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March 2009

EXCLUSIVE INSIGHT AND ANALYSIS FROM INSURANCETIMES, STRATEGICRISK & GLOBALREINSURANCE

Michael Faulkner ■ Editor

Capital is a key issue for insurers. With balance sheets hit by investment losses and high levels of claims, the industry is looking for new capital to repair the damage and take advantage of hardening rates. This month *Insurance Agenda* looks at the options (page 2).

These capital pressures are also likely to increase the amount of business put into run-off (page 4). Insurers will also be looking to acquire businesses so excess capital is used more efficiently or capital levels boosted. Expect to see interest from overseas buyers in the UK insurance market as asset prices fall and rates begin to turn. But acquisitions need to be handled carefully to be successful (page 3).

There were high expectations that 2008 would be a significant year for cat bonds. But after a promising start, the market stalled in the second half of the year. David Sandham looks at the prospects for 2009 (page 5).

The industry's block exemption from European competition law may expire next year, which has raised concerns that the subscription insurance market will be investigated. But, as Nathan Skinner examines, an alternative to traditional subscription placement has been used with apparent success (page 6).

Finally, flooding continues to be a big issue for the insurance industry. Lauren MacGillivray looks at the key challenges ahead (page 7).

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Michael Faulkner • Editor • Insurance Agenda

Somebody out there loves you

Competition is tough, but insurers trying to raise capital can still find partners

There has been a surge in corporate bond issues in recent weeks, with hundreds of millions of pounds raised by companies. Investors have been flocking to mop up the supply of new bond issues by blue-chip companies, such as National Grid and Eon, attracted by the high returns that can now be achieved.

The success of companies in issuing bonds – albeit at a very high price – prompted Baroness Vadera, the business minister, to make her controversial comments about seeing "a few green shoots" of recovery in the economy.

The reason for the uptake is that the interest paid on bonds is now considerably higher than before the credit crunch and is much more favourable than government bond yields, which have been directly affected by the low rates.

Using the bond market to raise capital is not seen as an appropriate route for insurers, however. Bankers say concerns over the strength of insurance company balance sheets would dissuade investors from buying insurers' corporate bonds. Investors can also get similar returns from bank bonds protected by the government's guarantee scheme, which guards against the risk of default.

For listed insurance companies, the stock market is seen as the easiest route to raise additional capital. In recent weeks, Lloyd's insurers Chaucer, Beazley and Catlin have announced plans to raise money through share issues. Omega unveiled an equity fundraising last year.

The challenge for insurers is that they are competing with many other cash-strapped businesses that are looking to tap investors for funds. The insurance industry's advantage is that it has a good story to tell at the moment. Premiums rates are hardening in some lines of business and, as a result, the industry looks set to perform better than other sectors.

Nonetheless, insurers' balance sheets have taken a battering from investment losses and high claims. The challenge is to pitch the share issue as a means of taking advantage of a business opportunity rather than an emergency measure to stave off a rating downgrade.

The reaction to the equity fundraising at Lloyd's has been mixed. Only 60% of Chaucer's open share placing was taken up by shareholders. Catlin's fundraising move was expected by the market and analysts have been broadly supportive, although the rights issue was heavily discounted. Beazley's capital raising was more of a surprise. Omega has closed its £130m placing.

There are other mechanisms for insurers looking to raise capital. Swiss Re has already turned to Warren Buffett for a CHF3bn (£1.8bn) cash injection using a perpetual note, paying 12% interest and allowing him to raise his stake in the business at an attractive price.

Insurers could also look to special purpose vehicles to raise capital quickly. Last December capital-rich Amlin launched a special purpose syndicate, raising £50m in third-party capital for a new syndicate to provide additional reinsurance cover.

Capital can also be freed up using a quota share arrangement with a reinsurer. Chaucer was reported to be considering this option before it announced its equity fundraising. The popularity of qualifying quote share arrangements at Lloyd's has diminished in recent years after Lloyd's reduced their use to 10% of capacity; they are also expensive to undertake.
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Key points

- Companies are raising money on the bond markets, but this route not suited to insurers
- The equity markets will be the most appropriate route for listed insurers to raise capital
- But competition for investors' money will be fierce
- Equity fundraising by Lloyd's insurers has been well received
- Other options include quota share reinsurance structures and special purpose vehicles

Archive

➔ Beazley and Catlin chase extra cash with right issues
19 February 2009

➔ Analysts lob brickbats as Swiss Re predicts £580m loss
12 February 2009

➔ Sell out
5 February 2009

➔ Chaucer to raise £75m in share placing
28 January 2009

➔ Omega to boost underwriting with £130m share placing
11 December 2008

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Michael Faulkner • Editor • Insurance Agenda

Be clear before you buy

Prepare for a wave of insurer acquisitions as capital becomes king

If recent years have been marked by consolidation in the broker market, the next two years are likely to be all about consolidation among insurers. Mergers and acquisitions have already started in the Lloyd's market. Beazley has bought US insurer First State Management Group while Lloyd's insurer Chaucer is being circled by a number of potential buyers, including Novae.

Capital levels will drive this wave of consolidation. Under-capitalised insurers will need to raise funds; those with excess capital will be looking for ways to use the surplus more efficiently.

Investment losses have eroded the insurance sector's capital levels over the past year as the financial markets have plunged and claims costs have risen (2008 was the second most expensive natural catastrophe year on record). This has left some insurers in a weakened position, with rating agency Fitch warning of rating downgrades this year.

In addition, rates in some lines of business, such as catastrophe reinsurance, have risen, requiring some insurers to raise extra capital to write more business. The falling value of sterling against the dollar also means some insurers with US business have to raise funds.

A rights issue is the simplest way to raise money. But the acquisition of a capital-rich business can also achieve this. Novae itself is seen as an attractive acquisition target as it has £70m of surplus capital that could be unlocked.

Meanwhile, for insurers fortunate enough to have excess capital, an acquisition can mean diversification in terms of business lines, geographic spread and skills. There are also prudential benefits to a diverse business under the forthcoming Solvency II risk-based capital regime as relatively less regulatory capital could be required.

Financing an acquisition will be challenging in the current climate. Some insurers, such as Amlin, already have the capital to make a purchase; others will need to find the necessary funds. Debt is difficult to raise at the moment, but the equity market is a viable route. Mark Flenner, head of non-life at KPMG corporate finance, says companies will look for alternative means to fund acquisitions such as all-share deals and transactions supported by reinsurance structures.

The Lloyd's market is still seen as an ideal target for Bermudian insurers looking to diversify from catastrophe business and gain access to Lloyd's global licences. The interest in Chaucer from Novae has also raised the prospect of a wave of consolidation among Lloyd's insurers.

But there are dangers too. Acquisitions in the insurance market do not always create the anticipated value. Munich Re's purchase of American Re is a prime example: Munich Re had to pump in billions of dollars to prop up the loss-making American Re after buying it.

Conversely, Catlin's acquisition of Wellington worked. Despite losing a number of senior people, the combined company managed to retain much of its business.

What steps can be taken to ensure the acquisition creates value? First, it is vital to be clear why the deal is being done. If the strategic reason is not clear, then the deal should not proceed, according to Bryan Joseph, a partner in PricewaterhouseCoopers.

Proper due diligence must also be undertaken. It is imperative to understand fully the target business to avoid problems with legacy issues and to be fully aware of the capital implications of the purchase. A strategy is needed to address any legacy issues, as is a good understanding of the senior management of the target business.

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Key points

- Capital issues will drive insurers to make acquisitions
- An under-capitalised insurer could use a deal to boost capital
- An acquisition could enable an insurer to use excess capital more efficiently
- Care must be taken to ensure the deal creates value

Archive

➔ Beazley's £150m for US buy
13 February 2009

➔ Why Chaucer has plenty of suitors
9 February 2009

➔ Market waits for rival bidder to snatch Chaucer from Novae
5 February 2009

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David Sandham • Editor • Global Reinsurance

Don't rule out run-off

It can be an effective part of managing a portfolio

The run-off sector may boom as more insurance portfolios cease writing new business. A number of factors suggest an increase. First, the recession will affect the profitability of some portfolios. Demand will fall as customers cut costs and choose not to renew policies. Claims also tend to increase during a recession, putting downward pressure on margins.

Profitability has also been hit by last year's natural catastrophe losses of more than $20bn (£14bn) and losses on investment portfolios. Insurers that pursued anything but the most cautious of investment strategies last year have suffered badly.

The tough financial climate may mean some insurers whose capital base has been eroded by claims and investment losses may struggle to raise additional capital, forcing them to put the business into run-off.

In addition, the hardening of the reinsurance market is making it more costly for primary insurers to transfer risk through reinsurance – an alternative way to address capital shortages.

A further, unconnected factor relates to Solvency II, the forthcoming European risk-based solvency regime. Solvency II will impose new capital requirements on insurers to reduce the risk that they are unable to meet claims. Insurers preparing for the new rules will be looking carefully at where their capital is employed. One solution, again, may be to put certain capital-intensive lines into run-off.

Last year's $343m purchase of a book of run-off business from St Paul Fire and Marine Insurance Company by Enstar, a specialist in buying insurance and reinsurance companies in run-off, shows that large deals can be done in the current climate. More than half the acquisition price came from bank debt.

It is vital that insurers take a proactive approach to managing their portfolios during the recession. They should consider using run-off as part of prudent and active management of their business.

One issue that could hold companies back is that run-off can have the whiff of failure about it – although putting a portfolio into run-off does not necessarily mean the insurer is insolvent.

It is also complex. The different methods include run-off to expiry; accelerated run-off through commutation; using reinsurance to provide economic finality; a scheme of arrangement; the sale of the equity in the business; and a Part 7 transfer (selling a book of business to another insurer). The chosen option depends on the circumstances; experts say the choice depends on whether achieving finality is the short or long-term objective.

As the recession takes its toll on the industry, insurers and reinsurers must look at a realistic and tough-minded approach to managing their portfolios. Run-off should be considered as part of this process.

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Key points

- Higher claims, investment losses and Solvency II will put pressure on insurance companies to consider run-off
- The difficulty of raising new capital and the hardening reinsurance market make run-off even more necessary
- Many do not find run-off an attractive topic, and it is complex, but they should make the effort to understand it now

Archive

→ Compre buys Länsförsäkringar's companies in run-off
29 January 2009

→ Citadel in run-off deal with Arthur J Gallagher
20 January 2009

→ Wake up to run-off
20 November 2008

→ $343m run-off deal agreed
9 October 2008

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David Sandham • Editor • Global Reinsurance

Get ready to pounce

Cat bonds had a miserable 2008. But that doesn't mean you should ignore them

About $7bn (£4.9bn) of cat bonds (insurance-linked securities that provide transfer of natural catastrophe risk to the capital markets) were issued in 2007 – a record year. But only $2.7bn of the bonds were issued in 2008, all in the first half of the year as the market closed for the final six months.

Few industry observers will stick their necks out and offer a prediction for the year ahead. Not least because most of them got it wrong on 2008, with many forecasting about $5bn of new bonds. If a prediction must be made, however, it looks like the value of bonds issued will be similar to last year.

What went wrong in the second half of 2008? And does the shortfall mean there is roughly $2.3bn ($5bn minus $2.7bn) of bonds waiting in the wings? The secondary market – where already-issued cat bonds are traded – will be crucial. But it has been weakened by troubled non-specialised investors liquidating their cat bond positions. These investors have been troubled, let it be said, by the general financial crisis, not by cat bonds. Indeed, cat bonds were some of the best-performing assets in their portfolios. Nevertheless, their actions depressed bond prices, allowing investors to get higher yields in the secondary market rather than in new issues.

Whether the secondary cat bond market bounces back will depend on general improvement in the economy, but also on sector-specific factors, such as redemptions. More than $1bn of cat bonds have been redeemed since December last year; more are now due. Redemptions make more money available to investors, so leading to a possible improvement in the secondary market.

New issues were also delayed last year by potential issuers having a good alternative in the softening traditional reinsurance market; however, a recent hardening could lead to renewed interest.

The Lehman bankruptcy last September must also be considered. Willow Re Series 2007-1, a cat bond for which Lehman was guaranteeing interest payment, recently defaulted on its payments. However, only four cat bonds have been directly affected out of more than 100. They still offer good uncorrelated risk and have outperformed both equity and bond markets.

The $200m issue of Atlas Reinsurance V for SCOR by Deutsche Bank and BNP Paribas in February this year breaks the ice for the first cat bond new issue since August last year. This bond is notable for its tight collateral structure. The collateral for Atlas Reinsurance V may be invested only in a defined list of secure assets, such as government bonds. It is likely that future cat bonds will be designed so as to withstand events such as the Lehman bankruptcy.

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Key points

- Last year was disappointing for cat bonds
- There were several reasons for this, including a weak secondary market, the Lehman bankruptcy and softening reinsurance rates
- Although the first cat bond for many months closed in February, prospects for 2009 are uncertain

Archive

➔ Cat bonds are back
19 January 2009

➔ Hannover Re completes €100m capital markets deal
15 January 2009

➔ Rethinking cat bonds
19 December 2008

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Nathan Skinner • Associate Editor • Strategic Risk

A gentle makeover

Brussels may demand changes to the subscription market but there are alternatives

European regulators are pushing for change to the co-insurance system, but the insurance industry is loath to upset established business practices. Living up to the European commission's expectations, however, may not be as painful as some expect.

There is quite a bit of confusion surrounding the commission's position on co-insurance, the sharing of risk between more than one insurer.

As it stands, the Lloyd's subscription market – the most popular way of placing risk with multiple insurers – falls outside the industry's block exemption from certain competition rules, making it subject to competition law.

The European competition directorate has been pretty clear how it feels about some market-wide practices that lead to premium alignment. The problem, as the commission sees it, is that when multiple insurers agree to underwrite cover, the premium charged is aligned towards the price set by the first insurer to take on the risk.

Yet buyers do not feel they are being ripped off. They are aware of the process and, in the main, are happy because it provides quick and easy placement of cover for big risks.

The competition authorities have urged the market to come up with a solution that serves buyers' needs. The response was a set of principles for the placement of business with multiple insurers, which the commission accepted as a useful first step. But these principles do not represent a fundamental change in the way the subscription market operates.

However, the industry's block exemption rule, which lets insurers off some competition rules, is expected to be lifted next year and attention could turn to other parts of the market that are felt to be uncompetitive. When the block exemption ends, the commission could set its sights on the workings of the subscription market.

That is no reason to panic. The directorate is not about to overhaul hundreds of years of market practice. The sense is that it will be happy as long as it sees that buyers' interests are being respected and they are considering other alternatives – some of which are already in use, such as vertical placement.

Vertical placement still involves a lead insurer that agrees cover and deals with claims, but rather than subsequent insurers signing on and fixing their price to the one already set, the following insurers bid against each other and choose their own price in exchange for a share of the risk.

This system is common in the aviation market, but not restricted to it. Buyers who have trialled vertical placement say it delivers a fairer price, which is set by the market. It could also attract new insurers for certain business lines, which had previously been unattractively priced. If the price of the risk is not already set, insurers are free to decide their own price for the risk, which may be higher or lower, based on their own assessments.

The flipside is that smaller insurers find a traditional subscription market approach easier because they can follow the lead insurer rather than provide their own quotation.

Insurers should not be too worried about the European commission delving into the business insurance market. It does not herald the end of the Lloyd's subscription market. If policyholders are left to decide for themselves which system best suits their needs, quite a few are likely to choose the ease of arranging a traditional subscription placement over the cost savings of an independently priced placement.

In any event, the market has shown itself capable of adapting and change may not be a bad thing.

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Key points

- The European commission thinks certain practices in co-insurance are anti-competitive
- It won't overhaul the market but is expected to scrutinise the way it works more closely
- Alternatives to the traditional subscription market should be investigated

Archive

→ Throwing down the gauntlet
18 December 2008

→ Commission not listening, say risk managers
1 November 2008

→ Industry debates renewal of block exemption
2 October 2008

→ EC report voices competition concerns
3 October 2007

→ AIRMIC responds to EU business insurance enquiry
25 September 2007

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Floods: don't get swamped again

The impact of the 2007 floods is still being felt. There are six key issues for the industry …

Communication

Poor communication was a big problem in 2007. The government, local authorities, water companies and insurance industry struggled to determine their respective responsibilities. The Environment Agency has since become responsible for managing overall flood risk and local authorities will look after surface water. Councils are now producing co-ordinated plans to deal with local flooding. These still need to be tested.

The role of loss adjusters and disaster restoration and recovery companies needs to be clarified to stop any duplication of services. Better communication means claims can be settled more quickly and cheaply, so all lines of response need to run seamlessly.

Pricing flood risk

After a series of tense discussions with the government, in July the ABI renegotiated the statement of principles on flood cover. The agreement, which ends in 2013, guarantees that cover will remain widely available for existing homes and small businesses at risk – but only if certain conditions are met. Where insurers do provide cover, they must think carefully about how high they should set premiums, given the risk of customer backlash.

Mapping and flood data

The Environment Agency, insurers, water and sewerage companies and consultants must share relevant data more. At present, there is no one big picture of drainage, sewerage, reservoir, river and surface water risk. Some parties, such as water companies, have been accused of failing to share information.

New-build property

Planners are still approving buildings in high-risk areas – despite the government stressing that high-risk developments should be built only if necessary. Sixteen developments containing a total of 240 homes were given planning permission in 2007 and 2008.

Resilience

Homes must be made more flood resilient – and therefore insurable. In January the ABI launched a consultation aimed at developers to make sure new homes are flood resilient. But it remains to be seen whether the proposals will be followed. Insurers should also consider going beyond rebuilding "like-for-like" because it could save them money in the long run. Homeowners also need to take more responsibility.

Reputation

Twenty-two per cent of people affected by the 2007 floods said they were either dissatisfied or very dissatisfied with their insurers. Insurers need to strengthen customer relations. The government has said insurance companies should help educate the public on flood awareness and several have launched initiatives. This must continue.

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Key points

- Communication between government, the insurance industry and other stakeholders must improve, with greater clarity over respective responsibilities
- Insurers must give careful consideration to how to price flood-risk properties once the statement of principles agreement ends
- Information on flood risk should be shared between stakeholders
- There must be a greater focus on making properties flood-resilient
- High-quality customer service is vital for insurers

Archive

➔ Flood insurance 'at risk' if Environment Agency concerns are ignored
9 February 2009

➔ ABI wades in with guidance for developers on flood risk
29 January 2009

➔ It's not all your fault
29 January 2009

➔ ABI calls on government to boost expenditure on flood defences
21 November 2008

➔ Industry hails landmark flood deal
17 July 2008

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