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EXCLUSIVE INSIGHT AND ANALYSIS FROM INSURANCETIMES, STRATEGICRISK & GLOBALREINSURANCE

Michael Faulkner ■ Editor

The financial turmoil continues. A catastrophic collapse of the banking sector has been averted after hundreds of millions of dollars were injected into the sector by the world's governments. The focus of concern has now moved to the insurance sector, with fears over insurers' solvency levels as equity markets plunge. The global economy is teetering on the edge of recession.

Meanwhile questions are being asked about how the financial meltdown could happen. The new chairman of the FSA, Lord Turner, says financial regulators should be prepared to "wipe the slate clean" as they search for a more effective global regime. Insurers and brokers are likely to feel the brunt of the tougher regulatory regime that banks will face (page 2).

The heads of ratings agencies have been sharply criticised by members of the US House of Representatives, which accused the agencies of ignoring warning signs and following the "delirious mob" on Wall Street. Nathan Skinner argues that ratings agencies must be regulated if confidence in them is to be maintained (page 3).

The collapse of Lehman Brothers has also exposed a flaw in the operation of cat bonds as the collateral on some of Lehman's bonds was invested in risky finance products. Reform is needed, says David Sandham (page 6).

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Michael Faulkner • Editor • Insurance Agenda

A heavier touch

The end of light-touch regulation for banks will hit the insurance industry.

The era of light-touch regulation is over. Lord Turner, the FSA's new chairman, last month signalled the arrival of a tougher regulatory regime in response to the financial crisis. "There will be more people asking more questions and getting more information than we were getting before. There is no doubt the touch will be heavier," he said in a recent newspaper interview.

The FSA, he said, had been "over-deferential" to criticisms of too much bureaucracy. Over-regulation and red tape had been used as a "polemical bludgeon". Regulation, meanwhile, had been done "on the cheap".

Things are going to change. How the FSA under Lord Turner will work has been painted only in the broadest of terms, however. Areas such as capital adequacy, liquidity and mark-to-market accounting will all come under review.

Although Lord Turner's comments were aimed at the banking sector, the insurance industry is unlikely to escape the glare of this tougher regime. "If you change the guiding principles for banks, then it should apply to other financial institutions," warns Bryan Joseph, global actuarial and insurance management solutions leader at PricewaterhouseCoopers.

The regulator's main focus will be on the high-impact firms, such as banks and insurers, that present a systemic risk to the market. These firms could have their capital requirements raised and be subjected to much more stringent stress and scenario testing of the models they use.

The FSA has already stepped up its scrutiny of insurers amid concerns that the crumbling investment markets are putting their solvency levels under pressure. It is likely that insurance companies will receive more FSA Arrow visits and will be required to disclose more information.

Even low-risk firms, such as insurance brokers, could be subjected to a higher level of scrutiny, although the amount remains to be seen. The insurance industry will also be expected to pay for this additional level of supervision, so fees will rise.

This toughening of the regulatory regime will have consequences. In recent years, London's status as a global financial centre has been questioned as rival jurisdictions, such as Bermuda and Ireland, have increased in popularity.

The UK's tax and regulatory regimes have been central to the debate on London's competitiveness, with the insurance industry lobbying hard for lower corporate taxes in particular. A number of insurance businesses have already re-domiciled, including Hiscox and Kiln. Others, such as RSA and Brit, are looking closely at it.

The FSA's policy of light-touch regulation, under Lord Turner's predecessor, had won widespread praise for allowing the City of London to prosper. The danger is that a tougher and more costly regulatory regime will only speed up the exodus of businesses from the UK, which could damage the standing of the London insurance market in the longer term.

There could well be a high price for better regulation.

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Key points

- Tougher regulation of the banks will affect the insurance industry. Insurers are likely to face more scrutiny from the FSA.
- There will be a greater focus on solvency.
- Tougher regulator regime could affect the UK's competitiveness. Insurers may re-domicile to jurisdictions with lighter regulation.

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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

➔ Return to Solvency II
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➔ 'Solvency II must change'
16 October 2008

➔ To regulate or not to regulate?
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Nathan Skinner • Assistant Editor • Strategic Risk

Not quite AAA

Regulation is needed to salvage the credibility of the ratings agencies.

The financial crisis has raised serious questions about the ratings agencies. The agencies are meant to monitor company finances, so why didn't they identify the problems before the meltdown happened?

Regulators have launched inquiries to find out. One investigation by the US Securities and Exchange Commission (SEC) unveiled "significant problems" with ratings agencies. The SEC found that the agencies too readily accepted the information they were given by companies, didn't ask the right questions or probe deep enough, and were too tied in with the products and companies they were rating to provide objective analysis.

The trouble is that a handful of agencies are assigned to rate thousands of listed companies, so corner-cutting is inevitable. They also have difficulty holding on to the best talent because there are better-paid jobs available in banks. All this can make understanding, let alone rating, complex securities a problem.

The most popular grumble is that the providers of ratings are funded by those they seek to pass judgment on. Insurers and banks pay for a rating on a product and, if it doesn't fly, there's no money for the ratings agencies. That's why there's such a lull in business now; with bank lending frozen solid, there's nothing for them to rate.

These issues were compounded when it came to assessing the financial strength of the structured credit products that hid so many of the problems associated with subprime mortgages. Analysts should have been making aggressive downgrades against all the bond insurers that were taking on the toxic waste – not least AIG.

Instead of doing that, as the sector began to boom, the agencies, overcome with requests for ratings and eager to get in on the action, helped the banks shift their bundled debt products by giving them a favourable rating. By not turning investors off the products that turned out to be sour, they helped foment distrust in the system. It's that loss of confidence that has caused so many problems.

But the regulators deserve to bear their share of the blame for the failure of the ratings system. So far, none has come up with a foolproof model for supervision. The consensus, however, is that codes of practice are not good enough and tougher regulation is required. The SEC has been the strictest, but all it has agreed is a set of proposals that have yet to be implemented thoroughly. The French regulator, Autorité des marchés financiers, is in favour of registration and monitoring and is keen to push the European Commission forward with its plans to regulate the agencies. The FSA has been conspicuously absent from the debate, claiming ratings agencies are nothing to do with it.

In an effort to avoid tougher regulation, the ratings industry has agreed a voluntary code of practice to improve transparency and reduce conflicts of interest. It was formulated in July by an agency working group, part of the Securities Industry and Financial Markets Association (SIFMA). While they are wary of more bureaucracy, the agencies do accept that enhanced oversight could help restore market confidence in the ratings they provide. Most market participants agree that more disclosure around how the agencies come to a rating decision is overdue. Stricter rules may also help address some of the conflicts of interest.

Until the rules are agreed and enforced, risk managers and brokers need to be cautious when it comes to relying on the advice of the agencies. Insurers should heed the same advice and weigh up much more seriously whether investments, particularly complex debt structures, are as bombproof as their ratings suggest.

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Key points

- A commercial rating is just one factor that risk managers, brokers or insurers should use to assess financial strength.
- The loss of confidence in the rating system is a key contributing factor to the financial crisis.
- Voluntary codes of practice are no good. Proper regulation is required, but this should not be burdensome.
- Ratings agencies accept that good regulation will help restore confidence in the system.

Archive

➔ ERM in ratings
9 October 2008

➔ AIG's ratings remain unchanged
19 September 2007

➔ AM Best downgrades Lehman Re
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➔ S&P: More write-downs on the way
22 September 2008

➔ Why risk management has not failed
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David Sandham • Editor • Global Reinsurance

AIG asset sale: the clock is ticking

Time pressures and the market crisis will drive down prices.

AIG is in a race against time to sell off assets to repay government loans currently totalling $123bn (£74.7bn). Although faced with formidable obstacles, the AIG asset sale could be completed, if the price is right.

The insurer is undertaking a massive asset sale – about half the company – and finds itself in a highly unattractive negotiating position. It is a forced seller in a falling market, under pressure to complete quickly. This is compounded by the fact that potential buyers will not find it easy to raise capital in current financial conditions.

The time pressures include the countdown on its government loan and the eroding effects of loss of staff and of customers. The term of the US government loan is two years. That should usually be enough time; however, the government loan attracts a high interest rate of three-month Libor plus 8.50% – far more than AIG is accustomed to paying on its corporate debt. The longer the loan remains outstanding, the more expensive it will be.

Meanwhile, rival companies are making active efforts to poach key AIG staff and have not been shy about targeting AIG clients. So AIG is attempting to sell wasting assets.

There are a number of factors in AIG's favour, however: insurance industry buyers may also want to conclude deals quickly. The credit market shows signs of turning, which will help buyers raise funds for acquisition. Regulators are also likely to quickly wave through the sale of AIG assets.

One tactic for buyers would be to hang tough, waiting to pick up assets cheaply as the pressure on AIG intensifies. This tactic could be used by private equity companies, but insurance buyers are unlikely to avail themselves of it. Trade buyers will be concerned to preserve the franchise of the businesses they are buying: they would be motivated by a speedy purchase, while key staff remain on board. Even large mergers and acquisitions can be agreed quickly and due diligence can be completed, with focused effort, in three or four weeks. Regulatory approvals usually take longer, but regulators both in the US and internationally may expedite matters in the light of their governments' efforts to solve the credit crisis.

Companies such as Allianz, Munich Re and the Prudential are actively interested in the opportunities offered by the AIG asset sale. AIG's Asian assets, for example, offer an exceptional chance to access the fast-growing Asian market. Companies could raise the necessary cash by rights issues and, at the time of writing, the credit market shows signs of easing.

AIG is unlikely get a good price, however. Life insurers, for example, are trading at a substantial discount to their embedded value, compared with a premium over the past few years. AIG could turn out to be selling at the bottom of the market: if buyers believe that, that is precisely why the asset sale could get done.

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Key points

- AIG is in an unenviable position as a seller and is unlikely to command good prices for the assets it sells.
- Insurance companies are likely to want to take advantage of the opportunity, so AIG could well succeed in selling off major assets.
- Expect to see major disposals announced within the next six months. If not, something has gone badly wrong.

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➔ AIG could need even more cash
24 October 2008

➔ Pru eyes further AIG sale
24 October 2008

➔ AIG humbled over 'junkets and perks'
17 October 2008

➔ "This is not a fire sale" – Ed Liddy
3 October 2008

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Broker M&A activity is not dead yet

Credit is still available for sensible deals, but the terms are tougher.

After the frenetic pace of consolidation in the first quarter of 2008, mergers and acquisitions in the broker market appear to have all but ground to a halt as the economy heads towards recession. But there are some positive signs. Here are five reasons why the situation may not be as bad as it seems.

1. First quarter of 2008 was exceptional

In the first quarter of 2008, there was an exceptionally large number of smaller acquisitions below £40m in value. It has been 10 years since there was a similar level of activity in relation to deals of this size, according to analysis by Corbett Keeling, which advises on mergers and acquisitions.

The large number of acquisitions in the first three months of the year was due to the rush to complete acquisition before the changes to capital gains tax, which abolished taper relief, were introduced in April.

2. Smaller acquisitions are still taking place

Oval recently made two smaller acquisitions and has more in its pipeline, while Bluefin has indicated that it has more deals to come.

IMAS, a financial services corporate adviser, says the number of acquisitions has fallen back to 2005 levels – one or two a month. Whether it will remain at this level or slow further remains unclear. The economic situation will be a major factor.

Large acquisitions are still taking place. Aon's £900m acquisition of Benfield has been given the green light by regulators. AXA acquired SBJ earlier in the year. Further major deals could also take place this year, such as the sale of the bulk of IAG's UK businesses and the disposal of Royal Bank of Scotland's insurance arm, following interest from private equity.

3. There is still credit available for the right deal

Oval's £115m refinancing deal demonstrates that banks are still willing to lend, although credit terms are tightening and a sound business case is needed. Banks will be more likely to provide financing for individual acquisitions, rather than a war chest for a series of purchases.

Club-style debt facilities backed by a number of banks (such as Oval's refinance) are more difficult to pull together than has previously been the case. Banks will want to see that the acquisition is a sensible one and that the management has a good track record. Oval's management is well known and has produced good results.

"Borrowers need to show that the acquisition stacks up," says Sebastian Kafetz, relationship manager at Lloyds TSB Corporate Markets.

4. Prices have come down

More realism is returning to the market in terms of the prices paid for brokers. In the past year, prices had soared to as much as 15 times the broker's earnings before interest, tax, depreciation and amortisation (EBITDA). The high valuations had been fuelled by the prices some buyers were willing to pay for strategic acquisitions, the availability of credit and the expectations of sellers. The tightening of credit terms has dragged down prices to more sensible levels. IMAS says typical valuations are 1.7 times brokerage, which would equate to about four times EBITDA.

5. Foreign buyers are eyeing the market

There are indications that investors from Japan, Singapore, Hong Kong and the Middle East may be tempted to acquire UK brokers now that prices have declined.

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Key points

- Smaller value broker acquisitions are still taking place.
- Financing is available for sensible deals.
- Broker valuations are returning to realistic levels.
- Foreign businesses are considering acquisitions in the UK.

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➔ Hodson: Oval will not squander war chest
15 October 2008

➔ Oval seals £115m debt deal
16 October 2007

➔ Big merger activity dries up, but for how long?
9 October 2008

➔ Towergate renegotiates banking covenants
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➔ Gallagher confirms Oxygen acquisition
16 September 2008

➔ Most broker mergers don't work, says survey
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Cat bonds must be reformed

More control is needed over the investment of collateral funds.

One of the much vaunted advantages of cat bonds has been their full collateralisation. In traditional reinsurance, no collateral is offered to the cedant. In contrast, when a cat bond is issued, the investors' money is held as collateral. This collateral is released to the bond's sponsor (the cedant) in the case that the trigger event (storm, earthquake and so on) occurs. If the bond is not triggered, then the money is returned to investors on maturity of the bond. All good for cat bonds, you may well think.

Now, it turns out, to many people's surprise, that the money held as collateral for some cat bonds has been invested not, as might be expected, in low risk securities such as treasuries, but in subprime-related debt. This has only come to light because Lehman Brothers filed for Chapter 11 protection on 14 September and was unable to continue in its role as total return swap (TRS) counterparty on four cat bonds. (A TRS is a way of guaranteeing the bond: the guarantees, in the case of these four cats, are now likely to be worthless.)

The four bonds, the total value of which was three quarters of a billion dollars, are now in default. They are: Newton Re Series 2008-1 (sponsor Catlin), Willow Re Series 2007-1 (sponsor Allstate), Ajax Re Series (sponsor Aspen Re), and Carillon Series 1 (sponsor Munich Re).

Details of what the collateral funds were invested in have not been revealed, but it is understood to include, in at least some cases, mortgage-related collateralised debt obligations (CDOs). Again, it has not been revealed at what level these investments now stand, but it is understood that, in some cases, they stand considerably below par.

Therefore, if a trigger event were to occur, the full amount of money invested would not be available to pay sponsors. Equally, if there is no trigger event and the bonds mature, the bond investors will not, as things stand currently, get their principal back in full – even though the event they were insuring against never happened. While there is no suggestion of any wrongdoing, this is clearly not what investors expected.

Cat bonds need to be reformed. In particular, much greater transparency is necessary if the sector is to continue to flourish as it has done over the past few years. Currently, if an investor seeks to buy a cat bond in the secondary market, there is no way for that investor to find out what the underlying assets are invested in, whether treasuries, CDOs or CDO variants. That must change.

Michael Eakins, executive director, insurance financing group, at Goldman Sachs, suggests transparency could be increased by using online data rooms. The online data room would be kept live throughout the term of the bond and any information required to be shared with investors would be posted there. He also suggests that the rules governing investment of assets underpinning the TRS for cat bonds should be strengthened: certain structured asset classes should be excluded. In addition, there should be frequent marking to market, with collateral being posted below threshold levels and potentially independent third-party review of the asset valuation.

Cat bonds are a great financial invention. It would be a shame if the collapse of Lehman Brothers led to any sullying of their reputation. Rapid reform should ensure it does not.

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Key points

- One of the advantages cat bonds have over traditional reinsurance is full collateralisation.
- However, there has been insufficient transparency over what the underlying assets are invested in.
- Problems have emerged because of the collapse of Lehman, which guaranteed four cat bonds.
- The way forward involves more transparency and stronger rules.

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→ World Economic Forum issues ILS ideas
9 October 2008

→ S&P issues report on nat cat ILS ratings
1 October 2007

→ Cat bonds are here to stay
9 September 2008

→ $5bn new cat bonds for 2008?
Global Reinsurance, September 2008

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Michael Faulkner • Editor • Insurance Agenda

Where next for aggregators?

Personal lines insurers should examine their strategies on price comparison sites.

Norwich Union's decision to stop distributing its products through price comparison websites was bold and surprising. It also represents something of a watershed in the debate on personal lines distribution.

NU has been coy about its reasons, saying only that as a direct insurer it wishes to deal direct with clients rather than be one step removed. It is undoubtedly a blow for the aggregator sector to be rejected by a major brand. It also indicates that price comparison sites do not necessarily have to feature in a company's personal lines distribution strategy (whether NU's move is successful remains to be seen, however).

The market share of price comparison sites has increased rapidly over the past three years. At the same time, insurers have used aggregators to boost premium volumes. Medium-sized insurers in particular have increased premium volumes by using aggregator sites as a primary distribution channel. AXA, Esure and Admiral have delivered strong growth in their motor books thanks to this medium, according to analysis by Deloitte.

But the websites have been criticised for their impact on profitability, as the price transparency they bring has suppressed premiums and increased customer churn. One executive at a personal lines insurer described aggregators as a disaster for the industry.

It is too early to tell whether aggregator business is less profitable than business from other channels. Aggregators have only started to produce significant volumes of business in the past couple of years, so there has been insufficient time to conduct meaningful analysis. It is also difficult to isolate aggregator business from other channels.

Will others follow NU's lead? For smaller or niche insurers, aggregators are a powerful tool, giving them access to customers they could not otherwise reach in a cost-effective way. Aggregators also enable insurers to quickly build a portfolio in a particular niche. As such, the websites are likely to be of value to these companies. "Unless you have the scale of NU, it is a tough model to ignore," says Stephen Ross, a partner at Deloitte.

For larger insurers with multiple distribution platforms, the situation is not so clear-cut. These companies have the brand strength and financial muscle to compete without aggregators. If the larger insurers are spending money on marketing across other distribution channels, why spend extra to deal with aggregators? Price comparison websites also separate the insurer from the customer, which is undesirable, and diminish customer loyalty, which adds to overall acquisition costs.

"Aggregators have been spending more [on marketing] and need to recoup the money to maintain their margins," points out Clare Ryder, managing director of Salient Solutions, an insurance consultancy.

The question for the larger insurers is whether the additional business that aggregators can provide is worth the extra cost. NU clearly thinks it is not. In contrast, Royal Bank of Scotland has put its insurance brands, except Direct Line, on one aggregator site.

We don't yet know how the major insurers will adapt their personal lines distribution models. But larger companies should be reviewing their strategy, considering whether to work with the comparison sites at all or reduce their exposure. They need to consider the strength of their direct capabilities against the income that can be derived from aggregators.

In response, aggregators should be looking to develop their business model and considering ways to boost their revenues, such as offering premium finance services or cross-selling additional products.

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Key points

- Price comparison sites have enabled insurers to grow their business volumes.
- It is difficult to determine the profitability of aggregator-produced business.
- Smaller insurers will continue to use the websites.
- Large insurers will consider their involvement with aggregators. Some will scale back or withdraw from placing their products on the sites.

Archive

→ Battle of the clicks
2 October 2008

→ Norwich Union looks to deal direct as networks come under spotlight
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→ Comparison websites defend their prices after Which? criticism
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