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ADAPTING TO NEW REALITIES

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ADAPTING TO NEW REALITIES
by Roman Lechner

The events of the last three years have provided some very painful lessons to the insurance industry and its customers, particularly regarding the size of the material and financial risks they face. Insurers received their wakeup call at the bottom of the underwriting cycle, when the rates they offered were based upon an assumption of extraordinarily high investment yields. Today the soft market business model is no longer viable.

Already during 2000/01 renewals, it was evident that the soft market phase was coming to an end. Rates for commercial business and reinsurance began to rise slowly as equity markets peaked. The once constant capital gains income stream not only ran dry, but turned very sour. However, it was the tragic and shocking event of 11 September 2001, in which 3,000 people lost their lives and 2,500 were injured that finally catapulted rates in most risk categories. Insured damage amounted to approximately USD 40 billion – twice the amount of Hurricane Andrew in August 1992, the second largest insured single event. The insurance industry was called to pay for a hitherto unimaginable risk in a dimension they had not calculated.

From a financial perspective, the terrible spectre of 11 September did not represent the greatest burden for the insurance industry. Rather, it was the fall of equity markets world-wide that destroyed USD 100 billion in the non-life industry alone. Life insurers could have lost even more on their asset portfolios; however they offloaded

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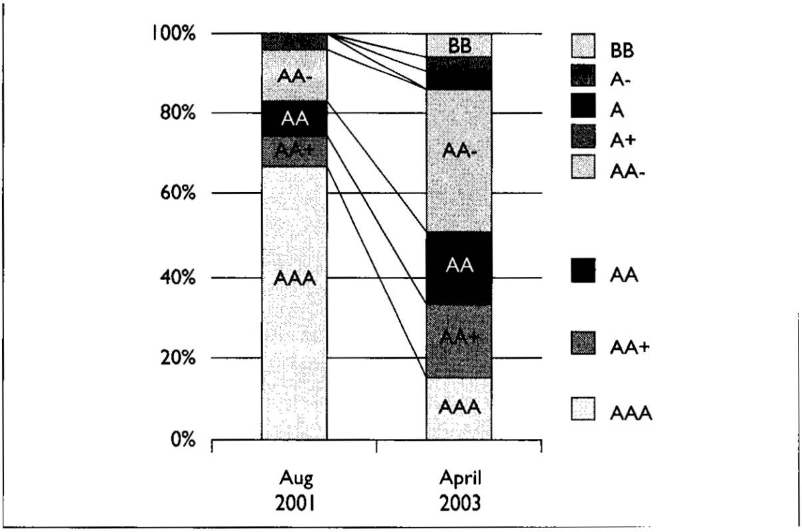
a major part of the burden to the insured, through profit-sharing arrangements between insurers and policyholders, which is common for most life insurance products.

Tightening capital base of the reinsurance industry since September 2001

Reinsurers' balance sheets and capital bases were also impacted by the unfortunate developments following 11 September. Aware of the industry's equity gearing and crumbling solvency margins, investors and rating agencies have exercised caution: virtually all reinsurers have been downgraded since September 2001, some of them even more than once, leaving just one leading player with a S&P AAA rating.

GRAPH 1
S&P RATINGS OF LEADING REINSURERS, WEIGHTED BY PREMIUM INCOME



Data on the leading reinsurers shows how ratings have diminished. The share of AAA rating decreased from over 60% in 2001 to only 15% in 2003. However, still over 85% of the reinsurance supply (measured by premium income) has a rating of AA- or above.

Ratings have been lowered despite tremendous improvements in the underwriting conditions. The events of the last few years have highlighted the limits and inherent risks associated with the soft

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market business model, and have led to increased rating agencies scrutiny. Any major worsening of current external conditions could impact on the claims paying ability of several players.

The world-wide aggregated reinsurance capital base (mainly of the largest reinsurers) decreased by more than 30% between the ends of 2000 and 2002. More than two thirds of this drop was due to Munich Re's capital losses on its large strategic participations. Excluding this special impact and because capital infusions of around USD 10 bn were made industry-wide over the last two years, the aggregated capital base in USD terms remained relatively stable. However, a large portion of this new capital is devoted to reserve strengthening and not additional underwriting capacity. While competitors from the US and Bermuda increased their equity, their European counterparts suffered a 15% decrease in USD terms. Measured in respective currencies, the decrease was considerably higher (since end of 2000 the USD has weakened by 10% against the Euro and by 15% against the Swiss Franc). This reflects the decreasing market capitalisation of the reinsurance sector, in which over the last 18 months the share prices of European reinsurers have suffered more substantially than, their US/Bermudan competitors.

Small effect of New Bermuda start-ups and Lloyd's capacity increase on reinsurance capacity

New reinsurance capacity generated by the Bermuda start-ups and Lloyd's syndicates is considerably lower, on a net basis, than one might assume. Some of this capacity came as well from the reinsurance sector itself and some supports direct insurance business. Of the USD 9 billion of equity capital raised through the new wave of Bermuda start-ups, only about 50% amounted to additional reinsurance capital. And of the USD 2 bn injected to support the Lloyd's USD 4 bn capacity increase since beginning of 2001, only a part is related to genuinely new reinsurance capacity. Ultimately, about USD 5-6 bn of fresh reinsurance capital has been channelled trough these two marketplaces. However, this was not substantial enough to lead to a general market softening, although some property rates showed a levelling out at the last renewals.

2002: the return of the hard market, but with disappointing underwriting results

Combined ratios of reinsurers and rates for non-marine insurance cover from the London market (both indicators of rate developments of the global reinsurance industry) reveal the industry's well-known cyclical pattern.

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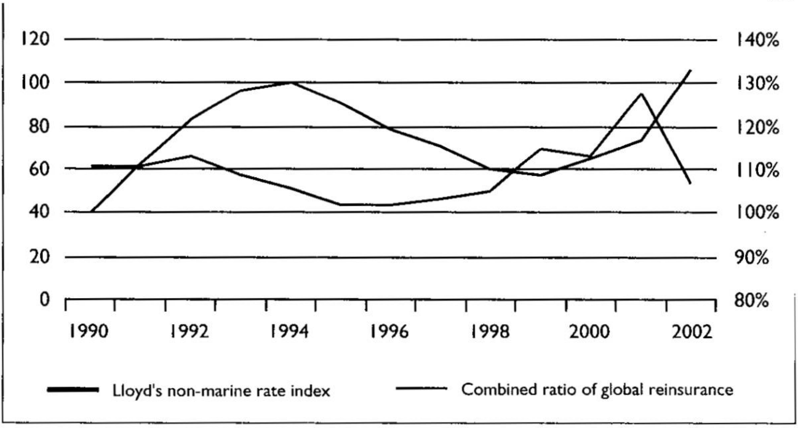
GRAPH 2
UNDERWRITING RESULT AND PRICE CYCLE



The reinsurance industry reported a disappointing 107% average combined ratio for the year 2002. The significant rate increases and tighter terms and conditions implemented did not materialise fully in last year's profit & loss accounts. The full effect of these underwriting efforts will only emerge over the next years. More importantly, in the US the combined ratios of many professional reinsurers were affected by prior year reserve-strengthening needs. Excluding the disclosed reserve-strengthening for asbestos liabilities and for under-priced casualty business ("adverse reserves developments"), in 2002 the average combined ratio of the leading reinsurers would have decreased to around 100%.

Starting from 2003, underwriting results are expected to show the full effects of recent price improvements. As an indication of this, the US property & casualty reinsurance industry reported improvements in their first quarter underwriting results. The average combined ratio of the members of the Reinsurance Association of America dropped to 96.4%, down from 101.6% a year earlier. This reflects the favourable pricing environment, the absence of significant reserve additions, as well as a low natural catastrophe occurrence.

Renewals 2003: stabilisation in property – further increases in casualty

2003 renewals confirmed the existence of a hard reinsurance market: property rates kept firm, with some rate increase in certain areas of Continental Europe and United Kingdom affected by natural catastrophe losses (flood "Jeannette"). According to broker renewal

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reports, property cat XL and aviation were virtually the only lines that have shown a slight softening of the rates, partly due to new Bermudan capacity. At the opposite end of the spectrum, casualty reinsurance experienced both considerable rate increases (20%-30%) and volume growth. Overall, the leading reinsurers have been successful in gaining more control over accepted risks by requesting more transparency, excluding certain classes of risks such as asbestos and imposing event limits on proportional business.

The focus in insurance has shifted as the industry has moved from over- to tight-capitalisation – Solid technical underwriting is key

As the industry has moved from an abundance of capital to a situation of tight capitalisation, the behaviour of the players has changed dramatically. The focus has shifted from expansion and diversification to concentration on core businesses and cost management. The attention has changed from an offensive strategy in which capital is not really a constraint, to a defensive strategy of funding and ensuring liquidity, of concentrating on freeing up capital and maintaining flexibility on assets and liabilities.

In the current low interest rate and high equity volatility environment, where investment returns are meagre and no fundamental short-term improvements can be expected, sound technical underwriting is an absolute prerequisite for profitability. Combined ratios of over 100% are no longer affordable for the reinsurance industry. The soft-market business model, which was based on huge capital gains through the asset management activities, is no longer possible.

Capital scarcity has also reduced companies' appetite for M&A activities. Growing market share through acquisitions has gone out of fashion; instead, spin-offs to raise capital for the core business have become more common. Big financial conglomerates like Zurich and St. Paul retreated from the reinsurance business. Others have also decided to divest their reinsurance operations, but are still waiting for better capital market conditions to make their exit.

The big swings, typical for the reinsurance business, are increasingly perceived as a burden for the non-specialised players, in light of their increased capital requirements and the impact they have on market valuation. At the same time, in order to profit from the hard market, insurers have invested heavily into the new Bermudian ventures. The main reason for this behaviour is to isolate reinsurance liabilities from their balance sheets and to treat reinsurance as a capital investment through minority shareholdings.

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Outlook

Even though the property & casualty insurance industry has prepared the ground for future improved profits, by increasing prices and tightening terms and conditions, balance sheets remain under pressure. The hard market is expected to last longer than in previous cycles, given the global shortage of quality capital, low interest rates and the ongoing concerns regarding reserves adequacy. Barring a repetition of the stock market boom of the 1990s, the industry will not enjoy a situation of excess capital in the foreseeable future. However the insurance industry is moving back to a normal profitability pattern: combined ratios are expected to be around 100% with investment results tempered by low interest rates and no major support from capital gains.

As a mature industry, insurance's long-term growth prospects are closed to that of general economic development, particularly for the property & casualty insurance industry. However, in certain year insurance price cycles can lead to substantial deviations of premium growth from GDP growth. While life insurance growth normally exceeds GDP growth due to the positive influence of saving patterns depending on wealth, the respective property & casualty reinsurance markets follow basically the trends of their underlying markets, exhibiting even more pronounced cycles.

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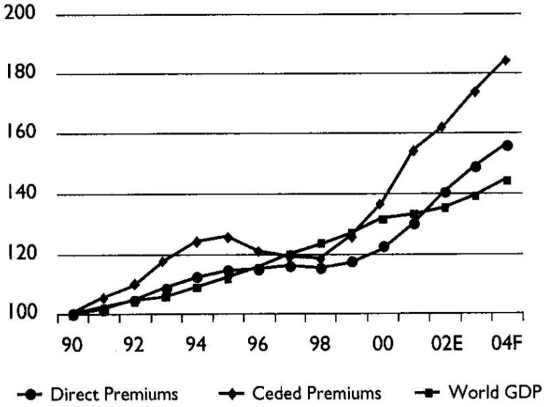
GRAPH 3
LONG-TERM DEVELOPMENT OF INSURANCE AND REINSURANCE

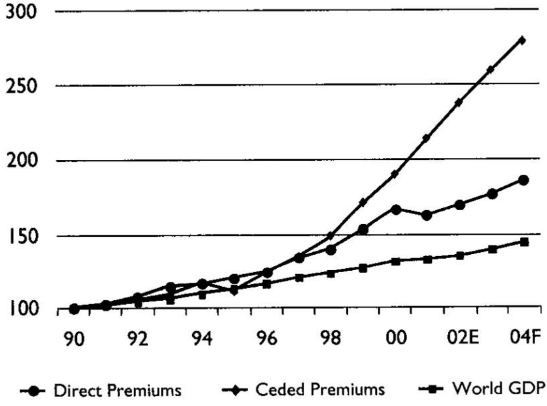
Property and Casualty

Premium index, based on annual real growth rates (1990 = 100)



Life & Health

Premium index, based on annual real growth rates (1990 = 100)



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