

Insurance outlook

The insurance industry has changed. It has become more robust, more resilient and more flexible. The result is a buyer's market. **By Lee Coppack**

In 2005, the insurance industry absorbed nearly \$57 billion in catastrophe losses in the United States alone with little fallout and without across-the-board price rises. This year, insurers have continued to make underwriting profits, despite about £3 billion in UK flood losses. Combined ratios are generally in the high 80s to low 90s, possibly buoyed with releases from claims reserves for old years.

"Something has changed in the dynamics," according to Ron Hayes, Managing Director of the Global Risk Solutions division of Jardine Lloyd Thompson. "Insurers are a lot more robust, more resilient. They are bigger companies, thanks to growth and consolidation, and they are better managed than they were ten years ago. They have a better quality of leadership."

Room for innovation

Prices for commercial risks have fallen, and no single event is likely to create meaningful upward pressure. Says Hayes, "We see nothing that suggests that rates would go up in 2008." He believes only a combination of adverse events, such as a stock market collapse and a catastrophic hurricane or earthquake close together, would swing the market.

Hard rates and tight capacity for US windstorm exposures following the damaging 2004 and 2005 hurricanes did not spill over to other geographic areas and



other classes of business as extensively as they would have done in the past. In the United Kingdom, property rates have fallen by about 25 per cent and liability rates by around 20 per cent since 2003. The summer floods of 2007 have had little impact on commercial property insurance prices.

For most risks, there is also plenty of capacity. Andrew Agnew, Chairman of Jardine Lloyd Thompson Limited, comments: "Certainly, there will be adjustments, for example on financial lines following the sub-prime debacle, but I don't think we are going to see huge withdrawals from classes of business."

There are a number of ways commercial buyers can take advantage of the situation. In addition to getting good prices for traditional insurable risks, they are likely to find their insurers receptive to new ideas and longer-term agreements. "There is opportunity for real innovation in the market," says Agnew. "Insurers have an appetite for non-traditional cover, because they know that this is how they are going to grow."

According to both Hayes and Agnew, exciting developments in the market will help clients manage tricky risks that they have not been able to insure in the past. Insurers are increasingly willing to find ways of underwriting damage to intellectual property and corporate reputation, and business interruption without physical damage, such as the revenue loss that a British food manufacturer suffered in the

“The market for commercial insurance property and liability risks alike is soft and very likely to remain so, although financial lines may get tougher as a result of the sub-prime credit crunch.”

summer of 2007 when its fresh water supply was cut off because of flooding at a water treatment centre.

With rates at current levels, there is also renewed interest in long-term agreements that would allow the buyer to lock in capacity and a level of predictability in pricing for three or more years. "I think they are a good opportunity for both sides," says Agnew, "provided both keep to the agreement."

Liability, energy, catastrophe

Underwriters are scrutinising the possible liability of financial institutions to fallout

from the collapse of the sub-prime home loans market in the United States, and rates are likely to stabilise. Otherwise, for liability risks, most lines of business are showing falling prices or widening conditions or both, with a few specific exceptions, such as product liability for bio-sciences and pharmaceuticals.

Even UK employer's liability, which had a spike in price five years ago, has settled back down and there is ample capacity, although employers with poor loss records will be penalised. The market for directors' and officers' cover is very competitive with no apparent reaction to the potential increase in liabilities as a result of the UK Companies Act 2006 or Corporate Manslaughter and Corporate Homicide Act 2007.

Some pinch points do exist, for example rates for long-term civil engineering projects and the peak catastrophe risks for property and business interruption. The reason rates remain high in long-term civil engineering is due to a lack of global capacity, particularly for tunnelling risks.

In the immediate aftermath of Hurricanes Katrina and Rita in 2005, property and business interruption rates for energy facilities in the Gulf of Mexico increased by three or four times, while capacity fell by one-quarter to one-third. New capital came in quickly, and the rates soon came off their peak.

"And until they start feeling significant pressure on margins or they start losing money, they are not going to change," says Agnew. Although, he adds, "Capacity has increased, but it has not returned to its pre-Katrina and Rita levels, and that situation is here to stay. Insurers are much more controlled in their assessments of their aggregations."

For energy risks in other locations, insurers' – and reinsurers' – main concern is business interruption, because the high price of oil and gas means any disruption to production will be very expensive.

Another factor keeping pricing pressure in check is the interest of new investors in insurable risks through the capital markets, a development known as financial market convergence. Dominic Burke, Chief Executive of Jardine Lloyd Thompson Group, says that over the last two years interest has been growing from investors keen to access insurance risk and from buyers looking to find new methods of transferring risk.

"We believe that this development is still in its infancy and that the types of



»»» risk that will be covered by capital from new sources, the mechanisms by which risk will be covered or managed and the structures and instruments by means of which the capital is subscribed are all subject to a process of development that can only accelerate," he states.

Good information rules

Lower prices and ample capacity are good news for insurance buyers. They also have their share to do. Underwriters continually ask for more and better risk information. Insurers, and their reinsurers behind them, have become much stricter about measuring their exposures, Hayes explains.

They want precise geographical location about property risks, and they are drilling down much deeper into exactly where and why companies state certain values, for instance for business interruption. They are much more involved than ever before in examining exposures, particularly with regard to dependences, which they want clarified with a greater degree of precision.

Traditional risk transfer remains a valuable procedure for business, says Agnew. The insurance market may have moved slowly, but today its management has greater resources to respond to the changing pattern of business. More capital and greater ability to measure exposures also mean a more sustainable and probably less volatile insurance market.

Taking advantage

To get the full benefit of such conditions requires wide market knowledge, flexibility, negotiating skill and an ability to present risks and claims in the right way. Agnew explains that through an understanding of insurance and what is critical to clients' businesses today, such as brands and reputation and supply and distribution chains, the broker turns knowledge into programmes tailored to the sustainability of individual operations.

Presenting risk and claims information the way underwriters want is another important part of the broker's role. For example, when it comes to business interruption and especially non-damage business interruption, exposure mapping and quantification of risk are essential. This can be difficult and time consuming, especially for complex supply chains, but there are tools, such as SCAIR™, that capture and display the information in a straightforward way.

Claims settlement can be improved. Progress on the process known as contract

certainty means buyers are getting more timely policy documentation, but it does not mean there will never be claims disputes, comments Hayes. He suggests that companies take the half dozen possible sets of events that really worry them, and with the broker's help, test how their policy wordings would respond if disaster occurred. Examining the way insurers would process a major business interruption loss gives an opportunity to stress test procedures.

The right environment and culture within the broking company create a collegiate atmosphere, in which people in different departments work together to create bespoke programmes for their clients, according to Agnew. "If we do this well, it makes a huge difference and ultimately it is the way we are measured," he says.

The impact of reinsurance

What happens in the reinsurance market eventually affects pricing to the insurance buyer, because insurers depend on their reinsurers for protection against the extreme events.

The effect of four major hurricanes in 2004 followed by Hurricanes Katrina and Rita in 2005 pushed up rates for property-catastrophe exposures dramatically, especially for US windstorm and other peak areas. "The catastrophes of 2005 had a massive impact, and the catastrophe market was extremely hard in 2006," says Alistair Lockhart-Smith, Managing Director of JLT Reinsurance Brokers Limited.

Healthy returns for reinsurers as a result of the relatively benign 2006 year have led to lower prices for property-catastrophe risks, but not to the same extent as in the direct market, Lockhart-Smith explains. "There is a degree of dislocation between insurance and reinsurance," Lockhart-Smith says. "Reinsurance prices are falling more slowly than direct insurance prices, which will put some companies under pressure when they renew their reinsurance treaties at 1 January 2008."

Although 2007 events have made more demands on reinsurance protection, Lockhart-Smith believes that many reinsurance rates will come down further, in the absence of major events. It is another reason to indicate that insurance will remain a buyer's market. **RS**

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For what lines of commercial business would you expect to see price increases in 2008?

Our expectation is that prices will fall for the majority of business classes.

However, we are currently seeing rate increases for political risk business, and we anticipate increases in some of the classes where we have seen large price reductions over the past few years, such as in the UK commercial market.

What would it take to turn the market?

In the short term, it will take a large loss or a series of large losses to turn the market.

The recent history of

catastrophe losses paints an uncertain picture: \$40 billion in insured losses in 2004, \$80 billion in 2005, and a relatively minimal amount in 2006 and so far this year.

Based on this record and the fact that the market is currently softening for most classes of business, I am not sure anyone could predict the level of losses the industry could absorb before the market began to turn.

Other forces are at work in the medium to longer term. All underwriters are required to be more explicit about their margins, the amount of risk they are underwriting and the capital they have.

Then you have the upcoming

Solvency II requirements.

All of this will have an effect on the amount of capital required for underwriting and, therefore, the prices the underwriters must charge.

What product or service innovations do you feel are (or would be) most valuable for larger businesses?

I believe that insurers should first concentrate on making our existing products work more effectively.

The large losses of the recent past have led to a spate of contested claims and litigation, because the expectations and interpretations of contracts by both insurers and policyholders have widely differed.

I believe that major improvements can be made in this area.

The current contract certainty initiatives are addressing some of them, but further work is necessary to ensure that a contract clearly describes the expectations of insurers and insureds.

There have also been some interesting initiatives by brokers to score or rank underwriters according to criteria other than price.

This is a useful development as there can be confusion between price and value when insureds are making decisions about the carriers with which to place business.

For what lines of commercial business would you expect to see price increases in 2008?

The rating environment continues to be mixed by geography as well as by line, sector and size of business.

Rate decreases in 2007 have slowed relative to 2006 for most lines of business and the signs for 2008 are that most lines of business will remain, in rating terms, relatively flat.

Lines of business driven by

attritional claims, such as motor fleet, are expected to experience rate increases next year.

Mid-range freedom of services or global property and casualty-based accounts are also expected to experience modest increases.

In late 2008, some casualty accounts may see moderate price increases in response to more intense capital ratios.

What would it take to turn the market?

As things stand, one major loss

event alone wouldn't be enough to trigger a market turnaround.

It would have to be accompanied by a significant deterioration in the capital market environment.

What is your view on long-term policies?

We know from the past that entering into a long-term policy without an effective relationship with a customer founded upon shared aspirations, a good understanding of the risk profile, pricing that is regarded by all

parties as reasonable and an agreed way of dealing with issues that will arise during the term is almost certainly dooming the long-term policy to failure.

Most companies' capabilities to enter long-term policies are greater now than at this time in the last market cycle. This is due to significantly increased net retentions ... the question is really more whether the above can be achieved to make it worthwhile.

For what lines of commercial business would you expect to see price increases in 2008?

After eight consecutive years of rate increases, the situation in the reinsurance market remains mostly favourable. Although the 2007 treaty renewals demonstrated that the hard market has generally passed its peak, rates in property/casualty reinsurance remain largely commensurate with the risks and, hence, attractive. Property catastrophe and marine are still the hardest segments. In light of

major loss events, including the European winter storm Kyril, floods in the UK and the storm/flood event in Australia, rates for natural catastrophe covers should remain stable, with increases expected in the affected areas. All in all, we anticipate no significant deterioration in catastrophe-prone property.

For what lines of business do you think terms and conditions will soften?

Although there is no material widening across the board, an ongoing softening is likely in the

US casualty market. Where we anticipate reductions, for the most part they will typically come from adequate price levels.

What would it take to turn the market?

A major loss would certainly have an impact. However, this would probably only affect the market and the class of business in which the loss occurs. Generally, insurers and reinsurers have been able to accumulate surplus, and we're still in an environment of more or less sufficient rates. Apart from major losses, we currently do not see

any other drivers on the horizon, like actions by the rating agencies or regulatory bodies.

What product or service innovations do you feel are (or would be) most valuable for larger businesses?

Larger businesses place their risk in the facultative markets. As speed for obtaining quotations is a decisive factor, internet-based quotations will increase in importance. Internet-based solutions also make facultative placements of smaller risks worthwhile because of reduced transaction costs.