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May 2009

EXCLUSIVE INSIGHT AND ANALYSIS FROM INSURANCETIMES, STRATEGICRISK & GLOBALREINSURANCE

Michael Faulkner ■ Editor

The hardening of the reinsurance market is now taking hold worldwide, with the Japanese market the latest to show an upturn in prices when its renewal season concluded on 1 April.

As David Sandham reports (page 2), what makes this part of the cycle different to other such periods is that new capital, attracted by rising premiums and potential for greater returns, is not flowing into the sector.

Insurers' distribution strategies are also changing with the use of managing general agencies (MGAs) coming under scrutiny. As a consequence the MGA model is evolving (page 3).

The economic climate is forcing the insurance sector to look at its costs. Some of the world's major brokers have announced major cost-saving initiatives in recent weeks. As Nathan Skinner argues, these companies must take care to ensure that the quality of service offered to corporate clients is not adversely affected by these measures (page 4).

Meanwhile, pressure is mounting on offshore financial centres like Bermuda after last month's G20 summit. Insurance businesses that operate in such jurisdictions are unlikely to escape additional regulation in the coming years (page 5).

Finally, Nathan Skinner argues that the financial crisis has exposed flaws in corporate governance that must be addressed to ensure the proper function of risk controls (page 6).

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David Sandham • Editor • Global Reinsurance

It's getting harder

The current hardening of the reinsurance market is different from previous upturns

The reinsurance market is now in a hard phase worldwide. The Japanese reinsurance market recently firmed and turned, following other international markets. At the 1 April renewals, Japanese wind prices were up for the first time in three years, firming in a range of 2.5%-12.5%, according to recent figures from broker Guy Carpenter. Furthermore, the oversubscription rate reduced from 114% to 109%, a sign of market hardening. Japanese earthquake prices were also up for the first time in three years: pro rata reinsurance was up by 2.5%, and excess of loss was from between 2.5% and 7.5% higher.

An important reason for the firming of rates in Japan is currency effects. The yen is very strong relative to the dollar and sterling. Providers of reinsurance capacity from weaker currencies have been restricted in writing business. Reinsurers in Lloyd's and the London market have seen their capacity to write Japanese business restricted because of the weakness in the pound sterling.

Although Japanese rates are firming, they are not doing so as fast as US rates. US property and casualty reinsurance rates were up 10-14% year on year on 1 April, according to Guy Carpenter. The US firming began at the 1 January, 2009 renewals, when the average reinsurance rate increase was 11%.

Behind the worldwide hardening reinsurance market is weakness in reinsurer balance sheets. Last year, many reinsurers saw their shareholders' equity contract sharply, hit by investment losses. Most reinsurers lost money last year. Guy Carpenter's Global Reinsurance composite, a selection of large reinsurance companies from around the world, saw an aggregate loss in 2008 compared with a profit in 2007. Return on equity across the composite in 2008 was minus 6.2%.

It is worth noting that reinsurance underwriting remained profitable last year, even though underwriting profits were very sharply down. In the early part of 2008 there were many large individual losses, then in the second half of the year the giant Hurricane Ike caused much higher losses than originally projected. But overall, losses on the investment side are the main reason for balance sheet weakness among reinsurers.

Unusually, despite the hard reinsurance market, there is little sign of new capital flowing into the sector. Market turns have historically been accompanied by an influx of new capital chasing the higher rates. Part of the reason for the lack of it this time, is that reinsurers' investment losses remain for the present mostly unrealised losses. Reinsurers have not been forced into a fire sale of underperforming assets. Their cash flow remains strong. In consequence, the reinsurance market hardening, though significant, is not dramatic or extreme. If negative operating cash flow were to occur among reinsurers, then reinsurance prices could turn up very dramatically indeed.

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Key points

- The reinsurance market is hardening worldwide
- The main reason for this is weakness in reinsurer balance sheets
- Reinsurers' cash flow remains strong, which has moderated the upturn

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➔ Video: reasons behind the hardening market
12 February 2009

➔ Rates: it's not what you think
5 February 2009

➔ Market enters new phase
12 January 2009

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Ellen Bennett • Deputy Editor • Insurance Times

A change of form

The MGA model is evolving as market conditions change

Managing general agencies (MGAs) are big news. For some months now, the major composites such as Norwich Union (NU) and AXA have been publicly critical of the model, threatening to pull capacity. The effects are now starting to be felt, with *Insurance Times* recently revealing AXA's withdrawal from Primary and NU's potential withdrawal in the autumn. NU has also decided to stop providing capacity to Ink, owned by consolidator Giles, from the end of this year.

MGAs flourished in the soft market because they were a means for insurers of widening distribution and gaining market share, even at the expense of profit. They offered the major generalist insurers a route to niche, specialised business and canny brokers saw an opportunity to up their commission levels. Many seized the chance.

But as the market hardens and the economy falls into recession, the big insurers have little motive to back the model. Many MGAs were making a marginal underwriting profit – often because of high commission levels – and this can quickly fall into a loss. The major insurers are now focused on underwriting profitability and are willing to sacrifice volume. Inevitably MGAs have been the first for the chop.

But the model is far from defunct. Innovative brokers still see opportunities. For instance, Giles has expanded its MGA and Oval is looking to launch one.

MGAs of the future are likely to take on one of two forms. The consolidators' MGAs will work with another tier of insurers that remains only too keen to access their huge distribution capabilities.

The consolidators can still offer a lot of value to Lloyd's and the London market, insurers such as Fortis that are developing their UK presence, and smaller insurers such as Groupama and Brit. But these insurers don't have the capacity to handle as much of the consolidators' books as NU and the other composites used to. Managing numerous small relationships would be cumbersome and inefficient for the consolidators. The answer? Bundle all that capacity into a MGA, push large amounts of their book through, cut costs through economies of scale, return a healthy profit.

There is a second model, favoured by some of the Lloyd's brokers and global players. These use operating efficiencies – for example, technology – to cut costs and save the insurers money. These MGAs are not driven by high commissions but by taking a slice of the underwriting profit. The brokers that run them only get paid when their capacity providers make money. This model is likely to survive – with even AXA and NU maintaining a number of such relationships.

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Key points

- Managing general agencies were popular with insurers during the soft market
- Major insurers are now withdrawing capacity as the market hardens
- But there are still opportunities for MGA business models
- MGAs can be attractive to smaller and specialist insurers
- The remuneration model underpinning MGAs will also evolve

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➔ Consolidators back MGAs despite insurer snub
19 March 2009

➔ Days numbered for MGAs
4 March 2009

➔ Norwich Union set to follow AXA in pull-out from PBS
5 March 2009

➔ Willis lines up Mitsui and Brit for MGA panel
4 September 2009

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Nathan Skinner • Associate Editor • Strategic Risk

For fools rush in…

Global brokers should think twice before cutting risk consulting services

Global insurance brokers should wield their cost-cutting axes carefully because if they sever risk services to corporate clients, they may not get that business back.

Faced with a global economic downturn brokers are suffering along with everyone else. This year, the big three global brokers have announced ambitious cost-saving initiatives.

Staff costs are one of the biggest expenses. In April, Aon said it would slash its contributions to employee pension plans and reduce the sums it pays some employees in bonuses. At the time, Aon said: "No stone is being left unturned during 2009 to drive out further cost." Marsh hacked about 1,900 jobs in 2008 and outsourced another 900. While Willis chief executive Joe Plumeri offered staff the option of taking unpaid leave.

These initiatives come amid declining results. Aon posted a 35% drop in net income to \$123m for the third quarter of 2008. Willis' fourth-quarter net income also declined 35% to \$62m. Marsh's job cuts helped the broker report better than expected fourth quarter earnings. But net income still fell 6% to \$80m.

Since October 2008 all of the global brokers have seen their share prices slide: Aon's stock price has fallen 6.5%, Marsh has dropped 30% and Willis shares have slid 10%.

Their performance is a major concern for risk managers. Brokers, in an effort to reduce expenditure, may be tempted to cut the risk consulting services they offer big corporates. Marsh has already admitted that it plans further spending cuts in its consulting units. But this would not be a wise move for brokers.

In the current tough climate, the risk management profession is under pressure to prove how it adds value. Companies won't want to outsource services that they can do themselves in-house. And risk managers are eager to take on more responsibility in order to avoid the axe themselves. That means that what brokers choose not to do, internal risk managers will snap up.

The downturn gives risk managers a major opportunity to add value to their organisations. Risk managers can save their company money by driving down the total cost of risk through loss prevention initiatives, accelerating the closure of claims and insurance programme optimisation. These activities are more important than ever now and successful companies will be putting more emphasis on them. Brokers can help them do this with advice and by doing some of the legwork. Rather than backing away, the clever ones will continue to provide these services to help risk managers.

If brokers want to retain good relationships with their corporate clients, they should be careful not to withdraw help when it is needed most. If they do, they may never see those clients again.

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Key points

- Brokers are suffering along with everyone else during the economic downturn
- They may be tempted to cut the risk services that they offer major corporates
- But they should be careful what services they decide to cut
- Risk managers, looking to prove how they add value, will snap up the services that brokers choose not to offer
- Brokers might find that they lose business, which will be tough to win back

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➔ Downturn forces Aon to cut pension contributions
7 April 2009

➔ Willis asks employees to take unpaid leave in bid to cut costs
24 March 2009

➔ Sears Tower in Chicago is renamed after Willis
12 March 2009

➔ Aon launches cost reduction initiative
5 March 2009

➔ Marsh pays 20c dividend
22 January 2009

➔ Marsh launches five new products
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David Sandham • Editor • Global Reinsurance

Fault lines

Crackdown on tax havens is a way of diverting blame for financial crisis

On 2 April the leaders of the G20, the world's most powerful nations held a summit in London with the avowed aim of addressing the world economic crisis. One of their main pledges was "to take action against non-cooperative jurisdictions, including tax havens". The G20 leaders threatened to hit havens with a "toolbox" of "effective counter measures", including withholding taxes, reviewing tax treaty policy, and putting pressure on development banks and aid programmes.

Although attacking tax havens was by no means the G20's only measure, the importance world leaders attach to it is indicated by the length of their statement on it: in their "declaration on strengthening the financial system", it was the second longest of eight statements.

Anti-tax haven rhetoric has also been a common feature of recent statements by US treasury secretary Timothy Geithner, UK prime minister Gordon Brown, German chancellor Angela Merkel and French president Nicolas Sarkozy. At the London summit, Sarkozy reportedly wanted a list of tax havens to be published by the G20 itself, but when China demurred, President Obama brokered a compromise under which the OECD would publish the list and the summit refer to it.

The OECD, in the scramble to get its list published on time, did not initially include the phrase "tax havens" but quickly replaced it by a new version including the controversial phrase (the jurisdictions concerned prefer the phrase "offshore financial centres"). The purpose of publishing the list was clear: to name and shame. Some jurisdictions on the list have complained that they were given no notice of their unwelcome inclusion.

Of course, the truth is that offshore financial centres had very little to do with the world economic crisis. The financial crisis was not caused offshore. It was caused by speculation by banks and investors onshore: in New York, London, Paris and Frankfurt – the financial centres of the G20 nations. However, politicians enjoy having someone else to blame, and they like it especially well if that someone is weaker and smaller than they are. The offshore financial centre nations, generally small island territories, have become scapegoats.

Every government has a right to set its own fiscal policy. The presence of low tax regimes in the world economy has the beneficial effect of helping to keep taxes down. The reinsurance industry in Bermuda (one of the jurisdictions named and shamed) is vital to the world insurance industry, and has protected the US from property catastrophe losses for many years. Bermuda may be moved off the OECD's list soon, however. In April, Bermuda signed Tax Information Exchanging Agreements (TIEA) with seven Nordic countries and New Zealand; a further TIEA with Germany is expected which will bring the total to 12, the magic number required by the OECD. The OECD indicates that it will update its list as jurisdictions fulfill its criterion.

The politicians' dislike of offshore finance predates the financial crisis. President Obama, his chief of staff, Rahm Emanuel, and his chief economic adviser, Lawrence Summers, have all been long-standing critics of tax havens. The financial crisis has given them the excuse they need. And of course they need the cash. The US Treasury Department is desperate to find revenue wherever it can to pay the mounting bill for the economic crisis. The US government is estimated to be spending and lending about $10trn on bailout and economic stimulus programmes. The warning is clear: over the next few years, expect tough US legislation against offshore financial centres.

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Key points

- The G20 nations have pledged to crack down on tax havens
- However, offshore finance was not to blame for the financial crisis
- Despite this, offshore centres are likely to be hit by tough US legislation

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→ Offshore myth
14 April 2009

→ OECD's 'tax havens' list criticised
7 April 2009

→ Don't blame offshore
5 March 2009

→ Brown calls for offshore to be outlawed
5 March 2009

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Nathan Skinner • Associate Editor • Strategic Risk

Toothless non-execs failed the banks

The latest meltdown reveals that impartial risk control has not moved on since Enron

Once again a crisis has raised questions about the effectiveness of non-executive directors. In theory, independent non-executives are business leaders capable of putting the brakes on executive management because their pay is not tied directly to the financial performance of the company they oversee. They are the ultimate risk managers and a cornerstone of good corporate governance. But where were they when banks like Northern Rock, HBOS and RBS were irresponsibly racking up exposures way beyond what they were capable of handling?

The obvious criticism is that the non-executives did not understand the businesses they were meant to be overseeing. And they did not have sufficient influence or incentive to challenge other members of the management board. Non-executive and executive management roles are sometimes too closely linked. If they are too chummy, impartiality is compromised. Stricter rules, invented in the aftermath of past corporate scandals, were supposed to boost the power and influence of non-executives. That does not seem to have worked.

The last time the role of the non-executive was called into question was after the collapse of Enron, Tyco and Worldcom in the US. In the wake of those scandals of the early 21st century, the American authorities wrote the Sarbanes-Oxley Act (SOX) (2002), which prescribed much stricter rules on transparency and accountability. The British government in turn asked Derek Higgs, a former banker with a strong dislike of prescriptive regulation, to review corporate governance. In his report, Higgs stopped short of proposing a major regulatory overhaul as in the US, but he did recommend separating the non-executive role of chairman and the chief executive's job, to remove conflicts of interest.

Unfortunately, neither SOX nor the Higgs review appear to have succeeded in preventing another corporate governance crisis. Why have the regulators and those responsible for corporate governance not learned from past mistakes? The main problem appears to be that maintaining the balance of power between the two leadership roles has not worked.

Whistleblower Paul Moore, the former head of regulatory compliance at HBOS, claimed he was ignored and eventually fired for raising concerns about his bank's internal risk controls. Moore blamed the banking crisis on a failure of all of the key aspects of corporate governance and an inadequate separation and balance of power between the executive and those responsible for reining them in, which included internal control functions, the non-executives, external auditors, the regulators, shareholders and politicians.

"When I was head of group regulatory risk at HBOS, I certainly knew that the bank was going too fast (and told them), had a cultural indisposition to challenge (and told them) and was a serious risk to financial stability and consumer protection (and told them)," he said. Moore alleged the non-executive directors charged with overseeing risk management were anything but qualified.

HBOS has rejected Moore's allegations and said they were fully and independently investigated and found not to be true. The bank also reportedly made changes to the regulatory risk function, which the FSA judged as "appropriate".

Without real independence and influence, the risk management function, in its widest sense, cannot perform properly. As long as senior management can pressure internal risk managers they cannot hope to be objective. Moore wanted the risk department to report to a non-executive director. But unless that non-executive is also properly independent (that is, does not have any financial, professional or friendship ties to the chief executive), then the corporate world seems destined to keep skipping on the same track on the record.

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Key points

- The banking crisis has revealed the limitations of non-executive directors
- Non-executives are not independent enough, which means they cannot rein in executive management
- Internal risk managers are not independent because they can be influenced by executive management
- Risk managers need a direct reporting line to a truly independent non-executive

Archive

➔ Turner review: What does it mean?
12 April 2009

➔ HBOS risk boss was ignored
12 February 2009

➔ FSA raised risk concerns before HBOS whistleblower
12 February 2009

➔ Almost 40% of independent directors don't trust the board
3 March 2008

➔ A grizzly end to Bear Stearns
1 February 2008

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