STANDARD & POOR'S

ROOM AT THE TOP

Look at this year's top 50 list and it appears much the same as previous rankings. But not for much longer, says **Nigel Bond**. Sales and restructuring mean significant changes are on the way

What are the key features of this year's list?
Each year, Standard & Poor's Ratings Services compiles this list of the top 50 UK non-life insurance groups and, each year, the groups and their positions remain virtually unchanged, especially at the top.

But take a close look at this year's list on pages 16-37 and you'll see that there may be some significant changes to come. For example, the credit crunch has led to Royal Bank of Scotland putting its insurance operations up for sale. It is possible, therefore, that the third largest group in the list for 2007 will disappear by 2009 and, depending on the buyer, will be replaced by a new name or by an existing, lower-ranked group jumping up the list.

Similarly, restructuring within the groups that own the UK insurance operations of AIG (sixth in 2007), HBOS (12th) and Fortis (17th) may result in further significant changes. HBOS is being acquired by Lloyds TSB, which, based on the 2007 figures, would create an insurance group ranked in the top 10 with aggregate gross written premium of £1.7bn. Meanwhile, the continued ownership by the AIG and Fortis groups of their respective UK insurance operations is not assured. Plus, Liverpool Victoria (26th) has just bought Highway (38th), thereby creating a group that would have ranked 22nd in 2007, with nearly £600m in gross written premium.

This means there is an unprecedented opportunity either to enter or to expand in the UK non-life insurance market, reshaping its competitive landscape.

> 'The third largest group in 2007 could disappear by 2009 and, depending on the buyer, be replaced by a new name'

What about the performance of the market?
Look at the table on page 42 ("10-year perspective of UK insurance companies") and you will see that the market made an underwriting loss of £354m in 2007 after four successive years of profit. This result, however, includes a gross incurred loss of more than £3bn from the floods last summer, so we can assume that the underlying performance was, in fact, profitable. Nevertheless, the reported net combined ratio of 101% was the weakest since 2002 (103%) and ended six years of continuous improvement.

In total, the market made a pre-tax profit of £3.7bn, which continued a long trend of pre-tax profitability. However, its pre-tax return on equity of 8.6% was the lowest since 2001 →

Understanding combined ratios

Financial analysts looking at non-life insurers use various ratios to assess the underwriting performance of a company or group. One of the most common is the combined ratio, which is essentially made up of two components: the loss ratio and the expense ratio. All of these ratios can be measured on both a gross of reinsurance or net of reinsurance basis, although the net ratios are the most widely used.

While there is no universal standard for its calculation, the net combined ratio in these tables is the sum of the net expense ratio and the net loss ratio. The net expense ratio, in turn, is the sum of the commission and underwriting expenses as a percentage of net written premium and measures the efficiency of a company's operations in relation to its overall premium base: the lower, the better.

The net loss ratio, meanwhile, →

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→ (6.4%). So 2007 was a weaker year, but not a disastrous one.

Dig a little deeper and there is cause for more concern. In 2007, the market released a massive £2.8bn of prior years claims reserves (see the box that starts on page 7, Understanding combined ratios, for an explanation of the terminology). In fact, 2007 was the third successive year of large prior years claims reserves releases, which have enabled insurers to report net combined ratios lower than their accident year performance.

'The market has been generally softening since 2005, causing accident year underwriting profit margins to shrink'

Premium rate development

(%)	FY 05	H1 06	FY 06	H1 07	FY 07	H1 08
Personal motor						
Aviva	4	2-5	5	8	6	5
RSA	3	4	4	5	6	5
Personal property						
Aviva	6	6	3	5	7	10
RSA	5	6	6	5	5	5
Commercial motor						
Aviva	-1	-2	-2	-2	-1	3
RSA	-6	-2	1	4	8	8
Commercial property						
Aviva	-1	-3	-3	-2	-2	2
RSA	-4	-3	-4	0	3	4
Commercial liability						
Aviva	-1	-4	-6	-6	-4	2
RSA	-7	-7	-9	-1	-1	2

Source: group news releases

The ability of the market to continue to do this is, in our opinion, diminishing. This will accentuate the weak accident year performance and, hopefully, prevent any further erosion of pricing.

Are prices a problem, then?
At the risk of over-simplification, yes. The market has generally been softening since 2005, causing accident year underwriting profit margins to shrink. In reaction to this, there is evidence that some underwriting capacity has been withdrawn from certain lines, and several of the largest groups, such as Aviva, RSA and Allianz, have said they are raising their premium rates.

Take Aviva, for example, the leading non-life insurer of UK risks (Lloyd's is much larger overall, but not when it comes to just UK risks). In its half-year results for 2008, Aviva talks of its UK business continuing to →

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Understanding combined ratios

→ is the net losses incurred as a percentage of the net earned premium and measures the profitability of the underwriting activity: again, the lower, the better. The net combined ratio, therefore, in essence measures the operating margin of an insurer: a ratio below 100% generally indicates a profit, above a loss.

Compare, for example, the 2007 reported year loss ratio and combined ratio of Direct Line Insurance with Hiscox Insurance. Both have similar combined ratios (93.4% and 92.3%, respectively), but the loss ratio of Direct Line is 78.2% while that of Hiscox is 51.3%. The two companies have, therefore, very different expense ratios, which can be largely attributed to their different methods of distribution, namely direct client contact for Direct Line and mainly through intermediaries for Hiscox. Both are profitable, but they get there in different ways.

To complicate matters, though, financial analysts also refer to prior years claims reserves movements and accident year performance. In essence, this is an attempt to remove distortions from the reported loss and combined ratios caused by changes that are recognised in the latest year for losses that were incurred in years before the latest year or accident year. This enables the analyst to arrive at a purer view of current underwriting performance.

For example, Royal & Sun Alliance Insurance reported a net loss ratio of 64.7% in 2007. This, however, included 12 percentage points benefit from the release of £346m of claims incurred before 2007. Its accident year loss ratio, therefore, was 64.7% plus 12%, or 76.7%. If Royal & Sun Alliance Insurance had needed to increase, instead of decrease, its prior year claims reserves, its reported loss ratio would have been 76.7% plus 12%, or 88.7%.

Understanding solvency and investment leverage

The analysis of a non-life insurer's solvency is becoming increasingly sophisticated. However, a simple tool enables us to establish a quick, if crude, view of an insurer's financial health.

Called the solvency ratio, in the accompanying tables it compares the net written premium with the adjusted shareholders' funds, although elsewhere you may sometimes see this ratio inverted. The ratio measures a company's overall underwriting exposure (premiums are used as a proxy for risk exposure) relative to its capital base.

In general, the higher this ratio, the greater the risk exposure for the insurer in relation to its shareholders' funds. Gross premium is occasionally used when there is some concern about the recoverability of reinsurance. The ratio is, however, less useful at times of rapid changes in premium rates.

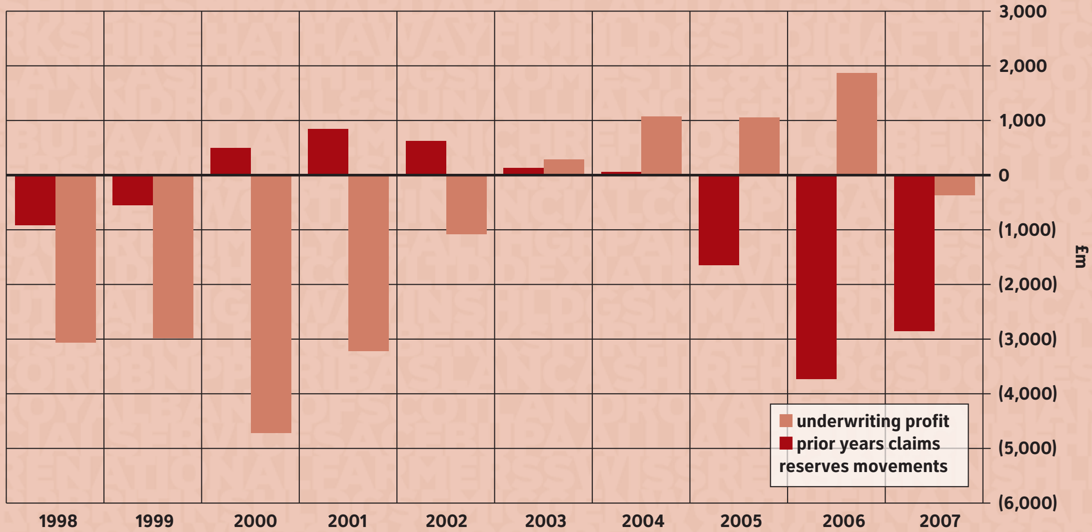
Investment leverage measures the exposure of an insurer's capital base to movements in invested assets that are primarily affected by market risk. In the accompanying tables, it is calculated as the sum of equities and property as a percentage of adjusted shareholders' funds. In general, the higher the ratio, the greater the exposure of the company to market risk in relation to its capital base.

If leverage is 100%, it suggests that if an insurer's equity and property portfolio loses 10% of its value, then the insurer will also have lost 10% of its capital (and vice versa).

The ratio does not take account, however, of the underlying volatility of the portfolio or any hedging that may be in place.

Underwriting profit vs prior years claims reserves movements

A negative figure for prior years claims reserves movements indicates a release and a positive figure strengthening of prior years reserves.



→ experience "challenging market conditions". In response, the insurer reported that it put in place annualised rate increases during the six months to 30 June 2008 of 5% for personal motor, 10% for personal property, 3% for commercial motor, 2% for commercial property and 2% for commercial liability. A similar picture emerges at RSA (see the table, Premium rate development, on page 8).

The question is, are these rate increases enough? Without being too scientific, it is not difficult to see that, with the consumer prices index running at about 5% this year, these rate rises, in the absence of changes in terms and conditions, have probably just stabilised profitability, not improved it. Of course, not all insurers have followed these increases. Indeed, Allianz made a telling comment in its interim results for 2008, saying: "The underlying profitability of the business we are writing today is unsatisfactory … [although] the market is starting to move in the right direction, albeit more slowly than we would like."

> 'The market is much less exposed to risk than it was when the stock market last peaked'

The weaker economy and stock market don't help either?

That's right. With underwriting margins struggling to recover, non-life insurers now have to stand up to the strong headwinds of a weakening economy and a very weak stock market performance. Broadly, deteriorating economic conditions mean slower or even negative real exposure growth, higher inflation and increased moral hazard, all of which could lead to lower profits. In this environment, it will be crucial to manage costs without sacrificing customer service.

As for the very weak stock market, the top 50 table on pages 38-41 and the 10-year table on page 42 show how exposed the leading groups and the market are to the performance of the equity and property markets. If you look at the top 50 column headed Property + equities/ASF (see Understanding solvency and investment leverage, left), you will see that the market's investment leverage was 36.9% in 2007, significantly lower than the 71.8% of 2000.

This means that, in aggregate, the market is much less exposed to market risk than it was when the stock market last peaked. Nevertheless, there are some companies that were heavily exposed at the end of 2007, including Direct Line (105.7%) and National Farmers (102.5%).

But how does this affect their solvency? Well, in aggregate, the market is more resilient than in the past. Although Standard & Poor's (and the companies we rate) assess solvency on a more sophisticated basis, the solvency ratio shows a healthier picture at the end of 2007 (80.8%) than at the end of 2000 (132.1%).

Ally this with the better investment leverage, and you can feel more comfortable today about the market's solvency as a whole than you might have in 2000. But the pressure on solvency is mounting and it is this that gives us a degree of confidence that premium rates will rise in order to improve underwriting performance. **IT**