



## **World Insurance in 2000 Another boom year for life insurance; Return to normal growth for non-life insurance**

**Report by Swiss Re**

### **Summary**

The following study examines the global development of premium volume written by life and non-life insurers in 144 countries. In short, insurance companies wrote USD 2443.7 billion in premiums worldwide in 2000. Of the total, USD 1521.3 billion was generated by life business and USD 922.4 billion by non-life business, translating into a 9.1% increase in life insurance and 2.7% in non-life insurance over the previous year when adjusted for inflation. Consequently, 2000 can go down as another boom year for the life insurance industry. Non-life insurers registered a return to normal growth rates.

Insurance business is concentrated in North America, Western Europe, Japan and Oceania. Together these countries account for 90.7% of global premiums. On a global average, 7.8% of gross domestic product goes on insurance. At USD 3165 per capita, outlays for life insurance continue to be highest in Japan, while people in Switzerland spend the most on non-life insurance, namely USD 1571 per capita.

### **Long-term comparison of the trend in global premiums**

Global premium volume amounted to USD 2443.7 billion in 2000, of which USD 1521.3 billion 62.3% was attributable to life insurance and USD 922.4 billion 37.7% to non-life business. On a USD basis, nominal growth was 4.6% over the previous year. In local currency and adjusted for national inflation rates, premiums rose over the previous year by 6.6%, with life insurance expanding considerably more +9.1% than non-life business +2.7%.

A long-term comparison shows that life insurance registered above-average growth in 2000, being exceeded only by the extraordinarily high growth rates witnessed between 1984 and 1986. In the period under review, the increase was once again stronger than that reported in non-life business, although the latter picked up some momentum. A contributing factor was the way in which deregulation in Europe, which had resulted in very low growth rates from 1994, ceased to have a dampening effect on global growth rates in 2000, thereby bringing a halt to the soft markets cyclical fall in prices.

The development of the global insurance industry over the past few years was considerably influenced by the booming stock markets, which enabled considerable capital gains to be made in non-life business. This strengthening of insurers equity capital increased underwriting capacity, while demand did not develop at the same pace, resulting in a dramatic fall in insurance prices. The stock market boom of the past few years led to soaring demand for unit-linked insurance products in life business.

The new economy bubble burst, however, in mid-2000, sending stock

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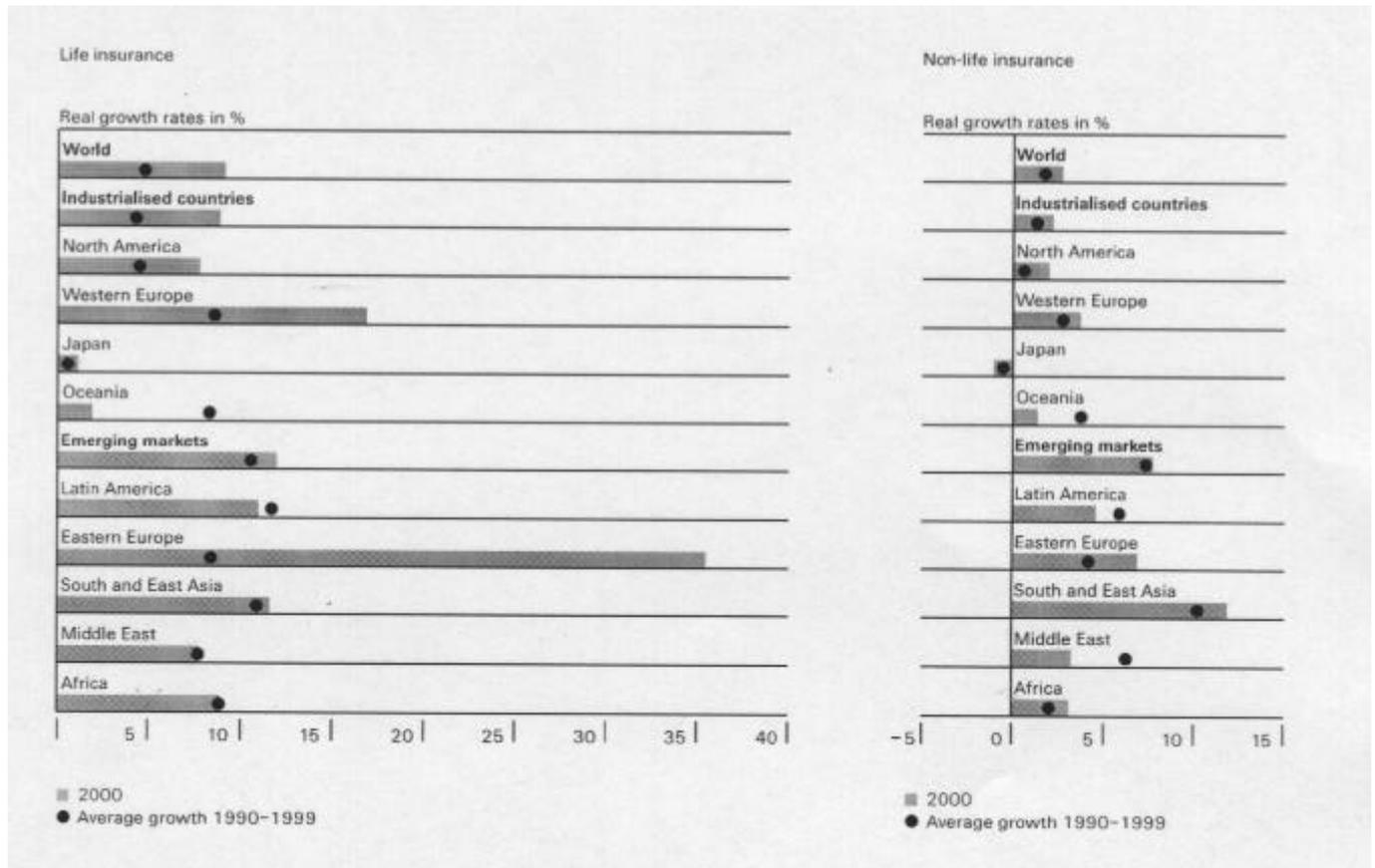
markets around the world into a tail spin, as they lost around 35% in value over their record highs by the end of October 2001. This correction which will be evident in 2001 led to the collapse of unit-linked life business and to a marked deterioration in the profitability of non-life insurers

The healthy world economy gave a fillip to the global insurance industry. In 2000 economic momentum picked up once more, resulting in an expansion of 3.8% in real terms. Growth in Europe and in the emerging markets in particular increased in 2000. The US economy revisited the 4.1% growth mark, although momentum started to slow down noticeably towards the end of the year.

**Premium growth by region**

Most regions either reached or exceeded their long-term growth averages, with only Oceania - and non-life business in the Middle East - registering growth that was significantly below the 10-year average. Japan premium growth continued to stagnate in 2000 - just as it had in the nineties. Strong growth rates in 2000 again confirmed the long-term trend of emerging markets outpacing the industrialized countries.

**Real Premium Growth By Region**



**Life insurance in 2000**

Growth rates in national life insurance markets were extremely diverse, with the range between the 10th and 90th percentile amounting to approximately 30 percentage points in both the industrialized countries and the emerging markets. In most countries, premium growth rates exceeded those of the overall economy. On average, life insurance premiums grew twice as fast as the corresponding gross domestic product. It must, however, be stressed that there are large differences between countries and that any direct correlation between the development of the overall economy and that of premium volume is not significant for statistical purposes. The business cycle, in contrast, has an indirect effect on life insurance premiums via disposable income and the savings rate.

The increasing importance of life insurance in pension provision - eg in the US - and low interest rates, which make life insurance a more attractive savings instrument than alternative investments, were additional drivers of the strong expansion of these markets. The stock market boom was a factor in the growing popularity of unit-linked policies - eg in the UK, France, Belgium and Sweden.

**Non-life insurance in 2000**

On average, non-life markets have grown in line with the overall economy. The median value for non-life growth in the industrialized countries corresponds to that of the overall economy; in the emerging markets this figure is slightly higher. This is confirmed by earlier observations according to which the income elasticity of the emerging markets is a little more than one. In other words, insurance penetration is on the increase in these countries.

## Significance of the regions and countries in world insurance

In absolute terms, the industrialized countries continued to clearly dominate the global insurance market with a 91% share of life premiums and 90.3% share of non-life premiums see below Table. This far exceeds their 14% share of the global population or 77% share of GDP.

The most important countries in the global insurance business continue to be the US and Japan, which together generate more than 50% of premium income, followed by the four biggest Western European countries, the UK, Germany, France and Italy. The European Union accounts for 29.4% of global insurance premium.

### Industrialized countries: life insurance continue to grow; non life starts to recover

#### North America

Both the US and Canada reported strong growth in life premiums. Premium growth in the US continued to be driven mainly by the annuities line of business, where premiums increased by almost 9% in real terms over the previous year, with personal lines in particular registering considerable growth. Among the main reasons for the strong growth of annuity business are demographics - higher life expectancy and the rising percentage of elderly people in the population - uncertainty about the future funding of state programmes such as Social Security and Medicare as well as the trend towards defined-benefit plans which do not offer long-term benefits. The deteriorating performance and strong volatility of stock markets increased demand for fixed annuities and traditional life products at the expense of variable products.

In 2000, non-life premium growth in North America accelerated marginally to 1.9%, but still lagged behind real GDP growth, which was 4.1% in 2000. US non-life markets are in a transition period now between a severe soft market and a hard market. Commercial lines premium rates started to rise in 2000, while prices in personal lines remained unchanged. These lines reported a moderate price increase only in 2001. Consequently, for the first time in over a decade, overall market growth was supported by strong real growth in commercial lines (+4.2%) and by acceleration in accident and health market expansion (+4.2%). Personal lines, however, contracted in real terms (- 1.5%). The hardening of the market will result in stronger non-life premium growth and also accelerate to some degree the shift towards alternative risk transfer (**ART**) solutions.

In 2000, Canadian non-life premium growth remained practically unchanged over the previous year at 2.6%. Over the past decade, the non-life market grew more rapidly in Canada than in the US. This is because commercial lines have a smaller share of the total market, thereby making the Canadian market less vulnerable to the eroding prices of these lines. Furthermore, commercial clients showed markedly less interest in alternative risk transfer mechanisms, with the result that demand for traditional insurance solutions remained intact. Further development will be influenced in general by the global hardening of market conditions and manifest itself in rising prices.

#### Western Europe

The strong growth in life insurance registered over the past few years in Western Europe continued unabated, reaching the 16.8% mark in 2000. Life insurers benefited from expectations that Europe well developed pay-as-you-go state pension schemes will not be up to the task of coping with the demographic changes. The Western European countries reacted at different speeds to the predicament - taking into consideration the structures of their social insurance systems and public opinion - and to the realization that a fully-funded second pillar was necessary as was the promotion of voluntary private annuity products. Life insurers are also involved in building up the necessary capital: for example, the extraordinarily high growth of 36% witnessed in Spain was mainly attributable to continuous pension fund inflows, as pension funds are now obligated to have their assets managed by banks or insurance companies.

The greatest contributor to growth was the most significant life insurance market, the UK. Here growth surged by more than 25%, three-quarters of which could be attributed to the increase in collective pension premiums: GBP 18 billion (USD 28 billion) in pension fund assets flowed to one major fund manager and insurer. Single premiums in personal lines have also increased in importance. During the stock market boom, insurers attracted a substantial share of private investment capital by marketing equity-index-linked policies. However, this expanding business had already started to decline in 2000 and collapsed in 2001 once equity markets had passed their record highs of mid-2000.

Non-life premium volume grew a vigorous 3.7% in real terms in 2000. The robust growth can be primarily laid at the door of the generally good economic conditions. Rate increases in some countries in the most important line - motor insurance - were also a contributing factor. The effects of the winter storms Lothar and Martin in December 1999 did not have a direct impact, although they reduced insurance capacities and will trigger premium increases.

The rapid growth in the UK (+5.4%) made the largest contribution to the region increase in non-life premium volume, followed by Spain (+9.7%), Italy (+3.7%) and Norway (+23.2%) Portugal (+17.2%) and Greece (+8.8%) also reported a strong surge in non-life premiums. Premiums in Germany, the biggest non-life market in Europe, remained virtually static, with rates of commercial lines falling further and those of personal insurance stagnating. Growth in France was also lacklustre.

#### Japan

Life premiums in Japan recovered slightly in 2000 to report a modest 1.1% increase compared to the previous year. Japanese life insurers continued to suffer from the problem of a negative interest rate spread, ie the rate of interest which

they had guaranteed on old policies was higher than the rate that they have been able to recoup from the capital market for some time. Major companies have so far been able to compensate for this negative spread by using their profits from lower mortality rates and cost rationalization. However, small and medium-sized insurers are coming under a lot of pressure due to their meagre investment returns. The contemplated reduction in the guaranteed return on current insurance policies will probably fail in the face of massive public resistance.

The growth in non-life insurance premiums in 2000 was once again below zero (-1.1% in real terms) - testimony to the difficult economic conditions in Japan. Voluntary motor insurance, however, held out relatively well particularly in view of the liberalization of rates, while insurers made improvements to their product and service portfolios.

On the other hand, intensive competition and the decline in residential construction took its toll on fire insurance. In light of the increasing liberalization of the market, Japanese insurers are forging alliances with each other in order to hold their own against the ever more fierce competition. They are also adapting to two major growth areas outside traditional non-life insurance: defined-contribution pension schemes and the so-called third sector business. The latter includes health and critical illness (serious illnesses, especially cancer) insurance and accident insurance products.

### **The significance of the insurance industry in the industrialised countries**

In 2000, the industrialized countries spent an average of USD 2384 per capita on insurance, or 9.1% of their combined GDPs. The Swiss made the largest outlays on insurance services in 2000, spending USD 4173 per capita. For life insurance alone, USD 3165 per capita was spent in Japan, the highest amount of all countries. The front-runner in non-life business was Switzerland, with USD 1571 per capita per annum. Measuring premiums as a percentage of GDP, the UK topped the league of industrialized countries, although in a global comparison it was exceeded by South Africa

### **Middle East and Central Asia**

Israel is the most important insurance market in the Middle East. In 2000 premium volume was almost twice that of all the other countries combined - at USD 6.1 billion or 5.5% of gross domestic product. In the Muslim countries in the Middle East, insurance penetration (insurance premiums per GDP) in life and non-life business is extremely low compared with the rest of the world, even after taking the comparatively low per capita income into account. This is mainly attributable to the strict enforcement of Islamic law, which forbids insurance, as we know it in the West. Commercial risks account for most insurance business in this region.

Life insurance growth in Israel accelerated once more, increasing by 6.2% (previous year: +1.9%) when adjusted for inflation. In the Muslim countries, life insurance accounts for only a fraction of all insurance premiums. Although starting from a low level, Iran reported extraordinary increases in premiums of 76.5% in real terms.

Despite a strong acceleration in economic growth, the Israeli non-life market experienced a renewed slump in 2000 (growth of +0.3%, adjusted for inflation). Motor liability and health insurance were the only lines registering significant growth. The high oil price started an economic boom in the oil-producing countries and - in Iran - triggered premium increases of 15.8% in real terms. The strong increase in health costs in the rich Gulf states in tandem with the governments drive to cut spending resulted in plans to introduce statutory health insurance for the region numerous foreign workers. This will boost premium growth over the course of the next few years.

### **Africa**

Growth was positive in the African insurance markets in 2000, with premium volumes in African life business increasing by a real 8.9%, and by 3.1% in the non-life area.

South Africa accounts for almost 95% of the life business written on the African continent, and boasts by far the highest insurance penetration in the region. Preliminary figures show that, despite its massive HTV problem, South Africa posted real growth of 8.9% in life insurance premiums.

About 55% of African premium volume in non-life business is generated in South Africa. Estimates show that real growth in South Africa was 4.1% in 2000. The South African non-life market was burgeoned by high crime rates and claims arising from the floods and storms in spring 2000. Non-life business developed unevenly in the other African countries. Although premium growth in Morocco and Tunisia increased in real terms, it shrank in Egypt, Kenya and Mauritius.

### **The significance of the insurance industry in the emerging markets**

Insurance density (premiums per capita) is markedly lower in most emerging markets than in the industrialized countries, being around USD 42 on average. Densely populated markets with very low insurance density such as China and India depress this figure. There are, nevertheless, great differences between the markets, with premiums per capita at between USD 100 and USD 400 in half of the countries. South Korea, Hong Kong, the Bahamas and Taiwan constitute exceptions among the emerging markets. These four countries record premium expenditure of over USD 1000 per capita and are thus comparable to industrialized countries.

Taking into account the fact that incomes in emerging markets are much lower than in the industrialized countries, the insurance industry is still of only marginal importance in these countries. This can be seen in the low insurance penetration (expenditure for insurance services expressed as a percentage of income), which amounted to an average 3.2% of GDP (industrialized countries: 9.10/o) in 2000. However, the country with the world highest level of insurance penetration, namely South Africa, is also one of the emerging markets. Here life insurance as a means of saving is particularly attractive when

compared with bank deposits.

**Development of Written Premium in Arab Markets From 1997 - 2000**

|                      | 97  | 98  | 99  | 2000 |
|----------------------|-----|-----|-----|------|
| United Arab Emirates | 654 | 741 | 703 | 728  |
| Saudi Arabia         | 763 | 793 | 764 | 757  |
| Lebanon              | 426 | 450 | 473 | 498  |
| Kuwait               | 203 | 199 | 196 | 198  |
| Oman                 | 145 | 167 | 167 | 164  |
| Qatar                | 155 | 150 | 159 | 158  |
| Morocco              | 860 | 935 | 972 | 964  |
| Egypt                | 538 | 539 | 579 | 598  |
| Tunisia              | 310 | 317 | 344 | 332  |
| Algeria              | 266 | 272 | 258 | 260  |

**Insurance Density in Key Arab Markets per Capita since 1997 - 2000**

|                      | 97    | 98   | 99    | 2000  |
|----------------------|-------|------|-------|-------|
| United Arab Emirates | 253.3 | 254  | 310.1 | 271.1 |
| Saudi Arabia         | 39.9  | 39.1 | 38.1  | 36.9  |
| Lebanon              | 133.8 | 141  | 111.9 | 151.4 |
| Kuwait               | 112   | 97.8 | 93.6  | 104.2 |
| Oman                 | 62    | 58.5 | 66    | 63.0  |
| Qatar                | 263.4 | 272  | 259.4 | 263.5 |
| Morocco              | 29.9  | 34   | 34.4  | 34.0  |
| Egypt                | 8.2   | 8.5  | 9.1   | 8.7   |
| Tunisia              | 32.6  | 35.4 | 35.1  | 34.7  |
| Algeria              | 9     | 9.1  | 8.1   | 8.2   |

**Insurance Penetration in Key Arab Markets:  
Insurance premium as percentage Of GNP from 1997-2000**

|                      | 97   | 98   | 99   | 2000 |
|----------------------|------|------|------|------|
| United Arab Emirates | 1.44 | 1.43 | 1.49 | 1.11 |
| Saudi Arabia         | 0.53 | 0.52 | 0.56 | 0.44 |
| Lebanon              | 3.32 | 2.69 | 2.61 | 2.63 |
| Kuwait               | 0.67 | 0.79 | 0.66 | 0.52 |
| Oman                 | 0.87 | 0.87 | 1.07 | 0.95 |
| Qatar                | 1.69 | 1.66 | 1.54 | 1.09 |
| Morocco              | 2.44 | 2.6  | 2.78 | 2.79 |
| Egypt                | 0.67 | 0.65 | 0.65 | 0.62 |
| Tunisia              | 1.58 | 1.65 | 1.57 | 1.69 |
| Algeria              | 0.55 | 0.54 | 0.62 | 0.49 |

**Development of Written Premium in  
Key Insurance Markets From 1997 - 2000**

|              | 1999   | 2000   |
|--------------|--------|--------|
| USA          | 798922 | 865327 |
| UK           | 204958 | 236960 |
| Switzerland  | 33242  | 29950  |
| France       | 123114 | 121910 |
| Germany      | 138829 | 123722 |
| Italy        | 66649  | 63062  |
| Japan        | 500037 | 504005 |
| Israel       | 5771   | 6125   |
| South Africa | 21175  | 21167  |

**Insurance Density in Key Insurance Markets  
per Capita since 1999 2000**

|              | 1999 | 2000 |
|--------------|------|------|
| USA          | 2925 | 3152 |
| UK           | 3245 | 3759 |
| Switzerland  | 4650 | 4153 |
| France       | 2100 | 2051 |
| Germany      | 1675 | 1492 |
| Italy        | 1150 | 1084 |
| Japan        | 3910 | 3938 |
| Israel       | 1012 | 976  |
| South Africa | 491  | 472  |

**Insurance Penetration in Key Insurance Markets:  
Insurance premium as percentage of GNP from 1999-  
2000**

|              | 99    | 2000  |
|--------------|-------|-------|
| USA          | 8.55  | 8.76  |
| UK           | 13.35 | 15.78 |
| Switzerland  | 12.84 | 12.42 |
| France       | 8.52  | 9.4   |
| Germany      | 6.52  | 6.54  |
| Italy        | 5.68  | 5.8   |
| Japan        | 11.17 | 10.92 |
| Israel       | 6.14  | 5.55  |
| South Africa | 16.54 | 16.86 |

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# Energy Market Review

## Report by: WILLIS

### Market Overview **the Energy Market in Perspective**

Recent insurance industry consolidation has seen the emergence of fewer, larger, entities writing a greater spread of risk across multiple lines. The single line specialist market is becoming a rarity as a stand-alone insurer, and, although the specialists exist, most are now relatively small subsidiaries of much larger multi-national concerns.

One of the consequences of this is that a major catastrophe, even if limited to a single line or industry sector, is likely to impact the capital base of most parent insurance companies (in other words, much of the insurance industry) even though not all their specialist subsidiaries are directly involved in the loss. The reduced capital base will necessitate a review of the profitability of every line of business as the parent looks at how best to trade going forward. In this situation the least profitable lines will be severely cut back, even where efforts are clearly being made to reverse poor performance, and from some classes there will be a complete exit.

The following table shows the extent to which a few major groupings now dominate world capacity. It also suggests that further consolidation is highly likely.

### Global Net Written Premiums in 2000 by Insurer Rank

|               | Share of Global net premium in 2000 |
|---------------|-------------------------------------|
| Top 1-10      | 41%                                 |
| Top 11 - 25   | 20%                                 |
| Top 26 - 50   | 15%                                 |
| Top 51 - 100% | 15%                                 |

### Energy losses: moving seamlessly from crisis to catastrophe

For the last three years the energy sector as a whole has been in dire trouble. The industry loss ratio has been running in the 200-300% range as premiums continued to decline whilst the frequency and severity of industrial accidents increased. Throughout 2000 and the beginning of 2001 a number of insurers gave up the unequal struggle. The new year was greeted with hope by the remaining market as capacity steadily declined and prices rapidly rose. Indeed the first two months of 2001 were exceptionally encouraging for underwriters. But the next seven months radically changed the outlook, with a spate of severe losses between March and September as the following chart demonstrates:

| year | Type  | Sub-category | cause                       | Land / offshore | CAR /op | location       | Country      | Actual total US\$ |
|------|-------|--------------|-----------------------------|-----------------|---------|----------------|--------------|-------------------|
| 2001 | Rig   | Jackup       | Blowout                     | Offshore        | OP      | Gulf of Mexico | USA          | 100,000,000       |
| 2001 | FPSO  | Semisup      | Fire / lightning/ explosion | Offshore        | OP      | Campos Basin   | Brazil       | 500,000,000       |
| 2001 | Plant | Refinery     | Fire/ lightning / explosion | Land            | OP      | Wicklund       | Aruba        | 305,000,000       |
| 2001 | Plant | Refinery     | Fire/ lightning / explosion | Land            | OP      | Humberside     | UK           | 260,000,000       |
| 2001 | Plant | Refinery     | Fire/ lightning / explosion | Land            | OP      | California     | USA          | 99,000,000        |
| 2001 | Plant | Refinery     | Fire/ lightning / explosion | Land            | OP      | Illinois       | USA          | 51,000,000        |
| 2001 | Plant | Refinery     | Fire/ lightning / explosion | Land            | OP      | Free State     | South Africa | 104,000,000       |
| 2001 | Plant | Chemical     | Fire/ lightning / explosion | Land            | OP      | Merseyside     | UK           | 119,710,000       |
| 2001 | Plant | Refinery     | Fire/ lightning / explosion | Land            | OP      | Illinois       | USA          | 380,000,000       |
| 2001 | Plant | Petrochem    | Fire/ lightning / explosion | Land            | OP      | Toulouse       | France       | 500,000,000       |
| 2001 | Plant | Refinery     | Fire/ lightning / explosion | Land            | OP      | Louisiana      | USA          | 85,000,000        |

To this can be added a probable \$1 billion of smaller losses to date making a total for the first nine months of the year of nearly \$3.5 billion. With almost a quarter of the year remaining it is a fairly safe bet that losses for the year will eventually exceed \$4 billion, of which at least \$3 billion will be for onshore risks alone - and this is not including third party liability.

When this level of loss is compared to world onshore energy premium currently estimated for this year at between \$1.2 and 1.4 billion there is no chance, despite rapidly increasing rates, of the energy sector getting anywhere close to profitability in 2001. There is also the danger that if rates rise too fast many clients will refuse to pay the price, and seek alternative financing

or mutual insurance company solutions elsewhere.

### Corresponding claims excess of \$ 50 Million for same period (to end of September) on previous years

| Year | Number | Aggregate total US\$ |
|------|--------|----------------------|
| 1998 | 10     | 1,300,000,000        |
| 1999 | 19     | 1,500,000            |
| 2000 | 10     | 1,100,000            |
| 2001 | 11     | 2,500,000            |

## Market Updates Onshore property

### Capacity

- ❑ There will be too few players to provide a stable global onshore energy market with adequate capacity in 2002, at least initially.
  - ❑ We estimate global onshore capacity for international non-US risks total capacity is somewhat greater, around \$2.2 billion. These totals should be compared with global capacity estimated at approximately \$3.5 billion as recently as June of this year and at nearly \$5 billion at the beginning of 2000.
  - ❑ As a generally accepted rule of thumb the normal maximum available capacity for any one placement is approximately one third of the worldwide total. On this basis there is currently not enough capacity to cover the estimated maximum losses (EML) of many major refining and petrochemical risks.
  - ❑ We do not see an improvement in this situation until new capital formations take advantage of the exceptionally high prices caused by this lack of supply. Whilst syndicates and corporate insurers are crying out for extra capital to do just this there is an understandable reluctance on the part of the capital providers to throw good money after bad, at least until it can be clearly demonstrated that the sector is really moving into profit.
  - ❑ Not just energy specialists but the whole non-marine property sector is in danger of losing the battle for capital to the life departments of the big insurers. Given the volatility of the property insurance market generally, and the energy sector in particular, in a world both politically and economically unstable the actuarial certainties of life assurance can seem highly desirable.
  - ❑ Whilst there is much talk (and considerable action) surrounding the emergence of new start-up insurance companies, and whilst there will undoubtedly be some successes, raising capital takes time, but We believe that new capital will have little effect on capacity in the first half of 2002.
  - ❑ Treaty renewals will be key to the capacity available in the onshore market. Risk excess treaty renewals are now being quoted at such high rates that there is a question mark over whether many onshore underwriters will buy them. If they do not then capacity will be massively reduced. To an extent, though, insurers have preempted these long expected draconian renewal terms by significantly reducing their capacity now as a precaution. Hence one of the major reasons for the capacity shortage today.
  - ❑ Full value (blanket limit) policies are generally no longer available, and loss limits are often much reduced. With such a shortage of capacity there is the possibility that some clients will be unable to buy high enough limits to satisfy their contractual obligations, and may be in danger of breaching their banking covenants. In addition, underwriters are applying great pressure on clients to significantly increase deductibles and self insured retentions. In this situation there will be a much higher demand than hitherto seen for capital market risk financing solutions, not so much as alternatives to traditional insurance but in addition to it.
- Finally, the capacity crunch will provide a great opportunity for Oil Insurance Limited, the industry mutual insurance company, to increase its client base.

### Cost

- ❑ Dramatic rise in rates and premiums, with 100% increases on clean renewals not uncommon, even after applying increased deductibles.
- ❑ As we have already seen treaty renewals are likely to accelerate the rate of increase in cost to clients, assuming insurers continue to buy traditional forms of reinsurance protection. It is probable that some will buy and some will not but all who remain in the energy market will carry greatly increased retentions. Underwriters will charge for their capacity in a way unseen for years and possibly decades. Our prediction is that prices will remain exceptionally high for as long as it takes to show that the onshore sector has returned to an acceptable level of profitability.

### Coverage

Many areas of coverage are currently under review by underwriters. The following are insurers most significant concerns:

**Terrorism:** currently generally unavailable for both onshore property renewals and new business, there is some specialized capacity but it will not be sufficient to meet the expected demand in 2002.

**Business interruption/contingent business interruption:** There is now a drive by the market to impose separate waiting periods for business interruption where property damage and business interruption are currently subject to single combined dollar deductibles. We are also seeing a tightening of the business interruption wording, particularly with respect to the period of indemnity, and concerns have been raised over the reporting of values and location limits.

**E-risks:** we expect the elimination of coverage for computer virus, denial of service attacks and similar e-risks, except through specialized policies.

**Earthquake:** coverage will continue to contract for earthquake in all the major zones worldwide.

**Coastal windstorm:** there will be a drive to aggregate liability for wind in much the same way as flood and earthquake are often aggregated. There have been failed attempts at this in the past, but we predict that reinsurers will now start to build a more united front in this regard.

**Reduced limits or scope of coverage:** in addition to some of the concerns in the foregoing paragraphs we will see coverage reduced for the following:

- Debris removal
- Demolition/increased cost of construction
- Ingress/egress
- Sue and labor
- Extra/expediting expense
- Service interruption
- Biological & chemical pollution
- Valuable papers, media and records
- Construction/Advanced loss of profits within operational policies

### **Market Updates: Upstream Energy**

Years of over-capacity in the offshore market had led to the lowest pricing and the widest coverage ever. This alone would have put underwriting results into the red but at the same time the oil price rise fueled a drilling boom which in turn spawned a raft of new construction projects. Since control of well and construction have historically been the most claims intensive classes in the upstream energy sector this led to an upturn in loss frequency which itself was exacerbated by a lack of trained drilling crews and by questions over the structural adequacy of equipment brought out of lay up to cope with the demand. All of these factors contributed to an attritional loss record that eclipses anything previously experienced. In addition to attritional losses there were several large construction losses plus the third largest offshore loss in history, being the total loss of the Petrobras P36 semi-submersible.

### **Capacity**

- Prior to September 11 capacity had already reduced from a high of approximately \$4.5 billion to around \$3.7 billion in response to the poor results. A further drop was already expected before September 11 at which time we were estimating capacity to be below \$3 billion for 2002.
- Since September 11 the landscape has completely changed and we now expect to see commercial market capacity for 2002 of around \$1.3 billion. Oil Insurance Limited, the energy industry mutual, provides alternative or additional capacity (\$250 million per insured) for its members. We can expect a flood of applications for membership as clients seek both additional capacity and stable, or at least transparent, rating.
- This anticipated reduction in capacity presents a huge challenge to the market, as many risks will require greater capacity than is likely to be available either individually or collectively. Capacity in catastrophe zones such as the Gulf of Mexico will be impacted significantly during the next round of renewals.

### **Cost**

- The London market can initially be expected to overreact in pricing and terms. Already the US market has taken several accounts at London) expense, and, as we have already said, Oil Insurance Limited can expect a rush of applications for membership
- For some specific classes prices will remain high with little inter-market competition for the business. In particular, control of well and construction have both seen a rapid increase in rates and restrictions in coverage. These classes should now start to attract the opportunists in the market.
- The majority of underwriters though will be more conservative and will wish to write traditional operating risks with higher attachment points than those we have seen to date. The problem is that there is not enough of this business to go round. Consolidation in the oil industry and a long-term trend towards self-insurance by the bigger clients have seen to that. Competitive forces will soon be at work and we believe that the rates now being talked up by the market will not be sustainable for long.

### **Coverage**

- Generally the coverage extensions enjoyed during the soft market will be progressively clawed back The main areas for attention are business interruption (particularly contingent) and control of well where a move is afoot to introduce aggregate limits.
- War and terrorism coverage merits special mention for obvious reasons.
- Finally, the reinsurance market is making some distressing noises about what precisely constitutes (offshore) coverage. Specifically, certain reinsurers are looking to restrict coverage to risks below the mean high tide. This would, for example, place the control of well market in complete disarray. Treaty reinsurance price rises and increased retentions are one thing, but this sort of restriction would make the original business unworkable.

### **Market Updates Power Generation Utilities**

Since 1998 the utility sector has experienced almost four years of unprofitable underwriting.

The poor loss experience has included both major machinery breakdown and fire losses such as the boiler explosion in Kansas estimated in excess of \$200 million, and the Ford Co-Generation Plant loss at over \$350 million (neither estimate including the contingent business interruption element of the losses). These and other significant losses coupled with a large number of small to medium size claims resulted in the utility sector annual average loss ratio exceeding 170% over the four year period, rising to 225% in the case of some individual insurers. For much of this period the market was unable to raise rates as many

clients had taken advantage of soft market conditions by locking into fixed-rate multiple year policies at the bottom of the insurance cycle. The upshot of this was that underwriters were only able to start increasing deductibles and rates from mid 2000 when these policies started to expire.

The reason for the substantial increase in utility sector loss frequency was mainly due to a combination of a reduction in maintenance spend and the continued use of aging plant that often exceeded its design life. Another contributing factor was a growing number of insured business interruption losses. Prior to 1996 most utility companies did not purchase business interruption or replacement power cost cover as the costs of any losses could be passed on to the consumer through the rate mechanism that existed under the regulated regime. As the industry deregulated and the power generation industry split up into smaller private companies which were not allowed to pass on costs in the same way as before, the purchase of business interruption increased, and this resulted in losses following forced outages. The volatility that was being experienced in the newly deregulated power markets in certain areas led to higher than expected business interruption losses emanating from what were otherwise fairly routine forced outages.

Following three years of losses, insurers took the opportunity to implement changes at program renewals during 2000 in the hope of returning their utility portfolios to profitability. Prior to WTC property damage deductibles were being substantially increased by a factor of two or three on standard generation assets, while time element coverage waiting periods were being raised by 50% to 100% 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 2000 were in the 30% range, but again in the case of combustion gas turbines the increases were substantially higher. Throughout the first three-quarters of 2001 higher increases were being seen as insurers continued to correct their portfolios.

Capacity remained fairly plentiful for accounts comprising standard assets, but in the case of prototype or unproven combustion gas turbines capacity started to diminish. Several insurers began to move out of the utility sector or decided to insure only portions of the industry. With appropriate deductible and rate increases full value (blanket limit) policies were still achievable as were defined loss limits in the \$750 million to \$1 billion range. Coverage however was beginning to be reduced with contingent business interruption and extra expense being severely restricted through the introduction of reduced sub-limits. Natural catastrophe perils were also experiencing pressure with substantial deductible and premium increases while restricted sub-limits were imposed.

It is anticipated that insurers will continue to look to increase deductibles, particularly for risks considered poor. Coupled with this will be a further restriction in coverage conditions, and many of the coverage extensions provided in the soft market will disappear. Further restrictions on sub-limits can be expected and where coverage extensions are granted the cover will need to be underwritten with supporting documentation provided to insurers. Before September 11 there was a move to restrict machinery breakdown cover by limiting the design coverage provided, and this can be expected to continue as risks renew.

The core driver for change will come from the reinsurance industry. This will impact both the cost and coverage afforded to clients as insurers pass their own reinsurers restrictions and increased costs through to the client. Given the technical exposures inherent in utility risks a lead time of at least 90 days and a carefully considered renewal strategy is strongly recommended when renewing property insurance in this very difficult market sector.

### **Market Updates Treaty reinsurance**

2001 is proving to be the year of great change: several meaningful losses, higher premiums, and narrower terms and conditions. Although reinsurance terms were perceived to be tough for 2001 a considerable hardening in 2002 was anticipated prior to September 11, with retentions and prices being increased once more. The main issues for reinsurers are past results (claims), the need to increase premiums in the direct market, long-term policies and the imminent collapse of reinsurance capacity to support the massive line structures that many direct underwriters have been relying on.

In addition there are major concerns over coverage for run-off, general terms and conditions and, indeed, the consequent structure of the energy reinsurance market itself. All of these considerations are under further review by a reinsurance market ravaged by the events of September 11.

- ❑ Many direct insurers have until now based their underwriting on huge line structures supported by massive reinsurance programs. In the past, capacity was plentiful enough for direct underwriters not to be too concerned about whether the unexpired portion of the direct policies they had written would continue to be covered at renewal of their reinsurance programs, their main worry being cost alone. With reinsurance capacity now being greatly reduced it is a certainty that some underwriters will be left with totally inadequate reinsurance protection at January 1, 2002, particularly as many have large lines on multi-year direct policies. This is why a number of direct underwriters have already issued blanket notice of cancellation on their whole energy book; the problem for them is that many of the policies they have written are non-cancelable.
- ❑ Any further reduction in reinsurance capacity or imposition of reinsurance exclusions will increase the pressures on direct underwriters. Orthodox facultative reinsurance capacity is severely limited and very expensive, so insurers are likely to be forced into either seeking alternative risk transfer solutions (which may contain penal repayment strictures in the event of a loss) or, secondly, into combining various narrow but expensive (pillars) (specific reinsurances for a single line of coverage or peril) in the hope that this will provide coverage that is broad enough for any complicated, multi peril loss that may happen. The third alternative is to retain, voluntarily or otherwise, large exposures and simply hope that the loss does not occur. Given the major increases in direct rating, larger retentions may be more manageable than in the past.

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However, if there are further major energy losses in 2002 on original policies attaching in 2001 then it is likely that there will be a severe impact on the balance sheets of a number of insurers and reinsurers, as a result of which some direct insurers may be forced to exit the energy market, and capacity will be yet further reduced.

### **Coverage**

Apart from potentially dwindling reinsurance capacity, a key issue is whether the market is going to issue or reissue exclusion clauses to address the current difficulties. At present, the reinsurance market is reeling from recent events and is not in a position to be definitive on these matters, hence the cautious nature of the following comments:

**Political Risks** - it seems probable that these will be excluded. At present this exclusion is likely to be restricted to Contract Frustration, but may be extended to Confiscation, Nationalization, Expropriation and deprivation.

**Terrorism** - may be excluded for fixed platforms, as they are perceived to provide an attractive target to terrorists. The argument between what constitutes terrorism and war remains unresolved.

**Refineries** - these may be excluded to return the market to the traditional boundaries of the onshore and offshore markets.

**(Two-risk) warranty** - in certain circumstances whole account marine market reinsurers may impose a (Two risk) warranty for onshore exposures.

**(Pillar) coverage** - where insurers are unable to purchase adequate whole account protection another solution may be to buy reinsurance on a (pillar) basis split by peril/geography/ product. In a hard market reinsurers become increasingly catastrophe orientated, and will insist that insurers buy more specific protections (or (pillars)) up to a percentage of their maximum line before the whole account protection attaches. As we have seen, this may be 100% for onshore risks.

**Multi-year contracts** - these will no longer be available. Renewals will be for a maximum of 12 months only.

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## Handling Advanced Loss of Profits Losses

### Report by GE Frankona

The enlargement of existing premises or the creation of a new factory usually involves heavy capital expenditure. The insured directors will have satisfied themselves that capital is available and that the project makes economic sense. Plans are prepared, planning permissions obtained and the construction work is put in hand. The new machinery and equipment is ordered for delivery at the appropriate time and everyone confidently looks forward to the time when the expenditure of the capital starts to show results. Following an incident a piece of equipment is damaged before the expected start of production, the whole project is delayed and in consequence part of the anticipated revenues can be lost.

This is a basic case scenario in which advance loss of profits (ALOP) insurance would be of use. ALOP insurance will cover the loss of gross profit during the period of delay, if following the incident construction could not be completed by the due date, resulting in a delay in commencement of production and commercial operations.

#### ALOP coverage

The insured financial loss is caused by the delay in obtaining the planned trading revenue, the continuation of overheads during the period of delay and the financing cost of borrowed capital for a longer period than planned.

ALOP coverage can be seen as a normal business interruption (BI) coverage with the difference that it covers losses of sales and increased cost of working sustained by a company arising from an incident during construction of a new project that causes a delay in start-up of its scheduled operations rather than from an incident occurred during its ongoing operations.

This cover is normally associated with builders risk insurance as a supplementary cover within contractors all risks (CAR) and erection all risks (EAR). In general principles and conditions an ALOP policy follow the lines of an ordinary BI policy.

#### Differences with normal BI

However, the policy commences as soon as there is any possibility of an insured contingency causing any delay to the start of factory operations, which may be as soon as plant and machinery is ordered or construction begins. The ALOP policy dies as soon as construction is completed at which point in time normal BI cover would take over.

The ALOP indemnity period is the period commencing on the date in which turnover would have commenced if the incident had not occurred (date of scheduled start of operations and ending at the point in which the results of the business stop being affected by the consequences of the damage. A maximum indemnity period is of course agreed, normally between 12 and 18 months, depending on the nature of the insured business.

Therefore, in contrast to BI coverage, the indemnity period does not commence on the date of the damage. However, the indemnity period relating to the increased cost of working (ICOW) applies immediately after the occurrence of the incident.

#### Typical adjustment issues

Even if the adjustment of a significant conventional BI loss is usually not straightforward, ALOP losses present additional difficulties and uncertainties.

When trying to determine the commercial loss sustained by the insured during the period of delay, one must bare in mind that a delay in production may not necessarily mean a delay in sales. Possibly under normal circumstances, the first production would have been used to build up stocks and extra expenses can be incurred to accelerate this process following the loss.

Typically only part of the delays sustained by a major project are related to a covered incident. The adjuster must investigate whether other not loss-related factors have delayed the project market conditions could have advised to start up later or internal problems may have been experienced.

When ALOP coverage has been contracted, it is important to have independent adjusters monitor the construction works in order to identify delays caused by the covered loss.

It is usually difficult to determine what the start-up experience would have been considering normal problems, the time required to achieve full rates and the production curve during that period. It would probably be necessary to wait until sometime after normal production rates are achieved to make a reasonable measurement of the loss. Since this is often not possible, reliance must be placed on the internally prepared operating and financial budgets for the start-up period.

Therefore, careful analysis of these documents is necessary in order to ascertain their reliability if they are going to be used in our projections.

If, once actual operations begin, budgeted targets are not achieved one must always question to what extent this shortfall is due to the delay caused by the incident, to market conditions or to an unrealistic business plan in the first place. The adjuster must investigate other factors which may have impacted performance since start-up other than the loss. Market conditions change and affect demand levels, finished good prices, cost of raw materials, etc. A six-month delay can substantially change the economic case for a business venture.

It could well happen that once operating the business never reaches its expected targets during the indemnity period. Possibly due to a change in the market condition or the entry of a competitor the delay may have caused a permanent loss of market share, a loss of competitive advantage.

It will then be necessary to look into measures to regain market position. Special attention must be given to possible trading discounts introduced during actual start-up period to gain market share: are they due to the loss or are they normal during any start-up period?

The sum insured is based on the gross profit that would have been earned had the damage not occurred. Again this must be analyzed as in the case of a normal BI but consideration must be given to the fact that some fixed costs may be postponed until actual commencement of operations, such as, wages, insurance, rent rates and depreciation.

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It is necessary to analyze all budgeted types of fixed expenses and investigate their actual commencement and degree of expenditure.

Wages are typically a complex issue: employees may have been hired before the operation start-up date and can be regarded as unlikely to be dispensed with if a delay arises, and therefore should be included within the covered gross profit. This largely depends on the stage of construction and finalization of arrangements at the time of the loss.

Depreciation is always a controversial issue: depending on how the machinery and equipment are depreciated it is arguable that depreciation costs during the period of delay have been saved. This is a position often defended by forensic accountants but not so clear to engineers or usually to the insured. It is largely based on the assumption that the machine has a fixed limited useful life which will be extended by the delay in start-up.

### **Adjustment approach**

Unquestionably, the adjustment of ALOP losses faces a greater degree of uncertainty than ordinary BI losses. In preparing a sales projection for a normal BI loss, the adjuster typically relies heavily on past operating experience over a reasonable period of time depending on the type of business. ALOP losses do not allow for such luxuries as past operating experience, there is no (benefit of hindsight) and the loss adjuster is forced to place more reliance on internal budgets and projections.

Always guided by common sense, the overriding principle to observe when adjusting a conventional BI loss, is the comparison of a hypothetical scenario (what would have happened to the business had the covered loss not occurred to the actual scenario (what really happened to the business given that the loss did occur). In doing that we must carefully analyze all the factors that have an impact on the insured business: economic conditions, the weather, industry regulations, competition, market trends, external political events, internal policies or strategies such as new product introduction, Diversification, promotions, etc.

We need to isolate the impact of the covered incident during the indemnity period from the effect of all other loss-unrelated factors. Once we extract the loss from the picture we can model the business performance to obtain our hypothetical scenario. The comparison of this hypothetical scenario to the actual experience during the indemnity period will give us the answer to what is the loss sustained by the insured as a consequence of the covered incident, subject to the insurance policy specifications, limitations and exclusions.

In the case of ALOP, the added difficulty in projecting our hypothetical scenario stems from the fact that we have no actual operating data during the period for which we are trying to project because the business has not started operating yet. We can know what the external factors were during the period and to some extent what the internal factors were (through the insured budgets and plans) but we have no empirical evidence as to how the business would have actually performed under these. It is always a good idea to wait and look at data since the start-up to obtain some empirical operating data even if it relates to a later period and, as discussed above, some of the external and internal conditions affecting the business may have changed. This is not always practical from a claims administration point of view since it may be some time before we can obtain reliable actual operating information.

In the case of ALOP losses, the difficulties apparent in gazing into the crystal ball of future possibilities are greatly increased. Therefore, both underwriters and claims experts need to understand that more than ordinary care is required to ensure adequate protection and full liaison should take place between the firms policy makers, financial experts, project controller, works technicians, marketing consultants and others who will be involved in the project, together with their insurance advisors.