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EXCLUSIVE INSIGHT AND ANALYSIS FROM INSURANCETIMES, STRATEGICRISK & GLOBALREINSURANCE

Michael Faulkner ■ Editor

The UK is now officially in recession and the insurance industry is bracing itself for a tough year. Insurers and brokers are positioning their businesses to weather the storm, and this month Insurance Agenda has put together an eight-point guide to beating the downturn (page 2).

Despite the economic gloom, comfort can be drawn from the fact that premium rates are beginning to harden in some lines of business. But the upward progress of rates may not be a foregone conclusion (page 3).

Trade credit insurers have come under fire in recent months for pulling cover from businesses. The government plans to intervene in the sector to help struggling companies. But while state aid will help the economy, it could threaten the industry (page 4).

Efforts are also being made to tighten up the regulation of credit rating agencies, a sector that has been strongly criticised for its role in the financial crisis. Although the new measures are helpful, they do not go far enough (page 5).

Global insurance programmes bought by multinational companies are also in the spotlight. It appears that some programmes may not be compliant with local laws. This is an issue that the insurance industry must address urgently (page 6).

Finally, offshore financial centres are being targeted by a number of governments, including our own. David Sandham argues that these centres are being unfairly maligned (page 7).

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Michael Faulkner • Editor • Insurance Agenda

How to stay ahead of the crowd

Insurance Agenda's eight-point guide to surviving the recession

Know your customer
Personal lines and commercial customers will be looking more closely at their spending habits. Insurers and brokers that best understand the needs of their clients, offering products and services they want, will be more successful than those that do not.

Service, service, service
If customers feel they are not getting value for money from the products and services they buy, they will look elsewhere. Excellent customer service is a key part of this.

Advice not price
Customers are more focused on price than ever, leaving brokers at risk of losing business to cheaper rivals such as the direct writers. High-quality advice to help companies buy the right insurance at the right price becomes even more important.

Diversify
Some sectors of the economy will be hit harder than others, such as construction, transport and non-food retail. Brokers and insurers heavily weighted towards these sectors should diversify as much as possible to hedge against the potential loss of business.

Pricing
Investment returns will no longer compensate for underwriting losses, so insurers will need to achieve underwriting profits. Reinsurance costs are rising and prior year reserves are dwindling, which means premium rates must rise. Failure to do this will erode capital. Insurers must have the courage to walk away from business that is not profitably priced.

Claims costs
Claims increase during a recession. To control this – and to control legal costs – insurers will have to recover as much as possible under subrogation rights and cut claimant lawyers out of the personal injury process. False claims also rise during a recession.

Supply chain
Insurers must ensure their claims supply chain is robust and that a contingency plan is in place in case key suppliers go bust. This could include alternative suppliers or cash settlement of claims, although the latter can push up the cost per claim.

Costs
Insurers must continue to look at distribution costs, such as commission levels and internal expenses, to safeguard profit margins. They need to look too at affinity partnerships and cull or renegotiate any unprofitable deals. On the direct side, insurers should examine the effectiveness of distribution through price comparison websites and consider outsourcing and offshoring. Brokers must also look at their cost base.

Insurance will not face the same level of job losses as other parts of the financial services sector, but there will be cuts. Companies must ensure that their skill base is not irreparably damaged and training budgets should be maintained wherever possible.

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➔ Don't cut back, warns Biba
22 January 2009

➔ GI bucks financial services fall
12 January 2009

➔ Staying afloat
15 January 2009

➔ All right and proper
8 January 2009

➔ Now what?
8 January 2009

➔ Navigating the storm
Global Reinsurance, December 2008

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David Sandham • Editor • Global Reinsurance

The hard facts

Reinsurance rates may be rising, but the market hasn't settled down yet

Reinsurance rates generally rose in the 1 January renewals. Guy Carpenter's world rate on line (ROL) index showed property catastrophe reinsurance rates rose 8%.

The hike confirmed expectations that the market has turned, entering a new phase in the pricing cycle – good for reinsurers but bad for insurers, who face paying more. Charles Philipps, chief executive of Amlin, expressed a view that is widely held: "We are through the bottom of the insurance cycle with strong prospects for hardening rates across our business."

There are a number of reasons for the rise. First, US hurricanes and other catastrophe losses were higher than expected – hurricane Ike turned out to be the third most costly hurricane in US history. Related to this is the reduced confidence in the abilities of the current generation of catastrophe models.

But the rise is also connected to the broader economic conditions. Many insurers have suffered investment losses in the financial crisis. With weakened balance sheets, they are keener to transfer risk. Indeed, to maintain capital ratios – and finding it hard to raise new capital – they may be obliged to transfer risk and buy more reinsurance.

In addition, little new reinsurance capacity has come in to meet the extra demand and retrocession capacity (where reinsurers themselves transfer risk) has decreased.

It is the wider financial conditions that make the prevailing (re)insurance pricing conditions different from previous years. Rates typically rise following a disaster, such as an especially bad hurricane season or the terrorist attacks of 9/11. The last market turn was in 2005, when Katrina and other hurricanes caused massive losses.

Although severe losses caused by hurricanes are significant, the financial crisis is a new factor, making this turn in the reinsurance cycle unlike previous ones. So the question arises, are we really in a normal phase of the cycle?

There is far more uncertainty than usual in the market. A closer look at the January renewals shows that although the market has hardened, it has done so in an inconsistent manner. As Chris Klein, global head of business intelligence at Guy Carpenter, points out, there have been wide differences in pricing, dependent on a number of factors, such as loss history, geography and line of business.

Instead of a predictable upward movement in reinsurance rates, we may be entering more unstable territory. It is even possible that the market has been wrenched away from its normal cycle and embarked on a more irrational phase, unlike anything known before.

Reinsurers that plan to expand rapidly should take care. The market may prove more volatile than they expect.

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Key points

- The reinsurance market has hardened, with rates increasing
- This has been caused by catastrophe losses and the global financial crisis
- The financial cause is unusual and there could be more volatility in the future

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➔ Hard market will persist in April-July renewals
9 January 2009

➔ Coming soon: the hard market
16 December 2008

➔ Market is hardening, says Benfield
31 October 2008

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A quick fix

The credit insurance market is in trouble, but the government can't solve all its problems

The government is likely to intervene soon in the distressed credit insurance market; the result of mounting pressure to provide a state-backed scheme to enable businesses to keep trading after credit insurers have pulled cover.

Lord Mandelson, the business secretary, and his team have been in discussions with a number of credit insurers over such a measure, although it is not yet clear what form any intervention will take. A comprehensive state guarantee has been dismissed, with ministers looking at more targeted intervention. The government may provide – at a price – additional cover for companies in the form of permanent credit limits or top-up cover.

The move is not without precedent. In November, France became the first major economy to offer state-backed credit insurance, with Caisse Centrale de Réassurance providing additional credit insurance for companies that have had their cover reduced.

But the UK government is wise to reject a comprehensive state guarantee. The state is not equipped to become a standalone credit insurer; it does not have the underwriting expertise and the cost of effectively insuring the workings of trade would be immense for taxpayers.

Mandelson is keen for any intervention to be effective, warning recently that there were significant barriers to offering government guarantees. "It's difficult to design an intervention that would make a substantial difference. We have to look at whether the marginal difference would be justified or whether it's not worth the candle."

Some credit insurance experts say a government scheme is feasible. Aon, for instance, argues that a scheme could work if it guaranteed permanent credit limits for businesses where cover is already in place. But there are potential downsides.

First, the provision of state-backed insurance cover could exacerbate the problem it is attempting to solve. Government intervention may accelerate the withdrawal of cover by credit insurers looking to shed risk from their balance sheets. Such a move could further damage the reputation of the credit insurance market – Amlin's withdrawal from the sector in November (it had a 4% share of the UK market) was a major blow.

Although demand for credit insurance is rocketing, brokers are concerned that clients could lose confidence and buy less cover, accepting a higher level of self-insurance.

Credit insurers have to some extent brought this situation on themselves as, in the past, they have underwritten business too cheaply to grow market share.

According to statistics from the ABI, insurers wrote £334m of premiums in 2007, covering £282bn of sales by British companies. As one commentator notes, this means insurers were receiving premiums equivalent to the turnover of a medium-sized business to protect more than 20% of the output of the entire British economy.

These decisions have come back to haunt them. The economic downturn has sent loss ratios soaring, prompting credit insurers to purge their books of high-risk business.

The credit insurance market must learn from its mistakes – and start by taking a hard look at its underwriting. Increasing premiums and changing terms and conditions may be a better alternative than pulling cover. There is a market for cover at the right price. If premiums are attractive then new capacity will enter the sector.

The credit insurance sector now has the opportunity to be part of the solution to the economy's woes, not part of the problem. Government intervention must be a short-term measure only.

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Key points

- The government is looking at steps to increase the availability of trade credit insurance to businesses
- Targeted intervention is likely, rather than a comprehensive state guarantee
- A scheme guaranteeing permanent credit limits is workable
- Government intervention has downsides for the credit insurance market
- Credit insurers must address damage to the sector's reputation

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➔ ABI welcomes government's trade credit moves
14 January 2009

➔ CBI wants government trade credit cover
7 January 2009

➔ Banks blame credit insurers
17 December 2008

➔ Ministers to act on credit cover?
11 December 2008

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Michael Faulkner • Editor • Insurance Agenda

They need better credit

Efforts to reform the practices of the rating agencies do not go far enough

Regulators on both sides of the Atlantic are taking steps to overhaul the working practices of the credit rating agencies. As *Insurance Agenda* reported in November, the agencies have been heavily criticised for their part in the global financial meltdown.

The key problem is the inherent conflict of interest in their business models: they are paid by the providers and issuers whose products they are meant to independently assess.

The US regulator, the Securities and Exchange Commission (SEC), has put in place rules to address this conflict and agencies are now prohibited from carrying out certain activities, such as executives providing both rating and advisory services.

The rules also bar those who assess products from discussing remuneration. Agencies must provide more information about how ratings are assigned and how they hold up over time.

Meanwhile, the European Commission has put forward proposals that would make the credit rating agencies subject to regulation and supervision for the first time. Agencies in Europe will be required to register with a central supervisor and disclose information about methodologies. They will also need to take steps to avoid conflict of interest, such as appointing independent directors to their boards.

While these measures have merit, they do not go far enough.

First, buyers rely heavily on the ratings attached to products and companies. SEC rules refer to the credit ratings of products and this, according to the system's critics, only increases the reliance on them. The forthcoming Solvency II directive could also increase the importance of agencies as the rules will require greater attention on credit risk.

Efforts should be made to reduce buyers' reliance on ratings. They should not be the only factor to be considered when deciding about the financial strength of a company. The SEC, however, has so far resisted a proposal to drop references to credit ratings from its rules.

Second, ratings should be more comparable – something that many argue is not the case. Regulation must define the processes and policies to be followed when rating a company, so that those delivered by different companies or in different markets and asset classes can be compared. While the SEC and European Commission's rules seek to increase transparency, they do not appear to address the issue of comparability.

Third, all agency employees should be accredited and regulated. For buyers and investors to have trust in the ratings, they must have faith in professionalism and skills of the analysts.

Finally, remuneration should be overhauled. There will always be a conflict of interest as long as the agencies are paid by the companies they are rating. Some have suggested that the financial markets should commission and pay for ratings. For example, the exchanges could pay the agencies in proportion to the financial values traded on each exchange.

A radical overhaul of the operation and role of rating agencies is needed if trust in the financial markets is to be rebuilt after the severe battering of last year.

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Key points

- Regulators in Europe and the USA are looking at the way rating agencies operate
- New regulations do not go far enough
- Less reliance on ratings should be encouraged
- Employees of rating agencies should be accredited
- Regulations should ensure ratings are comparable
- The way rating agencies are remunerated should change

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➔ Coface launches financial ratings service
18 December 2008

➔ Not quite AAA
Insurance Agenda, November 2008

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Nathan Skinner • Associate Editor • Strategic Risk

Come out from under the blanket

The industry must make sure global insurance programmes are compliant worldwide

Global insurance programmes are under the spotlight. Foreign regulators are increasingly looking at whether international insurance programmes are compliant with local laws.

The problem is that these multi-jurisdictional insurance policies, purchased by global companies to provide blanket cover anywhere in the world, generally have been sold without proper consideration of their limitations.

Multi-national companies may operate in hundreds of jurisdictions around the world, each with its own set of insurance regulations that can change quickly. In some places, foreign companies are not admitted to write insurance; in others, they require special clearance. Premium taxes are another hurdle: they have to be appropriately calculated according to where the risk is located. And claims payments could be subject to double taxation if not handled correctly.

This is a vital issue for insurers, brokers and risk managers. Big buyers expect their insurance partners to be able to service their global insurance needs.

The risks of non-compliance are increasing and many insurance regulators have started to enter into formal co-operation agreements. In January, the Qatar Financial Centre Regulatory Authority and Oman's Capital Markets Authority began to work together on insurance supervision. And in the past six months New York signed similar agreements with Bermudian and German regulators.

In the wake of the financial crisis, politicians want to show they are acting in the interest of stability – and that means the financial police will be cracking down. A foreign company acting illegally overseas is the perfect target for a local regulator eager to flex its muscles and win popular support. All this has dragged compliance to the top of corporate agendas.

As well as being squeezed by the regulators, insurers and brokers are being asked tough questions by their customers. Risk managers are nervous, because their necks could also be on the line if global programmes are found to be breaking the rules. A hardening market also makes buyers much more inquisitive about the products they are sold.

Some insurers have tried to address this issue. In the spirit of increased transparency, they have started to reveal where they are admitted to write insurance and where they are not. In the process they have learnt to distinguish themselves by demonstrating their programmes are globally compliant. Others are stuck with old processes.

Buyers remain confused at the industry's inconsistent response – some are annoyed they may have been sold products that were not strictly legal. This is another knock a tarnished industry can ill-afford to receive.

There are clear opportunities for those who know the ins and outs of global insurance regulation. Considering the complexity of the issues around compliance, it is no wonder risk managers want to offload the responsibility, providing many opportunities for intermediaries to provide products and services.

Just because their insurers are compliant does not absolve buyers of responsibility, however. They need to demonstrate diligence – asking their partners about international insurance rules will be, for many, the first move. The industry should be prepared to have the right answers.

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Key points

- Global insurance programmes are under increased scrutiny from financial regulators
- Administering them is not easy but it is an issue the industry needs to face up to
- There are opportunities for insurers and brokers to distinguish themselves
- Buyers, whose necks are on the line as well, are confused and annoyed

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➔ US may have super-regulator
14 January 2009

➔ Are you breaking the law?
November 2008

➔ Turmoil, transparency and compliance
30 October 2008

➔ New tool for global regulatory compliance
9 June 2008

➔ Global policies could create tax and regulatory nightmares
3 October 2007

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David Sandham • Editor • Global Reinsurance

Don’t blame the offshore centres

Caribbean islands are being investigated because of a banking collapse in Iceland

The financial crisis is set to bring in a wave of new regulations, including rules on offshore financial centres. During his election campaign President Barack Obama criticised “corporations that hide their profits offshore”, specifically mentioning Bermuda. Angela Merkel, the German chancellor, also has offshore centres in her sights: “We can no longer stand passively by as individual small countries attract financial institutions by ignoring internationally agreed upon rules.”

In the UK, Gordon Brown has promised “very large and very radical changes” in financial regulation, while Alistair Darling, the chancellor, has spoken of “potential problems with overseas territories and crown dependencies”. At the end of last year, the UK government launched a formal review into British offshore centres. A number of these have become popular domiciles for insurance companies – particularly Bermuda.

In announcing the review, Darling referred to the Icelandic banking collapse, which affected British investors with Landsbanki’s Guernsey branch or with Kaupthing Singer & Friedlander on the Isle of Man. Many victims probably did not understand that these banks were outside the UK supervisory system.

While the promised review appears to be motivated by problems with these banks, it will be much wider in scope, investigating all crown dependencies and overseas territories with significant financial sectors.

It is worth giving the list of the offshore territories affected: Jersey, Guernsey, Isle of Man, Bermuda, Cayman Islands, Gibraltar, Turks and Caicos Islands, British Virgin Islands and Anguilla. So Caribbean offshore financial centres find themselves caught up in regulatory change caused by a collapse in Iceland. That’s globalisation for you.

It is not clear what the review will cover. In announcing it Darling said: “Overseas territories and crown dependencies … attract banking customers with lower taxes – without contributing to the UK exchequer. But at times of stress, depositors need to know who will compensate them. The British taxpayer cannot be expected to be the guarantor of last resort.”

It seems the UK government is not considering introducing taxation in those territories, however. In subsequent statements it said the review would not look at changing the territories’ constitutional arrangements, including their independence in fiscal matters.

The exclusion of fiscal policy must have come as a great relief to the territories concerned – and the insurers domiciled in them. And as for the UK government being a guarantor of last resort, investors in the Isle of Man and Guernsey may have misunderstood, but surely no investor in a Caribbean financial institution could make the same mistake.

What, then, is the UK government’s purpose in launching this review? Perhaps it will increase the obligations for taxation disclosure on offshore centres, something that would help the taxman as he hunts down tax evaders.

The taxation advantages of offshore financial centres may remain unaffected, but their confidentiality may be reduced and the amount of red tape could increase. If so, this would be a long way from Darling’s statement, but a perfect example of how political rhetoric ossifies over time into a strengthened bureaucracy.

Not only would it be unfair to blame offshore centres for the financial crisis – they had nothing to do with it – doing so distracts us from understanding the true causes of the crisis.

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Key points

- Politicians are squaring up to offshore financial centres
- The UK has launched a review of offshore centres, but has promised not to challenge their independence in fiscal matters
- More regulation on transparency is a possible result

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➔ Obama bad for offshore insurers?
6 November 2008

➔ The cruel and the kind
19 November 2008

➔ Austerity is the new black
1 December 2008

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