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EXCLUSIVE INSIGHT AND ANALYSIS FROM INSURANCETIMES, STRATEGICRISK & GLOBALREINSURANCE

Michael Faulkner ■ Editor

It has taken many years, but the issue of whether brokers should be forced to disclose their commission to commercial customers has been resolved – well, nearly. The FSA has accepted an industry solution to the problem, lifting the threat of costly and burdensome regulation. Danny Walkinshaw assesses how brokers will have to change their businesses practices (page 2).

Meanwhile, the development of Solvency II, the pan-European solvency regime, continues to be anything but smooth. The latest setback could completely undermine the proposed legislation and, at the very least, is likely to delay its implementation. Ellen Bennett explores the implications for the industry (page 3).

Last year was the second most costly year ever for catastrophe claims ($50bn, or £34bn, according to Swiss Re) and the performance of catastrophe modelling software has come under fire. The software has some significant limitations but, as David Sandham explains, improvements are on the way (page 4).

The consolidating brokers are coming under pressure as insurers look to rein in commission growth. After years of calling the shots, they must adapt their business model (page 5).

Also in this issue, Nathan Skinner argues that risk management has never been more important (page 6).

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Danny Walkinshaw • Chief reporter • Insurance Times

Cheap and finally cheerful

Brokers are welcoming the industry-led solution on commission disclosure

The FSA has seemed obsessed with improving transparency in the commercial insurance market for years. Only now are brokers beginning to understand how the regulator hopes to achieve this.

After a cost-benefit analysis, a lengthy discussion paper, customer research and a period of "thematic work", the FSA has backed down from its early threats of compulsory disclosure, leaving many in the market wondering what all the fuss was about.

The regulator has now agreed to accept an industry-led solution on commission transparency. Industry guidance – guidelines on achieving the objectives required by the regulator – are being finalised.

How will this affect brokers in their day-to-day dealing with clients? They simply need to continue what they're doing now, but with greater clarity and added focus. The industry must prove to the FSA that the methods used in transactions give customers every opportunity to ask the broker to disclose its commission earnings.

Similar to the way they record information to meet the FSA's Treating Customers Fairly rules, brokers will need to work with precision. The FSA has already set out guidelines on how it will know if its new five outcomes have been achieved.

It says it will survey commercial customers in 2010 or 2011 to gather if they are getting "clear information about the nature of the intermediaries' services, capacity and remuneration and how they are using it". Separately, it will begin a period of supervision, testing brokers on the changes they have made to business processes and systems.

The FSA will be keen to see evidence of the guidance prompting customers to ask a broker to reveal their remuneration arrangements. In instances where firms complete transactions over the phone, brokers will need to tell customers of their rights verbally. A written statement will be given if a transaction is undertaken electronically or manually.

Those close to the negotiations on the industry guidance say the costs of implementing the new system will be minimal compared to the huge costs of any FSA-introduced mandatory disclosure. Terms of business agreements are likely to need amendment, but the expense is not expected to provoke great concern.

As with contract certainty, the industry has put forward its own solution. Brokers will learn the details at some point in the first quarter of this year but will hope that, with another two years of FSA deliberation on the cards, this finally settles the matter.

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Key points

- Brokers will follow industry guidance rather than being obliged to disclose their commission
- Bigger emphasis on customers' right to find out brokers' commission
- New guidance will add "minimal" cost for firms
- Industry guidance will be finalised and approved in the first quarter of this year
- FSA will assess findings in 2010 or 2011

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➔ Brokers given chance to test guidelines on disclosure
18 December 2008

➔ How disclosure could shape the market
14 August 2008

➔ Biba and IIB join forces to lobby FSA
10 July 2008

➔ FSA will back down on mandatory disclosure
29 May 2008

➔ VP chief speaks out over disclosure
22 May 2008

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Ellen Bennett • Deputy editor • Insurance Times

Solvency gap

A squabble may derail the EU legislation. Insurers must fight to keep group supervision

Getting a piece of legislation through Europe is a little like herding cats, so it should be no surprise that Solvency II has come a cropper. Group supervision, a key provision that would allow multi-national insurance groups to be regulated primarily in their domestic territory, has fallen victim to a turf war between European countries. The smaller states are scared they would play host to insurance companies over which they had little or no regulatory control, but be left to pick up the pieces in the event of any AIG-style disaster. This point of view has won the support of the French, who held the European presidency in the second half of 2008, and thus the backing of the European Council of Ministers. But the European parliament holds the opposite view – and the two bodies must agree for the regulation to pass into law. Now the Council of Ministers is playing for time as frantic negotiations take place behind the scenes. There is a real risk that the implementation date of 2012 will be missed.

Not only that, but the concept of group supervision is in serious danger – and it is crucial for insurers that it goes ahead. Group supervision will enable the free flow of capital across jurisdictions and offer equal protection to all policyholders, regardless of nationality or borders. It should not be sacrificed to a squabble between countries worried about their own status and power.

Luckily, the European parliament is standing firm. Peter Skinner, the British MEP in charge of steering through the legislation, has said there will be no Solvency II without group supervision. No doubt he is stalling in the belief that the Czech presidency, which started on 1 January, will be more sympathetic and that an agreement with the Council of Ministers can be hammered out, probably by including important guarantees for local supervisors that lead supervisors will consult with them effectively.

He needs the support of the insurance industry and he needs to know its views. This is not the time to sit back and wait: insurers should use the cumbersome European legislative system to their best advantage and fight hard to keep this legislation in the right form, at the right time.

Incidentally, this is also an opportunity to revisit any other provisions that are looking troublesome in light of the recent economic tremors – such as mark-to-market accounting. As Philippe Maso, chief executive of AXA Insurance, has pointed out in *Insurance Times*, valuations could be artificially low at times of market turmoil. Insurers would have to hold on to more money to meet potential claims, or risk being declared insolvent.

Now that Solvency II is back on the table, insurers can make this argument again – this time with an economic backdrop that will lend massive credence to their views. They must be heard.

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Key points

- The provisions for group supervision in Solvency II are at serious risk because of a turf war between European member states
- The 2012 implementation date could be missed
- The European parliament is fighting to keep group supervision and needs the support of the insurance industry
- This is a good time to bring back to the table arguments about mark-to-market accounting

Archive

➔ Solvency II hits buffers as EU ministers ditch group proposals
4 December 2008

➔ ABI pleas to save Solvency II
19 November 2008

➔ 'Solvency II must change'
16 October 2008

➔ Industry 'must grapple with Solvency II soon'
2 October 2008

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David Sandham • Editor • Global Reinsurance

Ike and the trouble with cat modelling

The software that estimates hurricane losses is flawed, but there's hope on the horizon

Catastrophe modelling has been getting some bad press over the estimates for last year's hurricane losses. Risk Management Solutions (RMS), one of the leading vendors of cat modelling software, almost doubled its initial loss estimate for Ike, which turned out to be the third most destructive hurricane ever to hit the US. RMS raised its estimate to $13bn-$21bn (£8.7bn-£14bn), from earlier predictions of $6bn-$16bn and $7bn-$12bn.

The error in the initial estimate may have been caused in part by the fact that Ike was a category 2 storm on the Saffir-Simpson scale. The Saffir-Simpson scale is a useful method of classifying hurricanes by wind speed, but it tells little about the ability of a hurricane to cause storm surge (the rise in sea levels caused by a cyclone). The shape of the seabed also has a lot to do with it.

Ike made its final landfall in Baytown, Texas, as "only" a category 2 hurricane. But its path ended up being much wider than previous category 2 storms and it caused damage more on the scale of a category 4 hurricane.

Users of cat modelling software may simply be asking too much of the technology. All the systems currently in use have limitations in estimating hurricane risk:

■ There is a time delay between an event and receipt of all the relevant data. This is longer for hurricanes than for an earthquake. Although a hurricane's location is tracked in real time, other important data is not available for months. So the models rely on a predefined event that is similar. Sometimes no such predefined event is in the model, such as for European wind storm Kyrill

■ There is a mismatch between insurers' exposure data and the data used in the model. This is a point often made by the cat modelling vendors

■ The models rely on historical data that is partial and may be inaccurate

■ The models do not always incorporate all natural variability or take into account future climate change, despite the fact that global warming is likely to increase hurricane activity.

These problems are being addressed, however, and there are signs that the climate change issue could be closer to being solved than had been thought.

A group led by Dr Greg Holland of the US National Centre for Atmospheric Research (NCAR) recently completed a 350-terabyte-generating run of a new computer model on a supercomputer called Bluefire. The run was unusual, because it modelled feature-rich hurricanes not just from equations describing weather, but also directly using equations describing the underlying climate of the globe. Rowan Douglas, chairman of Willis Research Network, which is contributing to the NCAR research, believes the future unification of climate science with weather forecasting will bring about a new era in cat modelling and rational risk allocation.

But don't hold your breath. Dr Holland's model is likely to be used at first for predicting 10-year chunks of weather, although at small enough geographic scales to be useful for city officials planning buildings. Shorter timescale predictions, such as next season's hurricanes, will take more research.

Until then, here is my prediction for this year's North Atlantic hurricane activity: 16 named storms and eight hurricanes. How do I know? Because that's the average of the past five years. No computer necessary. And unfortunately, current statistical models cannot predict much more accurately than that.

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Key points

- Current catastrophe modelling software has limitations in estimating hurricane risk
- There are many reasons for this and improvements are needed across a broad front
- The future unification of climate science with weather forecasting could bring about a new era in cat modelling

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→ Scientist reveals storm risk research
10 December 2008

→ The size of a market-changing loss
22 April 2008

→ Willis in search for world's best storm forecasts
31 October 2008

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Michael Faulkner • Editor • Insurance Agenda

The consolidators' survival guide

To stay afloat in 2009, the broking giants must adapt to a changing marketplace

The consolidator model is under greater pressure than ever before. Insurers that encouraged the growth of these broking beasts with generous remuneration are turning off the tap. At the same time, the cost and availability of acquisition finance is being squeezed by the financial turmoil. The consolidators must adapt.

At its heart the consolidator model is simple: using scale to leverage better remuneration from insurer partners, while growing through acquisition.

In recent years, the insurers offered the consolidators such as Towergate, Jelf Group and Giles Insurance generous commission and improved service because of the volume of business they could produce.

Meanwhile, the consolidators aggressively bought brokers, fuelled by the availability of finance. They grew in power and demanded ever higher commissions, something insurers found difficult to resist.

The picture has changed. Insurers faced with spiralling expenses and falling underwriting profits are resisting the consolidators' demands, warning that commissions have become unsustainably high – although remuneration terms seem not to have been cut so far. Indeed, Norwich Union has been actively looking to support independent brokers through its Club 110 initiative and senior insurance executives say the consolidators are now accepting deals that would have been unacceptable six months ago. The rising cost of finance has added to the pressure.

Consolidators will need to respond to these challenges. At the heart of the issue is the question of the value they add to the distribution equation. Does the underwriting performance of the business produced justify the commissions charged?

Risk selection will be critical. If the loss ratios on consolidator-produced business are poor, the firms cannot hope to command top-notch remuneration.

Efficiency is also vital. One of the perceived benefits for insurers is that the average cost of servicing consolidators is lower than if the business had come from a large number of producers. The extent of this cost reduction depends on how the consolidator integrates its acquired businesses, such as harmonising software platforms or centralising risk placement.

The consolidators will also need to examine their own cost bases. Integration and cost reduction – areas that some companies have focused less on – will be essential. A model that simply bolts on acquired businesses without any significant attempt to integrate them into an organised, efficient structure will be unsustainable.

Organic growth must also receive greater focus. The number of acquisitions is expected to slow this year and consolidators must place more emphasis on new business and cross-selling extra products to boost revenues. They will need to invest in staff and infrastructure. There will be some acquisitions (of high quality targets) but the pace of deals will be markedly slower than in 2008.

The business case for two consolidators merging is questionable in the current environment. Insurers will not be willing to offer higher commission levels to the merged business, so the benefit must come from cost savings. Making such a deal work would be a massive challenge and the entrepreneurs who run the consolidators are unlikely to have the stomach for such a protracted project (putting aside the inevitable clash of egos that a merger would entail).

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Key points

- Insurers will take a closer look at the value of deals with consolidators
- Consolidators must look at the quality of business provided to insurers
- Insurers will look at their costs of servicing consolidator-produced business
- Integration of acquisitions and organic growth will be a focus in 2009
- The business case for the merger of two consolidators is questionable

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➔ The party's over
24 July 2008

➔ Insurers fight against consolidator power
1 May 2008

➔ The maths will play out
15 May 2008

➔ Towergate to scale back acquisitions as growth fails to hit target
5 June 2008

➔ Who's calling the tune in the broker band?
24 April 2008

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Nathan Skinner • Associate Editor • Strategic Risk

Credit where it's due

Remember why risk management is there – and what it can do

The economic crisis has damaged the reputation of risk management. Yet, if done properly, it can help organisations move ahead during an economic downturn.

Banks once were willing to lend to practically anyone. Now counterparty risk is a serious concern. It has taken some spectacular failures, but most senior financial executives would acknowledge that managing credit risk strategically is essential.

There are clear benefits. Some organisations will find credit hard to come by as financial institutions tighten their lending terms, but those with identifiably good risk management might be able to jump ahead in the queue for cash. And when the banks do start lending again, the firms with the tightest grip on their risks are likely to be at the front of the line.

As the trading environment deteriorates and financial markets continue to look unstable, businesses want more reassurance that their financial instruments are sustainable. These concerns are demonstrated clearly in the commercial insurance market. Corporates wary of the losses insurers sustained after an active hurricane season, the financial crisis and poor investment returns are considering how much risk they should put into an unsteady market.

This mistrust has been exacerbated by the failure of credit rating agencies to issue timely warnings about companies and their losses.

Insurers wanting to win good business need to be more transparent about their financial position so insurance buyers can do their due diligence and reassure their boards – even though this demand for more detailed and up-to-the-minute information means increased paperwork and legwork for intermediaries.

All businesses are taking a closer look at the value of their assets. The same goes for commercial insurers, which will become more selective about the risks they take on. That may increase the amount of risk retention in the corporate sector, as insurance becomes more expensive in a hardening market.

But it will also focus more attention on companies and their risk management credentials. Like the banks, insurers will look more closely at the quality of the businesses they trade with. Buyers will be expected to present detailed and wide-ranging information about the risks they want to transfer.

Another consideration for big commercial buyers is the number of insurers on large schemes. It makes sense to spread the risk among many carriers and reduce the impact if one of them goes under. The commercial insurance market also remains fairly well capitalised – the few casualties of the financial crisis are notable exceptions.

The main lesson from the financial crisis is that risk management is only truly effective if it is done strategically. That means getting an overall picture of the risk and matching it up with a company's goals.

It also suggests that organisations should breed a culture that values the role risk management plays. To achieve this, risk managers need to step up to the challenge and present the right insights but, equally, senior managers need to take on board that advice. Times are tough. Risk managers must now prove how they add value – or they could be on the chopping board.

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Key points

- Strong risk management can help organisations earn credit from underwriters
- Buyers are demanding more information about their insurance provider's financial strength
- Insurers are looking for the best commercial risks, which puts more emphasis on risk management
- Buyers have a responsibility to support their insurance partners

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→ Insuring against the downturn
9 December 2008

→ Tough times ahead
9 December 2008

→ Downfall of the Model?
9 December 2008

→ Risk bonuses tumble 23%
18 November 2008

→ Downturn focuses attention on risk management
11 November 2008

→ Businesses are still prepared to take risks
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