rates up by between 10% and 15%. 1 Jan 2010 renewals will depend on the hurricane season.

### 2. Reinsurers recover capital

This year's rates increase was mainly down to erosion of reinsurers' assets during the financial crisis and the impact of last year's hurricanes. In the first half of 2009, some reinsurers recovered half of what they lost last year, and this will continue if the financial market further stabilises.

### 3. Cedants examine counterparty risk

Reinsurers' widely varying investment strategies has led cedants to become choosier about which reinsurers they include. Expect this trend to continue, as well as preferring diversification.

### 4. Merger mania

There have been two high-profile mergers recently: IPC, which looks set to merge with Validus, and PartnerRe/Paris Re. Expect stronger companies to opportunistically target weaker rivals.

### 5. Cat bonds recovering

The financial crisis indirectly affected new issues of cat bonds (whereby a bond issue replaces a traditional reinsurance contract) in the second half of last year. But this recovered in the first half of 2009, with nine bonds issued totalling \$1.38bn. There are more bonds in the pipeline.

### 6. Catastrophe modelling

The large footprint of Hurricane Ike in 2008 caught many out, and reinsurers spent the next six months revising their estimates upward. Expect ever-increasing efforts trying to get it right.

### 7. Mother Nature

The 2009 hurricane season is forecast to be moderate, but even if there are only a few storms – one major hurricane among them – striking a highly insured area, it could hurt reinsurers badly.

### 8. Offshore woes

The G20 nations have threatened to clamp down hard on offshore financial centres. Several among them – especially Bermuda – are major centres for reinsurance. But political rhetoric has a tendency to get watered down when it's time for practical action.

### 9. Bureaucrats in Brussels

London faces a proposal by the European Commission to end the Block Exemption Regulation for some forms of co-operation. There is a real danger that, by not fully understanding the unique nature of the subscription market, Brussels could adversely impact London's ability to compete.

### 10. *Wasa* legal case

Reinsurers were encouraged by an historic House of Lords decision on 30 July that means the inclusion in the contract of a "follow the settlements" clause does not bind reinsurers to provide coverage for losses that fall outside the period clause. Expect changes to wordings.

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## Key points

- The reinsurance industry is recovering capital after the financial crisis
- Rate movements will depend much on the results of this year's hurricane season
- More mergers are on the cards, as the industry appears to be in a consolidation phase
- The industry faces political threats from the G20 nations and Brussels

## Archive

- Reinsurers win historic case, 30 July 2009
- PartnerRe to buy Paris Re for \$2bn, 6 July 2009
- July 1 rates up 10-15% in peak zone US catastrophe, 1 July 2009

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