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EXCLUSIVE INSIGHT AND ANALYSIS FROM INSURANCETIMES, STRATEGICRISK & GLOBALREINSURANCE

Michael Faulkner ■ Editor

The financial reporting season is under way and, not surprisingly, the financial turmoil and catastrophe losses have taken their toll on results. Investments returns have been hit hard by plummeting stock and bond markets. But as David Sandham argues on page 2, the insurance industry's conservative investment strategy means it is in a stronger position than the banking sector.

Insurance Agenda also looks at the performance of Aviva's UK general insurance business (page 3). As the analysis reveals, there are still challenges ahead for the senior management in terms of improving underlying profitability.

The price comparison sector is facing tough times too as the competition for customers becomes increasingly fierce. Advertising spend has increased dramatically over the past few years and this is affecting profits. Price comparison sites will need to adapt their business models if they are to survive (page 4).

Directors' and officers' insurers are starting to feel the fallout from the financial crisis, as investors who have lost money look for legal redress against company directors.

Nathan Skinner says insurers could face significant losses; something that could have a profound effect on the structure of the market (page 5).

Finally, with the growing insurance market in the Middle East, David Sandham examines how Qatar is attracting the attention of the elite (page 6).

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David Sandham • Editor • Global Reinsurance

Shafts of warmth between the clouds

The insurance industry is better placed than banking to weather the financial crisis

In the 2008 investment race, the tortoises beat the hares. It was the worst 12 months for investors in most people's lifetimes – a financial cataclysm, the consequences of which are yet to be fully worked out.

Although originating in credit markets, the financial tsunami was also devastating for equities and corporate bonds. Investors lie disoriented, battered and bruised.

The crisis also exposed the ignorance of company leaders about the risks they were exposed to. For example, AIG made less than 1% of its revenue from credit default swaps, yet its involvement with these derivatives cost the entire company.

Reinsurers have been hit too, but they fared better than the banks. Insurers' financial structures are more conservative and they have lower asset-to-equity ratios (about 5:1 for many P&C insurers, compared with 30:1 or 40:1 for many banks).

Guy Carpenter calculates that 18 of the world's largest reinsurers (excluding Lloyd's vehicles, many of which have yet to report) lost $20bn (£13.6bn) in shareholders' equity in 2008 and ended the year with 18% less shareholders' equity than they started it with. This is bad but it is not terminal, as can be seen from reinsurance rates. Although there has been upward movement, especially in peak zones, there has not been a sharp upward spike in pricing such as one might expect were the sector in deep trouble.

Reinsurers differ widely in their investment strategies and range from the very conservative, such as companies at Lloyd's, through to the more aggressive, such as Swiss Re. Conservatism is clearly the winning policy. Swiss Re recently lost its chief executive after announcing huge investment losses. Higher-risk approaches may have been partly motivated by an attempt to offer lower reinsurance rates, and thus grow market share.

Most reinsurers have been relatively protected in the financial crisis for three reasons. First, they are protected by the constraints under which they invest. Strategy is not just about maximising returns; it is about satisfying shareholders, boards, regulators, auditors and rating agencies. Reinsurers are also generally more conservative investors than mutual funds or pension funds, with their portfolios comprising 80% to 85% bonds.

Second, unlike general investors, reinsurers must manage their portfolios with an eye to future insurance liabilities. This also tends to make them conservative. Reinsurers need bonds to come due when they need to meet the liability. Most property and casualty reinsurers prefer bonds of a three-and-a-half or four-year tenor, and are mostly in A or higher rated bonds, although they may also have higher-yielding BBB products.

Third, reinsurers' liabilities are not liquid, so unrealised losses cause less pain. Depositors at a bank can demand their money back immediately, but policyholders cannot cash in their policies. Unrealised investment losses hurt reinsurers less acutely than a major natural catastrophe, which makes a more immediate demand on cashflow.

These factors mean the insurance industry is better placed then the banking sector to weather the financial crisis. Those pressing for tougher regulation of the financial services sector should bear this in mind.

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Key points

- All investors suffered in the financial cataclysm of 2008
- Conservative investment strategies helped protect most reinsurers
- Reinsurers have suffered a painful but not mortal blow from investment losses

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➔ Baptism of fire
12 March 2009

➔ Uncertainty over Swiss Re
9 February 2009

➔ Investment losses hit Max's 2008 figures
26 January 2009

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Michael Faulkner • Editor • Insurance Agenda

Testing times for Aviva

The company's UK general insurance strategy will be under scrutiny this year

Aviva's results for 2008 reveal the challenging position it faces in knocking its UK general insurance business into shape. It reported UK general insurance operating profit of £566m, an increase of about 50% on its restated 2007 UK operating profit of £368m.

But the performance must be put in the context of the flood-related losses in 2007, which cost the insurance industry billions and had an £475m impact on Aviva's operating result. In 2006, the UK business delivered record profit of £1.075bn, nearly double the 2008 performance.

Prior-year reserve releases also mask the underlying performance: £285m was released in 2008, £430m in 2007 and £435m in 2006.

Strip out the impact of adverse weather and the prior-year reserve releases, coupled with the long-term investment performance, and a picture emerges of declining underwriting performance over the past three years:

- 2008: a £222m underwriting loss
- 2007: a £176m underwriting loss
- 2006: a £130m underwriting loss.

The reason for this decline appears to be a mix of tough market conditions and rising distribution and claims costs (the UK general insurance claims ratio has risen to 62% in 2008, from 58.7% in 2006).

These factors are not lost on Aviva's management. Over the past two years, the insurer has taken action with a series of rating increases across its book of business and changes to its risk selection. It has walked away from unprofitable business and cut its costs – redesigning its operations functions, for example, and cutting some brokers' commissions. There has also been a shift in focus away from (expensive) consolidator-produced business to the small and medium-sized broker channel.

These actions resulted in £265m of cost savings last year and a reduction in the expense ratio to 12.1% from 13.9% in 2007. But it is taking time for this action to filter through to profitability.

Aviva admits that its rating increases are struggling to outpace claims inflation in commercial lines, while rate rises in personal lines have been "marginally better" than headline claims inflation. However, an increase in claims farming, personal injury claims and credit hire costs has hit the profitability of its personal lines book, which has operated at a combined operating ratio of more than 100% for the past three years. Igal Mayer, Aviva UK's general insurance chief executive, admits this is not good enough.

The question is when the various strategies employed by the Aviva management will bear fruit, and whether they will be enough. The insurer insists these efforts will lead to a "real improvement" in profitability this year. Indeed, it suggests that it will achieve a pure combined operating ratio of 98% without the benefit of prior-year reserve releases.

It is clear that this year's performance will test the management's strategy. If the underlying performance does not begin to show a significant improvement then perhaps a different course of action will need to be taken.

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Key points

- The underlying performance of Aviva's UK general insurance business has declined over the past three years
- The business has been hit by tough market conditions and high costs
- Action has been taken to improve profitability through rate increases and cost-cutting, but these have yet to be fully effective
- The performance in 2009 will be a crucial test of this strategy's success

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➔ Net premium slumps in NU's personal lines business
12 March 2009

➔ NU pulls capacity from Giles-owned Ink Underwriting
12 March 2009

➔ NU to shrink gap between broker and direct prices
4 December 2008

➔ Norwich Union to revamp Club 110
20 November 2008

➔ Norwich Union looks to deal direct as networks come under the spotlight
18 September 2008

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Michael Faulkner • Editor • Insurance Agenda

A click away from failure

A bloody advertising battle is hitting the profitability of aggregators

The demise of Confident Cover, the price comparison website owned by Saga, the over-50s insurer, underlines the fierce competition in the aggregator sector.

In the past five years the number of price comparison websites has increased from about five to at least 130, with major players such as the Admiral-owned Confused.com and Moneysupermarket.com now spending millions on marketing to maintain market share.

Confused.com spent £15m on marketing last year, about one fifth of the sector's total advertising spend. Three years ago, the sector's total spend was £5.5m.

Price comparison sites took up more than half of all television and press car insurance advertising last year, up from 35% in 2007. In the same period, policies purchased through the sites made up 38% of UK motor sales compared with 24% in 2007. This was all too much for Saga, which was unwilling to spend the money needed to develop Confident Cover.

Not surprisingly, this bloody advertising battle is hitting the profitability of aggregators. Confused.com's profit fell to £26m in 2008, down 30% compared with the previous year. Meanwhile, Moneysupermarket reported that its margin from insurance price comparisons last year was squeezed by rising marketing and increased acquisition costs through search engines such as Google, although it did not say by how much.

It is not just increasing marketing costs that are hitting these websites' profits. Competition is suppressing the fees that aggregators charge insurers and brokers for using their service, known as click-through fees.

Margins will be squeezed further if click-through fees continue to fall. As *Insurance Agenda* wrote last year, insurers are examining their aggregator strategies and some could follow Norwich Union's lead and withdraw from using the sites. This could reduce click-through fees further.

Confident Cover therefore is unlikely to be the only the casualty as the smaller players find they do not have the marketing muscle and the financial strength to survive. The recession will also mean customers reduce the amount of insurance they buy.

Much will depend on how intense the competition is this year. Some analysts point to indications that it could be moderating. Price comparison ad spend slowed in the final quarter of 2008 to year-on-year growth of 3% compared with 42% in the third quarter (although the third quarter of each year is traditionally a competitive period for the motor insurance sector).

So how will aggregators adapt to these challenging conditions? They will have to cut costs so will need to look for ways to extract value from lower marketing spend. They must also boost revenues through expanding their product ranges and look for cross-selling opportunities, such as selling premium finance.

They also should try to improve customer loyalty and conversion rates through improved websites and pricing consistency – they have been criticised for not consistently providing the lowest prices.

Finally, they must get closer to their product providers to ensure they maximise their value as a distribution channel and provide the right type of customers for profitable business.

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Key points

- Competition between price comparison websites is fierce
- Aggregators spent about £80m on advertising last year
- High marketing and acquisition costs are hitting profits
- Aggregators must adapt their businesses to maintain profitability

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➔ Aggregators plan code of practice to silence critics
26 February 2009

➔ Where next for aggregators?
Insurance Agenda, November 2008

➔ Norwich Union looks to deal direct as networks come under spotlight
18 September 2008

➔ Aggregators to hit profits
24 July 2008

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Nathan Skinner • Associate Editor • Strategic Risk

D&O insurers under pressure

Stock market turmoil means angry investors are looking for someone to blame

The financial crisis is putting the directors' and officers' (D&O) insurance market under extreme pressure.

D&O claims are common when markets crash. Directors become the target of lawsuits as stocks and investments crumble and angry investors (and there are plenty of them) look for someone to blame.

As more companies collapse, regulators and shareholders are filing more claims of negligence or misrepresentation. Allegations of accounting fraud increase and liquidators may also sue former boards for mismanagement. Class actions are at an all-time high and these are no longer restricted to the USA. The Netherlands, Germany and the UK are building the legal mechanisms to encourage collective redress.

The economic slip comes at a bad time for the D&O insurance market. For the past five years capacity has been flooding in and insurers have been competing to offer the best cover at the lowest price – which makes life dangerous now the claims are coming in.

The soft market is particularly risky for new entrants that have yet to build up their reserves. Plus, several of the big D&O insurers – AIG, XL and Hartford – have been hit by their own financial problems.

This market pressure means serious readjustments are to be expected. But, so far, prices across most commercial D&O lines have remained stable. This is partly because of a glut of capacity and insurers attempting to win business from the troubled AIG.

The most dramatic changes are in D&O cover for the financial services industry. On some of the most distressed risks – such as banks with US exposure – premiums have increased by as much as 200%. Some insurers are stopping writing cover altogether while others see sky-high premiums on financial D&O as a bet worth taking. Overall D&O cover for financial institutions is being restricted.

At the same time, buyers are looking for more, not less cover. Directors themselves are jittery and some are demanding dedicated "A-side cover" to protect their personal assets in the event that the company chooses not to indemnify them if a claim is brought.

The changing risk appetite could affect other sectors. Insurers will do much more due diligence on the clients they take on with conservative insurers only wanting the best risks. Some are trying to claw back certain terms that in the past were standard fare, such as restricting the breath of cover relating to regulatory investigations. Those insurers would prefer to go back to the days of tightly worded policies with extensions sold as add-ons.

There are also questions over whether the insurance industry has properly risk managed D&O, which could have solvency implications for the sector. Insurers with a lot of exposure to the financial services sector could face significant losses on D&O business.

There is likely to be much more focus on capital management in the future with insurers spreading their exposure across a portfolio of risks. Reinsurers will pressure them to do this. This will mean writing a combination of low-risk, low-premium business as well as the high-risk, high-premium lines. Corporate buyers, concerned about the stability of their partners, will also want to spread their risk among carriers.

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Key points

- The D&O market will undergo radical change as a result of the financial crisis
- Insurers face a mountain of D&O claims but consistently low prices mean losses will be high
- D&O cover for the financial industry will undergo the most dramatic change
- Insurers will conduct more due diligence on the risks they take on
- Insurers that have not risk managed their exposures to D&O liability could face financial problems

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→ Madoff D&O and E&O claims set to hurt insurers
19 January 2009

→ Marsh warns of rising D&O demand
22 September 2008

→ Zurich extends D&O cover
27 June 2008

→ D&O and claims climb list of risk manager concerns
16 June 2008

→ Subprime D&O/E&O claims could reach $4bn: Fitch
10 April 2008

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David Sandham • Editor • Global Reinsurance

A wealth of development pays off

Qatar could soon take over from Dubai as the region's financial centre

During a period of recession it makes sense to pay more attention to areas of the world still enjoying strong growth. In the general global economic gloom, the Gulf region stands out as a ray of light.

In the fourth quarter of last year, gross domestic product (GDP) declined by a frightening 6% in the United States and the eurozone. Japan was even worse (down 13%). This year, the USA, Europe and Japan will suffer negative GDP growth. The Gulf region, in contrast, will show strong growth, although not as much as last year.

The region is not uniform. Dubai, whose oil reserves have run down, has until now pursued economic growth aggressively, particularly through property. But the bubble has burst. On 22 February the central bank for the United Arab Emirates came to Dubai's aid by purchasing $10bn (£7bn) of its bonds, enabling the emirate to meet its obligations.

Dubai's strategy contrasts with the more conservative strategy of Qatar. Qatar's capital Doha ("Dull Doha" as it is sometimes called) is sitting on vast hydrocarbon wealth. Its relative financial conservatism now looks decidedly canny. It has more than 5% of the world total reserves of natural gas, the third largest after Russia and Iran. It earns huge sums in foreign currency and, with a relatively small population, is one of the richest countries in the world in terms of GDP per head.

The Qatari government is applying this wealth to development in other areas, including finance. In 2005, it set up the Qatar Financial Centre (QFC), a business centre to attract foreign companies and develop the market for financial services, and has plans to become a regional hub for insurance. One investment is Qatar Insurance Services, a technology-based insurance system, currently being tested by companies such as Aon, Robert Fleming, AIG and AXA. It has also opened a Qatar Finance and Business Academy and is investing in its regulatory and supervisory infrastructure.

But the emirate is not immune from the financial crisis. The Qatar Investment Authority has recently been buying equity in local banks to support them. A planned unification of its three financial regulators – the Qatar Financial Centre Regulatory Authority, the Qatar Central Bank and the Qatar Financial Markets Authority – has been delayed. With a currency pegged to the dollar, inflation has also been a problem.

Qatar is surprisingly culturally diverse. Visitors are often struck by the international outlook and sophistication of its people. The media is free by Middle Eastern standards and links with the UK are strong. The emir, Sheikh Hamad bin Khalifa Al-Thani, attended Sandhurst military academy. Many key positions are held by British expats.

Lloyd's of London is currently looking for somewhere to site an office in the Gulf region. It was rumoured to have been considering Dubai, but the decision has been delayed, and some think Qatar's strong showing, as well as the recent economic troubles in Dubai, may be tempting Lloyd's to reconsider.

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Key points

- In contrast to the USA and Europe, the Gulf is enjoying strong, though tempered, growth
- Qatar, with vast natural resources wealth, is investing heavily in the financial sector
- Qatar plans to become a regional hub for insurance

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➔ Qatar's insurance venture
19 March 2009

➔ Qatar committed to insurance growth
18 March 2009

➔ Mitsui Sumitomo opens in Qatar
3 February 2009

➔ Lloyd's postpones Middle East decision
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