

HORUS

Second Year, Issue 22

December 20, 2001

As the world economies continue to integrate through globalization of business, coordinated monetary policies and increased trade linkages, the insurance cycles of individual countries will become more closely aligned with a world insurance cycle.

This Issue is concerned with monitoring the growing worldwide phenomena of hardening insurance conditions.

Which will have much effect on all other markets around the Globe.

Insure Egypt

Insurance Market Review 2002 **Report by: Willis**

Property

We can expect further significant short-term reduction in capacity, perhaps by over 30%, However, much will depend on the availability of treaty reinsurance capacity at January 1, 2002. Risk excess treaty renewals are now being quoted at such high rates that it is questionable whether property insurers will buy them. If they do not, capacity will be greatly reduced; if they do, then premiums will be massively increased.

We predict that in 2002, at least initially, there will be fewer players with too little capacity to provide a stable global property insurance market.

Areas in which we see longer-term contraction are coastal windstorm, earthquake, terrorism and flood.

Faced with inadequate rate increases prior to September 11, and with increased treaty costs already incurred or anticipated, we expect property insurers to look to take giant steps forward. Major rate increases will be the norm in 2002, even with favorable loss experience. We believe large multinational risks will bear the brunt of this.

Alongside drastically increased rates, insurers will try to pare coverage. Exposures that cannot be readily identified and priced will be eliminated or liability for them greatly reduced. Besides terrorism these include:

Eliminated

- Computer virus, denial of service attacks and similar e-risks, except through specialized policies
- Mold contamination
- Indirect contingent time element (i.e., suppliers of suppliers, customers of customers)

Reduced in scope or limits

- Debris removal

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- Demolition/increased cost of construction
- Sue and labor
- Period of indemnity for time element
- Claims preparation expense
- Extra/expediting expense
- Service interruption
- Biological & chemical pollution
- Full value (blanket limits)
- Contingent business interruption

The continued feasibility of controlled master global programs is in doubt. In light of the difficulties individual markets Fronting carriers are increasingly unwilling to bear the credit risks they see as inherent in these arrangements. We expect to see fewer markets willing to front and significantly higher charges from those who do.

Sabotage & Terrorism

There has been a small, long-established market offering specific sabotage and terrorism coverage in areas of the world where the Property policies would not provide for this. This market has essentially been centered on Lloyd and in particular the marine underwriters who write sabotage and terrorism as part of their war, marine and aviation book. This section of the market was already significantly affected by the Sri Lankan loss in early 2001 when terrorists caused damage to installations and planes estimated at in excess of US\$400m. Since September 11, this specialist market has been asked to quote Property risks from all over the world as opposed to just a few countries (or competing against Pool Re in the UK). The market expects to receive a number of firm orders from clients able to obtain only small sub limits (if at all) under their Property policies for sabotage and terrorism. The market has between US\$100m and US\$250m of capacity on a per assured basis but we expect underwriters to monitor their country aggregates very closely, providing only a limited number of policies over the next 12 months.

Energy

The utility sector has experienced almost four years of unprofitable underwriting. The poor loss experience has included both major machinery breakdown and fire losses. The annual average loss ratio in the sector exceeded 170 per cent, rising to 225 per cent for some individual insurers. Prior to September 11 property damage deductibles were rising by a factor of two or three on standard generation assets, while time element coverage waiting periods were being raised by 50 per cent to 100 per cent for standard risks. In the case of combustion gas turbine assets the deductible increases were even more substantial, particularly in the case of prototype or unproven equipment. On average, rate increases in the first three quarters of 2001 have been in the 30 per cent range. Since September 11, the market has suffered a severe contraction in capacity, resulting in even higher rate increases than earlier in the year. The biggest impact so far has been in the property and business interruption arena. Into 2002 utility property rates are likely to rise on average by up to 100 per cent and in some cases even more. Reinsurers will look for increases in pricing as they seek to spread the World Trade Center property losses across other lines. Casualty insurers have indicated that they are experiencing difficulty in their treaty renewals and expect to see some impact in renewal terms for their insureds. With few exceptions, insurers have stated that the capacity available for utility risks has reduced substantially from that available prior to September 11. Notable exceptions are the industry mutuals. Quality of risk will be a big issue in future and those risks perceived to be of poor quality will prove difficult to place for substantial limits. We expect that insurers will continue to seek to increase deductibles, particularly for poor risks. This will be coupled with a further restriction in coverage conditions, leading to the disappearance of many of the extensions provided in the soft market. Blanket unnamed suppliers and customer extensions are unlikely to be available. Underwriters will likely require supporting work sheets for reported business interruption values and interim updates, while business interruption coverage as a whole may be subject to the imposition of coinsurance provisions. Many insurers expect sabotage and terrorism to be excluded in their treaty reinsurance renewals and this cover will probably either be excluded from property policies, or heavily loss-limited.

A spate of severe accidents between March and September 2001 radically changed this outlook. It is likely that total losses for 2001 will exceed US\$4 billion, of which at least US\$3 billion will be for onshore risks. This excludes third party liability. When this loss is compared to an estimated world onshore energy premium of between US\$1.2 and US\$1.4 billion, it is clear that, despite rapidly increasing rates, the energy sector will not approach profitability in 2001. Moreover, if rates rise too fast insureds will seek alternative financing or mutual insurance company solutions. Business interruption is a major concern to the onshore market. The onshore energy insurance market is facing even greater challenges than other sectors of the market and is now seeking to impose separate waiting periods for business interruption where property damage and business interruption are currently subject to single combined dollar deductibles. In addition, business interruption wording is being tightened, particularly for periods of indemnity, and concerns have been raised over the reporting of values and location limits.

Reinsurance

A number of major factors were already affecting the state of the insurance and reinsurance market prior to the World Trade Center (WTC) loss. They include:

- ❑ The very poor underwriting results for the reinsurance industry in 1999 and 2000 underwriting years arising from inadequate original rating.
- ❑ Deterioration of past years reserves from asbestosis and other long tail exposures.
- ❑ Poor investment returns in falling equity markets and a low interest rate environment.

Reinsurers were seeking to address these issues prior to September 11. However, the improving trend had only just started in the 2001 underwriting year and reinsurers are now facing the burden of paying the huge WTC loss at a time when their balance sheets have not yet fully recovered from earlier poor results. In addition reinsurers are facing uncertainty about the quantum of the ultimate loss from the WTC, its apportionment across property, casualty and life businesses, and the possibility of some reinsurance markets failing to meet their liabilities.

September 11 events are likely to result in greater shareholder pressure on the management of reinsurance companies to improve returns, thus leading to rate increases.

The WTC loss will impact the capital base of the reinsurance industry though there are some signs that fresh capital is being raised.

This is taking place either through rights issues of existing companies or through the creation of new reinsurance ventures. Despite these efforts however, overall the reinsurance industry faces a capital squeeze. Insurance and reinsurance companies solvency margins are primarily calculated on the volume of premium they are accepting. In a market where rates will increase substantially a number of reinsurers will be constrained in terms of the amount of business they can accept due to a lack of capital.

Already the reinsurance market is seeing a reduction in the amount of capacity available. Aside from the problems arising from capital constraints most reinsurers have relied on reinsurance capacity (retrocession) to build up their capacity. The WTC loss is ravaging the retrocession market, especially for the coverage of single risk as opposed to natural catastrophe perils. Most prudent reinsurers are assuming that their existing retrocession capacity will either not be available in 2002 or the cost of such cover will be prohibitive.

In recent years many large risks have been more easily absorbed by the insurance and reinsurance industry through the application of estimated maximum loss (EML) underwriting techniques. The severity of the WTC loss has cast doubt on the whole concept of EML underwriting. Thus the worldwide insurance industry faces a difficult situation of demand increasing at the same time as supply is reduced, leading to further upward price pressure.

In light of the WTC catastrophe, reinsurers will demand much greater disclosure of underlying exposures. One possible scenario is that very major and complex target risks may be forced out of automatic treaties into a much-reduced facultative or single risk market.

Construction

For many years construction risks business has failed to make underwriting profits.

In reaction, and largely through the influence of the major European reinsurers, the construction market hardened significantly in the first half of this year with increased rates, reduced capacity and threats to coverage scope.

In recent months, the move towards increased pricing and reduced coverage has accelerated at unprecedented rates and there are now serious concerns that some sections of the market will no longer be willing to insure major construction risk exposures.

Certainly capacity and scope of coverage will be very severely limited and prices will be significantly higher.

While some projects will be delayed or cancelled as a consequence of the events of September 11, there is a massive demand worldwide for new infrastructure. This need, coupled with the availability of finance, should mean that there is no long lasting reduction in demand for construction investment and consequently construction risk insurance. Whether the insurance market will continue fully to meet that demand is not certain.

We expect further rating increases in an endeavor to return accounts to profitability, with average increases of 40-50 per cent anticipated overall. Risks will be quoted on their own merits depending on factors such as parties involved and territory.

Undoubtedly carriers will be reluctant to offer quotations without full and detailed information. They will be very selective.

The oil, gas and power classes are likely to see the highest increases. Heavy civil engineering, including tunneling, dams and bridges is also likely to see substantial rises since capacity for these types of risks has already been reduced and will fall further.

Coverage extensions will be separately rated Delay in start up coverage rates will increase several fold following major losses in 2001.

Risks involving new technology will be even more closely vetted and may become uninsurable for testing and commissioning exposures. Breadth of coverage generally for these risks, particularly in the power sector, will be restricted.

Catastrophe perils, windstorm and earthquake will be substantially harder to complete and reduced sub limits can be expected. Many carriers buy catastrophe protection on a claims made annual basis and early indications are that substantially increased reinsurance costs could force them to avoid risks in areas that are exposed to such perils.

Marine

The events of September 11 accelerated hardening market conditions in the marine sector. Prior to September, capital providers were beginning to force the upward trend of the cycle. This trend was underpinned with some withdrawal of capacity and reduction in the overall number of players through

mergers or withdrawal from the class.

Much of the recent aviation war losses (Air Lanka and WTC) are to be paid by the marine war market in which they were underwritten. It is therefore unsurprising to see a strong impact on the appetite and rating of marine war business.

Annual marine hull war rates have moved from, typically 0.01 per cent to 0.02 per cent prior to September 11 to 0.04 per cent to 0.05 per cent, irrespective of where the vessels trade, although even harsher rating has been imposed in the cruise vessel sector. At the same time, the trading warranties have been amended to exclude a wide range of destinations in respect of which additional premiums are charged. There is, however, a competitive market developing in war business.

We anticipate that even the best fleets will attract some level of increase as the market contracts. These same conditions are expected to apply to the marine liability market as reinsurance costs and limited capacity drive rating levels upwards.

With the main protection and indemnity (P&I) renewal date being February 20, the main focus of concern has been in connection with the P&I Clubs stance on war risks. The P&I Club market has explicitly stated that P&I war cover offered by them is only in excess of any underlying war P&I cover, bought with the hull insurance, or in excess of the hull insurance value, whichever is the greater.

The perceived deterioration in the political situation in certain parts of the world since September 11 has resulted in revised war risks rating schedule for marine cargo risks.

The practical application of these war rates has translated into general premium increases for cargo owners, depending on the destination of their goods.

Also, the reductions in capacity over the past few weeks have contributed further to the general upward cycle.

Aerospace

Operators in the Aerospace sector face uncertainty over both the amounts of liability protection they require and the ability of the insurance market to meet that need.

Temporary withdrawal of third party legal liability cover for war and terrorist acts underlined the importance of insurance to commercial operations. Governments, although able to provide short-term solutions, prove unwilling to accept long-term risk.

Losses arising from September 11 will cause rates within the reinsurance market to rise significantly and these will be reflected in direct rate increases to aviation insurance buyers. Already the basis of reinsurance protection is moving towards (losses occurring during) in place of (risks attaching), enabling reinsurers to better adjust their pricing.

Direct insurers may also experience cost and coverage restrictions, causing them to reduce capacity in certain sectors of the class or to retain a greater proportion of the risk.

Direct insurers will therefore write for their net account and this will force rating levels up.

Since September 11 the level of increase for all classes of aviation exposure is averaging in excess of 100 per cent, with (hull war) averaging over 700 per cent. The market has re-priced its capacity across the board.

The market is set to remain hard for the foreseeable future, encouraging some increase in capacity from existing and new markets. However, this will not lead to a rapid fall in rates. Prevailing market conditions will result in direct insurers being selective in the use of their capacity.

More expensive reinsurance and reduced protection will cause the capital providers and reinsurers of direct insurers to analyze their underwriting strategy. This is likely to result in the imposition of stricter underwriting conditions while maintaining higher rates. As premium levels increase the general aviation class may experience capacity reduction. This class has low premium value risks and is unable to offer the volume of income per risk of other major classes.

The capital providers and managers of direct insurers may seek to generate premium income from classes that offer greater premium volume per risk.

Space underwriters, following a string of major satellite losses, were already reviewing satellite coverage terms, conditions and future rating levels.

Space underwriters will limit post launch cover to one year and placing insurance programs more than one year prior to launch will be impossible. Also, the point at which a satellite will be declared a total loss will be pushed higher as will satellite margins for power. Satellite bus specific defects will be incorporated for known problems and/or financial deductibles will be imposed.

Rate increases of 50 per cent for all classes of exposure in the satellite account are probable, although increases will go higher depending on the availability and cost of reinsurance.

Profitability of the non-life insurance industry: It is back to basics time Report by: Swiss Re

Executive Summary

This report examines the key factors and latest trends determining profitability in the major non-life insurance markets. The price or underwriting cycle and investment performance are the two most important factors shaping profitability. Currently, profits are elusive, despite a hardening market. Interest rates are low and most equity markets are in the doldrums, making profitability through investment returns challenging and highlighting the need for improved underwriting results.

The following profitability trends have been identified:

- ❑ Worldwide, non-life insurance markets are currently in a period of declining profitability. The decline reflects the soft underwriting cycle, weakening investment performance, and the high level of capital finds. Falling interest rates and robust stock markets have increased insurers capital funds. Insurance capacity had reached historically high levels in 1999, which had led to downward pressure on premium rates. As a result, underwriting results declined in all major markets.
- ❑ The long-term return on equity for US non-life stock companies has been comparable to the return on equity (ROE) of broad market indices, once unrealized capital gains are taken into account. Also, the stock market performance of non-life insurers has been roughly comparable to broad market indices over the last 20 years. However, non-life insurers have underperformed significantly over the last few years.
- ❑ Non-life insurance markets are currently in a transition period between a severe soft market and a hard market. Commercial lines and reinsurance premium rates started to rise in 2000, and have gained momentum in 2001. Prices in the personal lines have lagged behind slightly, but are now increasing moderately. Nevertheless, reported underwriting results will be undermined for quite some time by adverse reserves development.
- ❑ Underwriting results follow a cyclical pattern, caused by external factors affecting capacity - such as catastrophic events and investment performance. In addition, internal factors - such as insurers striving for market share during times of robust investment results - contribute to the cycle. The cycles average about six years in length and are synchronized across countries and to some extent across lines of business.

Investment performance has increased in importance to insurers, with net investment results rising from about 15% of net premiums written in 1985 to about 180/0 in 1999 and 2000. The two factors determining the improved investment results were the strong capital market performance from 1995 to 1999 and a long-term trend towards more asset leverage. Asset leverage, the ratio of invested assets to net premiums, has increased in all the major markets primarily because of the increase in loss reserves. The reserve ratio - reserves over net premiums written (NPW) - has risen in all the major markets along with the increasing importance of liability lines of business; higher inflation for indemnified services, such as medical care; and mounting litigation costs.

- ❑ Inflation and interest rates have been falling worldwide. The monetary authorities of the major economies have become more independent and have narrowed their focus to maintaining inflation at a low level. Hence, interest rates are expected to remain low for the foreseeable future.
- ❑ In the near term, the equity markets of the major economies will remain volatile and uncertain. After a long period of robust returns, equity markets are unlikely to produce strong results in the short run. With investment returns uncertain, insurers are increasingly striving to boost profitability through improved underwriting. After a prolonged soft market, prices are rising and the market is hardening. However, there is still a long way to go. Underwriting results must improve in the major markets by 7% to 14% of net premiums, depending on the market, in order to return to average profitability.
- ❑ Weak investment returns and a hardening market are not coincidental. Over history, underwriting and investment results have been negatively correlated - strong investment results increase capital finds, softening prices.

Introduction

Non-life insurance markets are currently in a transition period between a severe soft market and a hard market. Profitability is low, but should be improving. During the soft market, rising insurance capacity and fierce price and market share competition led to

widely available coverage and low premium rates. Underwriting results declined in all major markets. Net investment results, including realized capital gains, increased until 1998 in most major markets, bridging the gap between falling underwriting results and providing a small improvement to net income. Investment results deteriorated after 1999 as interest rates bottomed out and stock markets declined, setting the stage for a hardening of the market.

The main questions addressed in this analysis are:

- ❑ What are the main drivers of profitability?
- ❑ How does the long-term profitability of non-life insurers compare to benchmarks in other sectors?
- ❑ How important is investment activity as a driver of profit, capital finds (leverage), and volatility?
- ❑ What patterns are there to the insurance cycle, in length and between countries?
- ❑ What underwriting result is necessary to achieve an average economy-wide ROE, given the current investment outlook, the level of asset leverage and the solvency ratio (capital finds as a percentage of net premiums)?

What are the profitability drivers?

To analyze the drivers of profitability, it is useful to decompose ROE into its main components. Profits are determined first by underwriting performance (losses and expenses, which are affected by product pricing, risk selection, claims management, and marketing and administrative expenses); and, second, by investment performance, which is a function of asset allocation and asset management as well as asset leverage. Capital efficiency (ROE) is additionally affected by tax strategies and solvency.

Cross-country comparison of profitability

The benefit of this type of decomposition is to separate the various factors affecting profitability, isolating them for further analysis. Though they will be analyzed separately, they are interrelated through the decision-making processes of insurers. Table 1 compares five-year average performance ratios of the major non-life markets, based on statutory data.

Table 1
Profitability decomposition of major non-life markets
Five years averages in % of net premiums unless marked with +

Years	US 1996-00	Canada 1996-00	UK 1996-99	German 1995-99	France 1995-99	Italy 1995-99	Japan 95-99
Loss ratio	77.5	73.4	75.4	70.5	84.5	85.7	56.7
Expense ratio	27.4	32.0	32.5	25.3	22.5	27.1	35.7
Underwriting result	-6.5	-5.7	-7.9	1.5	-8.3	-14.1	3.3
Investment yield +	7.0	8.3	9.0	7.2	5.8	7.8	2.9
Asset Leverage	268.0	199.4	273.3	217.3	265.3	202.0	435.1
Net Investment result	18.8	16.5	24.6	15.7	15.4	15.8	12.4
Other expenses/ earnings	-0.1	0.9	-2.7	-6.6	-1.5	1.9	-11.8
Profit margin (pre tax)	12.2	11.7	14.0	10.5	5.7	3.1	3.9
Tax rate +	21.2	29.4	24.0	60.3	41.6	87.6	69.9
Profit margin (after tax)	9.6	7.9	10.7	4.1	3.4	0.8	1.0
Solvency	106.1	84.9	102.7	145.4	111.5	n.a	n.a
ROE+	9.1	9.4	10.1	2.9	3.2	n.a	n.a

The table shows that loss plus expenses exceed premiums resulting in combined ratios over 100% and negative underwriting results in all countries.

Long Term Profitability trends

Is non-life insurance a profitable business in the long-run?

Many analysts believe that the non-life insurance industry underperforms other industries on profitability. This arises, for example in the US, from a comparison of the average ROE figures of the US non-life industry with the S&P 500 companies. The 20-year average for the insurance industry is 10.1%, while the S&P ROE has averaged 13.4% over the same period.

Given this apparent long-term under performance on ROE for the insurance industry, it is puzzling that capital keeps flowing into the insurance sector. From 1980 to 2000, fresh capital and ongoing profit retention resulted in an average surplus growth of 9.5%. While the decision to retain profits may be biased by management interests diverging from shareholders interests (agency conflict), there is no bias in the investors decisions to supply fresh capital. The annual average of paid-in fresh capital from 1980 through 2000 equaled 2.8% of surplus. This accumulation of additional capital suggests investor confidence in the industry, despite the low ROE.

The past three years have been more difficult for insurance stocks. Valuations dropped dramatically at the end of the last decade when investment returns sagged and the underwriting conditions hit the bottom line. Non-life stocks under performed the S&P 500 by more than 50% percent between the fourth quarter of 1997 and the first quarter of 1999. Another reason for the relative under performance of insurance stocks during the 1990s was the technology stock market boom, which contributed to the strong S&P 500 performance.

As mentioned above, the low ROE arises from two factors: a low profit margin and a strong increase in surplus (average annual increase of 9.5%). The increase in surplus is actually good news, since it is mostly determined by unrealized capital gains that are not included in profits. Unrealized capital gains do not flow through the income statement, but are credited directly to capital finds in statutory accounting. Insurance companies benefited from bullish stock markets, resulting in strong asset valuation gains.

What are the long-term profitability trends?

The first important long-term trend is the increasing importance of investment returns for non-life insurers. Net investment results rose relative to premium volume from 1975 to 1990 and increased in most markets in the second half of the 1990s. The main reason for the increasing importance of the investment result is the trend to a higher asset leverage, which makes more assets per premium available for investments.

There are two main sources for assets to invest: (1) technical reserves that are being generated out of underwriting activity, and (2) shareholders finds, which are kept as risk capital.

Of the two capital sources, technical reserves are particularly important. Premiums are received before losses are paid, creating a period during which the finds can generate investment returns for the insurance company. The length of that interval varies with the type of insurance business and can extend over many years for long-tail lines, such as liability insurance.

Reserve ratios have been increasing steadily in most major markets since 1975.

The reasons for the increase of reserve ratios are the growing importance of liability lines of business.

Both, insurers capital finds and technical reserves are sources for investments in financial assets. Insurance companies solvency in Europe and the US has risen sharply in recent years, as a result of booming stock markets and relatively good technical results in the mid-1990s.

A major driver of investment income generation is asset leverage. This key ratio indicates the volume of investment activities in relation to underwriting activities, measured by net premiums. Asset leverage has increased in all major markets since 1975, contributing to the increasing importance of investment returns for non-life insurers. The increase in asset leverage was driven by the upward trend in both reserve and solvency ratios.

Another long-term trend with significant importance for non-life insurers profitability is the decline of inflation in the western economies.

Falling inflation has had a positive impact on both underwriting results and investment results. As inflation fell, incurred but not realized losses also fell, improving underwriting results. On the investment side, insurers benefited from the lower inflation causing lower interest rates, which systematically created capital gains on bond portfolios and contributed to the rise of equity markets.

The benefits of e-technology are also unlikely to improve insurers profitability. The new e-business capabilities bring significant potential for efficiency improvements in distribution, administration and claims settlement. But the new technology also lowers

market entry barriers and increases market transparency, intensifying competition and forcing prices down. Tougher competition between insurers will again benefit clients via lower prices.

There are three things that affect total investment returns - bond yields, dividend income and capital gains. Since most insurers invest heavily in bonds, interest rates are most important in determining insurers investment returns, On occasion, capital gains can be very important, particularly to smooth investment returns when interest rates are low.

After a long period of good performance, non-life insurers investment yields are declining but still reached 6 - 8 %in 1999 in all the countries examined except Japan.

Looking forward, strong investment results are no longer assured - equity markets are weak and interest rates are low. To sustain profitability, insurers will need to maintain investment returns or improve underwriting results. Maintaining investment results will be very difficult because asset leverage cannot simply be increased at the will of the insurer. To boost asset leverage, insurers would need to increase reserves or raise equity. However, bolstering loss reserves would need to reflect increased underwriting losses, so this will only change slowly as the mix of lines of business shifts. Also, raising equity to finance investments is not an economical option, since the cost of capital is higher than the after-tax investment yield. Hence, the main task for insurers must be to improve underwriting results.

Underwriting results show a strong cyclical pattern

A review of the evidence on underwriting cycles indicates that they exist in all major markets and that their average length is about six years. These cycles are increasingly correlated among the major markets. However, though there is some correlation of the cycles between lines of business, there is no evidence that the business line cycles are becoming increasingly correlated.

Non-life insurance is characterized by periods of high premium rates (hard markets) and low premium rates (soft markets). A cyclical pattern can be detected over the past century. One usual indicator for the cycle is the underwriting margin (underwriting result in percent of net premiums).

Statistical Evidence for underwriting cycle

A more comprehensive analysis of the major non- life markets shows the existence of underwriting cycles for all countries in this analysis. Using advanced statistical techniques, we tested for cyclicity and determined the average length of the cycle to be between 5.6 and 7.3 years in the seven countries.

Table 3
Empirical evidence for cyclicity for major insurance markets.

	Period	Cycle length
US	1953-2000	6.2
Canada	1950-2000	5.6
UK	1969-2000	6.1
German	1975-1999	6.6
France	1975-1999	7.3
Italy	1979-1999	7.1
Japan	1970-1999	6.3

Explanations for the underwriting cycles

The cycle is best explained by a combination of two hypotheses - the (rational markets with imperfect foresight) and the (capital constraint hypotheses.)

The first view of cycles is that the market is basically competitive and that participants make rational decisions. However, the market is susceptible to the influence of external events and industry institutional features which, even if participants act rationally, can lead to cycles. Important external features and events which can provide a shock to the industry or which can delay a response to a shock include:

- Entry and/or exit costs,
- Regulatory constraints,
- Accounting characteristics including data and information lags,
- Catastrophic events,
- Unexpected changes in claim costs or loss distributions, and

- Unexpected changes in interest rates and equity values.

Under this hypothesis, delays in information or the stickiness (or political constraints) of the regulatory process in establishing the correct price will exacerbate market swings. Thus, insurance pricing and rate making, by virtue of their backward-looking nature, cannot immediately respond to changing market conditions. This institutional feature is especially problematic when there are significant changes in risk exposures, loss distributions, interest rates, or when insurers balance sheets have become (unbalanced) from low premiums. Thus, after a sharp change in the market, insurers and/or regulators are unable to adjust prices rapidly. The lagged response to market conditions naturally creates a cycle because there is a tendency to (overshoot) the price necessary to equilibrate the market. The overshooting is later followed by undershooting, creating a price cycle until the next major shock.

The capacity constraint model implies that cycles are caused by impediments to capital flows, creating alternating periods of excessive and insufficient capital. Exogenous shocks to the capital funds of insurers result in a capacity shortage, causing price increases. Shocks to the capital funds can arise either from the asset side or from the liability side (loss shocks).

The capital constraint hypothesis provides a very plausible explanation to the most recent significant hard markets of 1969/70, 1975/76, and 1985/86 in the US, and 1990/91 in the UK.

Underwriting cycles are increasingly correlated among the major markets.

Profitability drivers are highly interdependent

The investment and underwriting results of non-life insurers are closely linked. Good investment returns allow insurers to post losses on underwriting without risking overall losses. One reason for this link is that both pricing decisions and investment results are directly affected by interest rates. In addition, there is an indirect effect of investment performance on pricing decisions - a strong performance tends to lower pricing and underwriting results as insurers strive for market share.

As investment income rises sharply, there is a tendency for the underwriting results to deteriorate. This happens to a certain extent directly. To the extent that insurers use regular updates of forecasted interest rates in their pricing decisions, the premium rates fall when interest rates rise. Equilibrium premium rates are supposed to reflect the present value of expected future loss payments, plus some loading for expenses and capital costs. The higher the interest rates the stronger the discount effect and the lower the premium rate.

Aggressive pricing during periods of high investment returns is commonly called (cash - flow underwriting). Good investment returns allow insurers to aggressively price new business - hence incurring higher underwriting losses - without risking overall losses. This is probably the strongest link between improved investment performance and weak underwriting results.

The negative correlation between investment and technical results can be observed in most markets, but it can be disturbed by unforeseeable developments in claims.

There is also a negative correlation between realized capital gains & underwriting results. This indicates the use of capital gains to smooth earnings.

Realized capital gains helped to compensate for the extreme underwriting losses. This resulted in fierce competition at insufficient levels.

Sensitivity of ROE to investment yield and combined ratio:-

How do investment yield and the combined ratio affect ROE? While it is difficult to predict future investment returns and returns on equity, near-term performance can be reviewed under several scenarios.

At a combined ratio of 110.3 and an investment yield of 7.2%, the market ROE is a low 5.8%. Every decrease / increase of one point in the combined ratio results in an increase / decrease of about 0.7 percentage points in the ROE. So, to achieve a ROE of 10% under the listed assumptions, a 7.2% investment yield requires a combined ratio of 104.4, which is about six points better than the current underwriting margin.

If future investment yields are not as high as they were in 2000 or 1998, which seems to be a reasonable assumption, the picture becomes even bleaker. For every percentage point increase / decrease in the investment yield, the ROE is increased / decreased by about two percentage points. For example, an investment yield of 6% requires a combined ratio of about 108, with every thing else constant, just to achieve the disappointing ROE of 5.8%. While it is quite likely that solvency will reduce to compensate for lower profit margins, these things change slowly and the near-term profitability picture does not look strong.

Solvency & profitability

Insurance companies solvency in Europe and the US has risen sharply in recent years, as a result of booming stock markets

and relatively good technical results in the mid-1990s. The inflow of fresh capital dried up in the late 1990s.

Underwriting results must improve substantially to provide widespread profitability

Non-life insurance market is currently in a transition period between a severe soft market and a hard market. Commercial lines and reinsurance premium rates started to rise in 2000, and gained momentum in 2001. Prices in the personal lines have lagged behind slightly, but are now increasing moderately. But how much improvement in the underwriting results is necessary? How will underwriting and investment results interact in the future? To illustrate the main findings of this study, an accounting scenario is compared for five large markets in Table 5. The following assumptions are key to the results and form a substantial part of the medium-term outlook:

- ❑ Investment yields will essentially follow long-term interest rates. The magnitude of realized capital gains of the last five years is unlikely to be repeated.
- ❑ Difference in investment yield between countries reflect differences in long-term interest rates, the asset mix, and accounting principles.
- ❑ Solvency and asset leverage have exceeded their medium-term peak, a return to the average levels of the last five years is assumed.
- ❑ Tax rates reflect the averages of the last five years. For Germany the proposed reduction of corporate tax rates to 40% is assumed.
- ❑ Target ROEs are set to approximate long-term average returns, adjusted for inflationary effects. They refer to market ROEs including mutuals. Stock companies enjoy on average higher ROEs, but all players have to be considered for a comprehensive market scenario.

Given our investment yield forecasts, the target underwriting results for each country are calculated. Target ROEs are linked to profit margins via the solvency ratio. The difference to the current underwriting result shows the trough of the soft market and emphasizes the need to improve premium rates.

Table 5
Profitability outlook

In % of net premiums unless marketed with +	US	Canada	UK	German	France
Target ROE+	10.0	10.0	10.0	9.0	9.0
Solvency ratio	106.1	84.9	102.7	145.4	111.5
Profit margin (After tax)	10.6	8.5	10.3	13.1	10.0
Corporate tax rate +	21.2	29.4	24.0	40.0	41.6
Profit margin (pre tax)	13.5	12.6	13.4	18.3	14.2
Investment yield +	6.2	6.4	5.8	5.7	5.1
Asset leverage	268.0	199.4	273.3	217.3	265.3
Net investment result	16.6	12.8	15.9	12.4	13.4
Other expenses / earnings	-0.1	0.9	-2.7	-6.6	-1.5
Target underwriting result	-3.0	-1.1	0.2	12.6	2.3
Latest underwriting result	-10.4	-8.1	-12.4	-1.6	-10.0
Gap	7.4	-7.0	-12.6	-14.2	-12.3

The table indicates that non-life insurers in most major markets must improve their underwriting performance from 7 to 14 percentage points, depending on the market, to achieve a reasonable return on equity. It is important to note that the actual degree of underpricing is larger than shown as insurers already smooth underwriting results via reserve policy and reinsurance. The shortfall of premium rates is also larger if more aggressive target ROEs are expected by investors. This could particularly be the case in the UK, where past results of insurers have been extremely volatile. Reducing expenses and managing claims will help, but will not be sufficient to meet the goal. A substantial improvement in prices and underwriting activity will be necessary.

Will industry capitalization further decline, supporting the hardening of the market, or will fresh capital flow into the insurance market, stopping the upswing of premium rates? Will the alternative market absorb the potential for future rate increases? Given the current state of insurance-industry profitability and the weak capital markets, it is unlikely that the current movement to a harder market will be restrained in the short-run. One reason for the decline of market capacity is the low level of profitability, which has disappointed investors and led to divestments from the industry. For fresh capital to flow into the

market, profitability must first improve, restoring investors confidence. This will take time since there will be more adverse reserves developments undermining reported profitability.

Another reason for the decline in capacity is the weak performance of capital markets, which has reduced the value of insurers assets. The present uncertainty regarding the world economy and capital markets makes it difficult to raise new capital and, also, causes corporate insurance clients to retain insurance contracts, rather than seek new ways to self-insure. This delay of an increase in global insurance capacity is a typical result of the interaction between insurance-industry profitability and capital markets. It is also one reason the industry will continue to experience price cycles for the foreseeable

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US attacks: A hard landing for rates

Release by: A.M. Best Review

End of the classic cycle

A few short months ago, commercial insurance leaders watched the signs of a changing market with acute interest. Although some thought the industry classic hard/soft business cycle was a thing of the past, the bitter mixture of shrinking investment income, growing combined ratios and a battered reinsurance market prompted several insurers, beginning in 1999, to pull from the pack and not only raise rates, but also turn away from writing unprofitable business. It was a new environment that many had never seen before, but they had time to prepare their underwriters and agents for the challenge. The terrorist attacks on September 11 ended the preparation time.

As the industry was experiencing sparks of a hardening market, where we are seeing renewals coming in at 50% increases, even 100% or more for various commercial properties, says Bob Rusbault, president of the Independent Insurance Agents of America. The challenges of the hardening market, as well as covering terrorism, are expected to have a profound effect on underwriting. (This event has changed the rules,) says Marita Zuraitis, executive vice president of US insurance operations at St Paul Companies. (Dealing with terrorism as a coverage will be something we will be talking about for the next ten years. This is going to be a back-to-basics market. It is really going to be pure underwriting, assessing risk, pricing risk, spreading risk.)

Firm beginnings

After a long soft market run that encompassed most of the 1990s, premiums for commercial multiperil insurance - the cornerstone of commercial insurance business - rose 3.9% in 2000, the largest increase since 1995, according to Conning & Co. Property rates increased between 7% and 9% in 1999 and 2000, Zuraitis says. In 2001, we began to see the beginning of double-digit increases to the point where many of us were seeing 12%, 13%, 14% and 15% going into the September event. All of a sudden, your price for reinsurance cover has gone up significantly, and, obviously, the price for primary insurance to your consumer has to go up as well, she says. A recent survey of 250 agents and brokers shows that the majority of third quarter price increases are in the 10% to 30% range in the eight commercial insurance lines, while other respondents reported increases of 30% to 50%. The Commercial Insurance Market Index, a survey by the Council of Insurance Agents & Brokers, shows no decreases in any lines.

Tough renewals

Brokers are experiencing the rate hammer as they renew contracts with insureds. Not only are prices going up, but insurers are withdrawing capacity on layers, making it necessary to sell numerous parts of large deals. (Now it is taking eight companies to provide the cover in smaller amounts. They are offering less limits than they ever did before, because less reinsurance is available to them,)

Even as September 11 casts its gigantic shadow on the industry, other nagging issues that add to the case for raising rates have not gone away. Issues like asbestos, pollution liability, construction defects, toxic mould and continuing troubles in the directors and officers line are also causes for bumping up prices.

Capacity and consolidation

Since the terrorist attacks, the property and casualty market rate hardening has accelerated because the insurance capacity in the marketplace has become strained, says Jack Sinnott, CEO and chairman of Marsh Inc., one of the largest insurance brokerages. (Pick your number, but this event is pegged to be twice and potentially more than twice the last single-largest event, which was (Hurricane) Andrew. That puts some strain on the market, resulting in rates going up,) he said. Bob Howe, Marsh managing director, is already seeing property insurance premiums rising by 65%. While last year some office buildings in New York were paying about \$500,000 for coverage, they now can expect to pay in the \$1m range, Howe says. AM Best also expects a significant change in the industry. In remarks concerning the effects of the September 11 events, AM Best executives say they expect further consolidation of business, an acceleration of rate hardening in many lines and a new generation of capital markets products.

Reinsurance problems

The terrorist attacks left the reinsurance market in a vulnerable position, right at the time of treaty renewals. Reinsurers are pulling back capacity and examining deals more carefully than ever before. They are looking to pull capacity from marginally profitable lines, such as accident and health, so they can make the money available to property and casualty lines on which they believe they can get greater return, says Norm Tardif, president of the management group of NiiS/Apex Holding Group, a reinsurance/insurance consulting firm. Tardif, who consults with brokers and insurers about their reinsurance contracts, describes reinsurers as (jumpy) and guarded. (Basically, it is a conservative industry that is even more so now. They are sitting on top of something that everyone wants - which is capacity - and are evaluating how to protect themselves and still be a viable partner,) he says. To accomplish this, reinsurers are tightening underwriting as they raise prices.

In a recent contract negotiation, Tardif says, the programme with the reinsurer had been trimmed and the rates increased from 10% to 40%, with virtually no room to deviate from what was agreed to in advance. (The concept of a successful negotiation upon treaty renewal period may have changed from capacity at a given price to getting capacity at any price. Everyone is walking on eggshells. You might have treaties delayed and not effective until February 1, instead of January 1,) Tardif comments.

Stability needed

Some industry experts see a reinsurance pool backed by the federal government as the stability the insurance and reinsurance markets need going forward and as a solution to years of rate hikes. Some say if a pool is not organized, insurers will reconsider their appetite for certain classes of business, such as large office complexes and landmark buildings or business interruption policies.

(There is no easy way to price for terrorism. We might begin to see significant changes in coverage, which could include attachment of a terrorism exclusion and restrictions or elimination of other coverages, too,) said Judith Blades, executive vice president, business insurance, at Hartford Financial Services Group Inc.

If a government-backed pool is not formed, the rates will harden like they did in the 1980s, says Rusbault of the IIAA, which represents more than 300,000 independent insurance agents.

(I've been told by some CEOs that it will be even more severe, and the availability and affordability crisis in certain lines like the commercial property and transportation industry could be severe. Agents and brokers will be left to explain to clients why they can not find a market, let alone something they can afford,) Rusbault says.

Underwriting challenges

To add to the industry troubles, most underwriters have never worked in a hard market, let alone one that became petrified almost overnight.

The events cast a spotlight not only on the industry lack of experienced underwriters, but also on its failure to educate and train the breed. Many of the purely technical underwriters, (the kind who can open a drawer and pull out a plan as to how it was handled in the 1980s,) have retired or were victims of downsizing, comments Dave Golden of the National Association of Independent Insurers.

Todd Bault, a research analyst for Sanford Bernstein, says his immediate thought was that insurers will be calling the 45 years old and older underwriters who were working in the 1980s and know how to underwrite a hard market.

In the past few years, underwriters have dealt with a price-driven market, getting all the coverage at the lowest possible price. Now they will be dealing with reduced capacity and greater risks. This means underwriters are going to have to learn how to ask the right questions. They will have to dig deeper with questioning and assessing risk.

For example, in a retail contract, underwriters will have to ask if the insured has a website, whether they take orders over the site and whether they accept credit-card transactions, Golden says. (All this information causes exposures to vary greatly. It is important to know enough to ask about other aspects and details when underwriting,) he says.

The catastrophe also propelled risk management of employee population as a future issue. With the loss of many experienced insurance employees - Marsh lost 292 workers in the World Trade Center attack - companies will be looking at the exposure of having so much talent in one place at the same time.

New model

Hartford did not wait to handle the underwriting problem. It recognized that its underwriters and producers cut their teeth in a soft market, so the challenge was to educate the producers about how to articulate the company position to customers.

Instead of relying on just raising rates to correct lacklustre results, Hartford created a model that takes into consideration risk, geographic and producer experience to differentiate price by account experience. Historically performing accounts require less total price than underperforming accounts.

(When you position your underwriters to have that conversation with agents who have established relationships with intermediaries, they are much more knowledgeable and able to deal with this market than the carriers who are not making that investment in how they distribute their pricing and educate their people,) Blades said.

Bault also says that it is not just the underwriters who are a weak link, but the brokers, too. He is concerned that newer brokers will have a tougher time trying to explain rate hikes to clients. (Think about what their relationships were. It was about keeping their clients happy in a soft market, which is extremely easy. But how do you keep them happy when you have to deliver a 20% increase to them?) Bault asks.

What is in the future? ...

Henry Schramm, senior vice president and chief underwriting officer of the PMA Insurance Group, sees the hard market mimicking the rate squeeze of the mid-1980s, when the products liability and directors and officers market all but shut down, and municipalities were ripping out diving boards and shutting down playgrounds.

(Prior to September 11, we were getting modest but needed increases and looking for them to be compounded over a period of time. But I think the events of September 11 are going to accelerate that issue for the industry, and my expectation is that the increases will be more substantive and be for a much longer period of time,) Schramm says. Nancy Benacci of McDonald Investments predicts the rate hardening will continue through 2003.

Robert Klein, director of the centre for risk management and insurance research and associate professor at Georgia State University, says the catastrophe will have a psychological effect on insurers pertaining to their perception of risk. When insurers are trying to price and underwrite risk, there is some uncertainty that requires subjective or judgemental decisions that can be affected by psychology when the news changes every hour, Klein says.

Everyone is anxious now. But if there is a quiet period with no high losses, the perception of risk will change again. If there is a perception that risk has actually decreased, it will have a dampening effect on rates.

... Securitization?

(If there are more significant loss events - particularly ones that indicate vulnerability of key infrastructure systems - then that will further the perception that risk is significantly higher than what people perceived prior to September 11, and it will sustain higher rates and tighter underwriting,) Klein says.

He also suggests that insurers consider securitising catastrophic losses from terrorism, as they have with catastrophic losses from other perils, such as hurricanes and earthquakes.

(It is not efficient for a reinsurer or insurer to hold \$10bn to \$50bn in capital in a pot to pay off a loss that has a small chance of occurring, if you could issue a cat bond for those kind of low probability but high consequence type events, and you split it up among investors, each with a small possibility of losing their investment,) Klein comments.

In fact, Marsh Howe has customers already asking about finite and integrated-risk products as they experience sticker shock. (I was talking to an insured recently about taking a larger deductible combined with a type of funding programme, rather than paying the full premium,) Howe says.

But there are lots of opportunities, too. (One of the great things about American genius is it is very opportunistic and creative from a business standpoint. Look at what Aon and Marsh are creating. When the rates begin rising, people turn to alternatives,) Schramm says.

Global Aviation Report: - WILLIS

Airline renewals, excluding long-term programmes, airlines emerging from long-term programmes and airlines rated following recent major losses, produced an average premium increase of 78% during November, similar to October average premium increase of 80%. The actual premium increase for those airlines reviewed amounted to 70% again this is similar to October 66%. Underwriters continue to differentiate, generally where exposure reductions are projected airlines are receiving higher rate increases. If growth is projected the level of increase is lower. Airlines that have experienced a recent major loss and airlines emerging from long-term programmes are receiving far harsher treatment, Total Average Fleet Values (AFVs) are up 2.6% whilst total estimated Revenue Passenger Kilometres (RPKs) are down 1% unchanged on last year.

The market approach to direct rates could be considered muted, considering the unique events of September 11 and the subsequent SAS loss, however, the (Special Additional Premium) of US\$1.25 per passenger being charged to all operators is producing an (invisible) but very significant increase in premium to underwriters. We estimate that this charge will generate US\$1.75-i- billion for a full year, an amount that exceeds the entire airline premium income of US\$1.45 billion for the year 2000. The total airline premium for 2001 (inception basis) could exceed US\$4 billion representing a minimum increase on year 2000 of 176%. This estimate excludes premiums paid by airlines for Third Party War and Terrorism cover above US\$50 million and the high premiums being charged for Combined Single Limits Liability cover excess of US\$1.5 billion.

The markets need for stabilization following the traumatic events of September 11 is understood. The loss has placed those underwriters involved under considerable pressure as they face cash-flow difficulties and additional reinsurance costs. The whole aviation market faces uncertainties concerning reinsurance programmes for 2002. Added to this is the fact that the loss has involved the whole insurance industry via the capital providers who have demanded and expect a re-evaluation of capacity provided.

The number of airline losses during 2001 to date is average, excluding war and September 11. The measures taken to stabilize the market, whilst understood, must be recognized as temporary measures following an extraordinary event.

Aviation Hull War

War risks continue to be the most severely impacted sector of the aviation insurance market. Massive rate increases, averaging in excess of 500%, are being applied in conjunction with a reduction of coverage provided and, as is the case with all risk insurance, a significant surcharge of 0.05% is being applied to all operators. Overall renewal premiums being applied now are set to take the annual war premium income base towards US\$600 million plus, an increase in premium of over 1,200% on year 2000 US\$42 million. As is the case with all risk insurance the need for market stabilisation is understood, as a temporary measure, following extraordinary events.

Aerospace

Post September 11 aviation manufacturers, airports, air traffic control, service companies and refuellers liability programmes are, where renewal sales or turnovers are static and loss history is good, all receiving substantial premium increases averaging around 100%. Accounts projecting increased sales or turnovers are receiving increases above 100% as are accounts where there is a deterioration in old year claims and recent losses.

Underwriters have asserted for some time that the class is seriously under-priced, with an estimated global income base for the year 2000 of US\$475 million. There is justification for this view, particularly as a single loss can in value exceed the total premium base. For example, a recent award of US\$400 million was made against a general aviation manufacturer, (being appealed), and who knows what potential exposure airports and service companies have in the events of September 11, Old year losses continue to deteriorate and on a ten year basis, as at the end of 2000 the class is unprofitable. Recent years losses are still to develop and as they do the class is set to fall further into loss.

However, despite the low prices and deteriorating loss experience underwriters have been very competitive within the class, determined to retain their share. Following the events of September 11 most aviation underwriters have had to review their business plans. Their capital providers are demanding a return to profitable underwriting from each segment of an underwriters portfolio. If this is not achieved they will re-deploy their capacity to other areas. Reinsurance costs are also set to rise for coverage of the class.

The pressure is on underwriters to increase the premium base for the class with a target of US\$1.5 billion being considered an absolute minimum amount required to meet major loss occurrences and redress old years deterioration. The problem for underwriters is that the majority of the income base is derived from accounts that are insured on long-term fixed premium basis programmes. Premium increases, where applicable, are pre-set at levels that are now inadequate.

The fact that many aerospace companies are not buying the AVN52D/F writeback, unlike the airline class, means that only a limited amount of additional income or (re-financing) is being generated by the aerospace class, consequently the non war renewal premium increases are being pushed higher and are being applied to all renewals. The drive to increase the aerospace premium base has started and will be sustained.

AVN52F & G

War liability coverage for service companies is still only available up to a limit of US\$50 million on the conventional policy through the application of the AVN 52F or G write-back clause. Rates charged are between 25%-125% as a rule, dependent upon security screening activities. Specialist security companies and freight forwarders are finding cover impossible to obtain. AVN 52F & G coverage in excess of US\$50 million is available for up to US\$100 million in the aggregate, however, any risk associated with security screening is excluded.

Airports, manufacturers and service providers AVN 52D Cover Available for Primary US\$50m

The aviation market leading underwriters are now agreeing to offer, on existing liability policies, the reinstatement of war I terrorism writeback coverage under the new Extended Coverage Endorsement (Aviation Liabilities) AVN 52D. This will provide a third party war / terrorism liability limit of US\$50,000,000 any one occurrence and in the annual aggregate.

Additional premiums charged for the AVN 52D writeback will be quoted on a case-by-case basis reflecting exposure, however, not all markets will agree to include the risks arising from the provision of electronic passenger, baggage and cargo security screening and X-ray services.