



## World Financial Centers New Horizons in Insurance & Banking Swiss Re

### Executive Summary

Operating from major global centers such as London, New York, and Tokyo, financial intermediaries (FIs) help clients manage risk, channel funds from savers and investors to businesses seeking capital, and facilitate the clearing and settlement of payments. Prominent examples of FIs include banks, insurers, securities firms, mutual funds, and pension funds. Since 1952, the assets of US FIs have grown at an average annual pace 2.4 percentage points above GDP growth. The US banking, insurance, and securities industries have expanded their share of nominal output since 1980, even though their aggregate share of the private workforce has declined.

FIs are changing in response to a wide range of social and economic forces. Financial deregulation makes it easier for FIs to cross industry and national borders. Technological progress reduces costs, stimulates innovation, and allows FIs to reengineer their value chains. The advent of online trading, for example, has radically altered the competitive landscape for stockbrokers. A growing focus on shareholder value pressures the management of FIs to deploy capital more efficiently by entering new markets, exiting others, making acquisitions, and returning capital to shareholders. In recent years, M&A activity among FIs has surged.

As FIs strive to offer clients new and innovative services, the following trends will continue to unfold:

- ❑ Corporations will increasingly raise funds through securities issuance, prompting commercial banks to enter new fee-based businesses;
- ❑ As global economic integration continues to deepen, FIs will grow increasingly circumspect about undertaking cross-border and cross-sector mergers and acquisitions to enter new markets;
- ❑ Though FIs will maintain their largely distinct value propositions, convergence will occur in asset management and risk management, especially in the wholesale arena;
- ❑ As FIs pursue a growing range of strategies, the (manufacture) of financial products will grow increasingly separate from their distribution;
- ❑ Ageing populations saving for retirement will continue to fuel the rapid growth of private pension plans, mutual funds, and insurance products with an asset accumulation component.

### The Performance of Financial Intermediaries

#### The world largest FIs

Any performance assessment of the different classes of FIs is sensitive to the measure used. One plausible measure is revenue. When ranked by year 2000 revenues, 115 of the 500 largest companies in the world are FIs. Ninety percent of these firms, which collectively hold USD 33 trillion of assets, are either banks or insurers (Tables 1 and 2). The largest banks (56 in total) hold

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nearly three times the assets of the largest insurers (48 in total) and generate roughly similar revenues. Among these large insurers, life & health companies collectively have more than twice the revenues and assets of property & casualty companies, yet less stockholders equity.

Securities firms figure far less prominently among the largest FIs, with only five among their ranks. Their revenues, assets, and equity each amount to less than 5% of the aggregate. These totals are modest in part because they exclude the substantial securities industry activity undertaken by FIs that are categorized as banks. Pension funds do not appear in these rankings because they are generally not separate entities, but integral parts of corporations and government agencies. Mutual funds are also absent. Their ability to execute a large volume of transactions using comparatively few resources means that they, like securities exchanges, generate relatively modest revenues and profits.

**The world largest financial intermediaries, as measured by year 2000 revenues, are predominantly banks and insurers.**

Industry	No. of Companies	Revenue US\$ Trillion	Share of total Revenue (%)	Assets US\$ Trillion	Share of total assets in (%)	Shareholders equity US\$ trillion	Share of total shareholders equity (in %)
Banks	56	1.44	43.0	21.33	64.3	0.91	52.8
Insurers	48	1.39	41.6	7.63	23.0	0.56	32.8
Life & health	32	0.93	27.8	5.35	16.1	0.24	14.0
Property & Casualty	16	0.46	13.8	2.28	6.9	0.32	18.8
Diversified financials	6	0.35	10.5	2.7	8.2	0.17	10.0
Securities	5	0.16	4.8	1.51	4.6	0.07	4.4
Total	115	3.34	100.0	33.17	100.0	1.72	100.0

Source: Fortune (Global 500)

**The largest FIs, as ranked by year 2000 revenues, in US\$ billion**

Banks	Life & health insurance	Property & Casualty insurance	Diversified financials	Securities firms
Deutsche Bank 67.1	AXA 92.8	Allianz 71.0	Citigroup 111.8	Morgan Stanley Dean Witter 45.4
J.P. Morgan Chase 60.1	ING Group 71.2	State Farm 47.9	General Electric Capital Services 66.2	Marrill Lynch 44.9
Credit Suisse 59.3	Nippon Life 68.1	American Int Group 46.0	Fannie Mae 44.1	Goldman Sachs Group 33.0
Bank of America 57.7	CGNU 61.5	Munich Re Group 40.7	Freddie Mac 30.0	Lehman Brothers 26.4
BNP Paribas 57.6	Assicurazioni Generali 53.3	Zurich Financial Services 37.4	American Express 23.7	Nomura Securities 11.8
Mizuho Holdings 52.1	Dai-ichi Mutual Life 46.4	Berkshire Hathaway 34.0	Household International 12.0	
HSBC Holdings 48.6	Prudential (UK) 43.1	Allstate 29.1		
UBS 47.3	TIAA- CREF 38.1	Royal & SunAlliance 25.6		
Fortis 43.8	Sumitomo Life 37.5	Loews 20.7		
ABN AMRO 43.4	Metlife 31.9	Swiss Re. 18.7		

Source: Fortune (Global 500)

### The profitability of FIs

FIs generate substantial profits worldwide. Last year, the world largest banks and insurers earned profits of nearly USD 100 billion and USD 60 billion respectively -roughly equivalent to the GDPs of Ireland and Chile. Although they ranked as the first- and third-most profitable industries in absolute terms, banks and insurers earned a comparatively lacklustre return on equity (ROE) of 11%.Diversified financial companies and securities firms earned ROEs twice this amount.

As US profitability data illustrate, the high ROEs of securities firms are offset by a fundamental disadvantage: extreme volatility. Securities firms were unprofitable in eleven of the thirty years from 1970-99.

Insurers, whose profits were also cyclical, lost money in just two of these years. Banks, by contrast, turned a profit each year.

### Asset holdings of FIs

Asset holdings provide further insight into the economic importance of financial intermediaries. Consistent US data on these holdings date back to 1952. As of March 31, 2001, five types of financial intermediary - depository institutions, insurers, securities brokers and dealers, pension funds, and mutual funds - collectively held USD 26.9 trillion of assets, more than triple the (inflation-adjusted) USD 8.3 trillion they held at the end of 1980.

This aggregate growth, which reflects increasing wealth, is perhaps not surprising. A more relevant question is whether the

assets of each class of FIs have grown faster, slower, or in line with the overall economy. A simple measure that addresses this question is the ratio of FI assets to GDP. This measure, taken in aggregate for US depository institutions, insurers, securities firms, pension funds, and mutual funds, grew from 0.87 in 1952 Q1 to 2.55 in 2001 Q1. This implies that FI assets have grown 2.4 percentage points per year faster than GDP, on average, since 1952.

Taken individually, each of the major classes of FIs has also experienced asset growth in line with or more rapid than GDP growth. Assets of FIs without substantial stock market investments - depository institutions and non-life insurance companies - have grown slightly more rapidly than GDP.

Since 1980, US pension assets have grown at an annual pace five percentage points faster than depository institution assets. If this trend continues, these assets will surpass US bank assets by mid-2006 - a marked change of the competitive landscape. By that time, the assets of US mutual funds might also exceed those of depository institutions or pension funds.

Comparable data for Japan and the UK confirm that banks have been losing asset share in these markets as well, while pension funds and mutual funds have become larger holders of assets. The forces underlying these trends, which we discuss later, are widespread.

### **Workforce size and output of FIs in the US**

Interestingly, US banks and insurers have reduced their shares of the national workforce but increased their share of nominal GDP. The workforce share of securities firms has grown, but its share of nominal GDP has grown even faster.

### **The leading players**

#### ***Banks***

Of the world fifty largest banks, as measured by revenues, 29 are European, 11 North American, and eight Asian. The European megabanks together hold USD 12 trillion of assets, more than half of the group aggregate assets of USD 20 trillion. From year-end 1991 through mid-2001, annual stock returns averaged 19% for US banks, 14% for European banks, and minus 10% for Japanese banks.

#### ***Insurers***

Europe and North America each have seventeen of the world 48 largest insurers, as measured by revenues. Asia has an additional twelve of these firms. From year-end 1991 through mid-2001, annual stock returns have averaged 18<sup>0</sup>/s for US insurers, 11% for European insurers, and minus 3% for Japanese insurers.

#### ***Securities firms***

In recent decades, a group of six investment banks commonly referred to as the (bulge bracket) - Morgan Stanley, Merrill Lynch, Goldman Sachs, First Boston, Salomon Brothers, and Lehman Brothers has dominated US investment banking. Since the mid-1990s, Merrill, Goldman, and Morgan Stanley (known as the MGM group) further increased their market share to become a (superbulge) bracket with leading positions in the profitable equity underwriting and merger advisory businesses. Stock brokerage, another important line of business for securities firms, has been hotly contested in recent years with the advent of Internet trading.

#### ***Mutual funds***

In recent years, as the number of banks has dwindled, the number of mutual funds has mushroomed. From 1995 to 2000, total assets under management worldwide more than doubled, reaching USD 12 trillion.

### **Mergers and acquisitions among FIs**

In recent years a surge in merger and acquisition (M&A) activity has fundamentally altered the competitive landscape for financial intermediaries. Since 1998, there have been numerous deals in the US, Europe, and Japan with price tags exceeding USD 15 billion.

#### **All but three of twenty-five largest mergers in the financial services sector have occurred since 1998.**

<b>Acquirer</b>	<b>Target</b>	<b>Value of deal US\$ Billions</b>	<b>Date Effective</b>	<b>Country of target</b>
Travelers group	Citicorp	72.6	1998	US
NationsBank Corp.	Bank America Corp.	61.6	1998	US
Royal Bank of Scotland Group	National Westminster Bank PLC	38.5	2000	UK
Norwest Corp.	Wells Fargo Capital	34.4	1998	US
Chase Manhattan Corp.	JP Morgan & Co. inc.	33.6	2000	US
Citi Group Inc.	Associates First capital Corp.	31.0	2000	US
Banc One Corp.	First Chicago NBD Corp.	29.6	1998	US

Shareholders	Associates First capital Corp	26.6	1998	US
Union Bank of Switzerland	Schweizerischer Bankverein	23.0	1998	Switzerland
Berkshire Hathaway Inc.	General Re. Group	22.3	1998	US
Firststar Corp.	US Bancorp.	21.1	2001	US
Allianz AG.	Dresdner Bank AG	19.7	2001	Germany
Zurich Allied AG.	Allied Zurich PLC	19.4	2000	UK
Zurich Versicherungs GmbH	BART Industries PLC- Financial	18.4	1998	UK
American International Group	SunAmerica Inc.	18.1	1999	US
First Union Corp.	CoreStates Financial Corp.	17.1	1998	US
UBS AG.	Painewebber Group Inc.	16.5	2000	US
Fleet Financial Group Inc.	BankBoston Group	15.9	1999	US
Lloyds Bank PLC	TSB Group PLC	15.3	1995	UK

An extensive study covering thirteen developed economies during the 1990s identified 7,300 deals in which a FI was acquired. The aggregate value of these deals was roughly USD 1.6 trillion both the number of deals and their total value increased sharply throughout the decade. During the final three years of the decade, there were nearly 900 deals annually, associated with an annual deal volume of almost USD 400 billion. Comparing this with a total market capitalization of USD 5 trillion for financial companies worldwide suggests that approximately eight percent of financial service firms were the target of an acquisition each year from 1997-99.

### The nature of M&A activity

International and cross-industry mergers were the exception rather than the rule. About 70% of total activity, both in number of deals and their value, involved firms in the same industry and from the same country. The next most common type of deal, accounting for about 15% of transactions, was between firms in the same country but different industries. Cross-border, same-industry deals accounted for about 10% of all transactions. Cross-industry, cross-border deals, the least common type, accounted for just 30% of transactions. These deals, moreover, were of smaller average value than deals between firms that shared a country, industry or both.

Banks represented the largest share of domestic, same-industry M&A. About 68% of transactions and 78% of the value of these deals were a bank being acquired.

These mergers facilitated substantial banking industry consolidation. In the six largest industrial economies, the number of banks declined by 7,700, or about a third, from 1990 to 1999. Industry concentration increased. For the six countries, the combined market share of the five largest banks grew from an average of 30% to 36% over the course of the decade.

### Benefits and risks of mergers and acquisitions

FIs frequently cite potential economies of scale and scope as motives for a merger. Although this is a logical response to the opportunities that have arisen due to financial deregulation, there is little clear evidence that mergers consistently realize these benefits. Studies show that while scale economies do exist, the benefits cease to be meaningful beyond a certain threshold that today medium-sized FIs far exceed.

A second potential benefit of mergers between FIs is risk reduction through the diversification of activities and locations. A recent study for the US suggests that the merger of a bank with a life insurer might reduce the volatility of the resulting firm return on equity because of the lack of synchronization across industry profitability cycles. The potential diversification gains from uniting a bank with a non-life insurer or securities firms are less compelling. Mergers also offer opportunities to diversify internationally. Among the six largest industrial economies, the median correlation of banking profitability is just 0.21, which suggests that the bank profitability cycles of these countries are largely independent. A third motive underlying FI mergers is the opportunity for cross selling. Nonetheless, mergers between firms in different industries, where cross selling opportunities are most pronounced, are only a minority of transactions.

Mergers and acquisitions pose risks as well. Mergers create additional risk due to the difficulty of monitoring and controlling the actions of individual employees in consolidated organizations. These challenges are especially severe for mergers that are cross border or cross industry. A recent study of 78% M&A deals each valued at more than USD 1 Billion found that 55% of transactions within an industry succeeded, but only 32% of transactions across industries did.

### Value proposition for financial intermediaries

FIs provide ways for individuals to save for the future, for businesses to fund their growth, and for individuals and businesses to manage their risks. This section examines the value propositions for various types of FIs.

### Collaboration among FIs

The roles of FIs are evolving. Some FIs are constantly reinventing their core value propositions, blurring the distinctions between intermediaries. This happens when, for example, banks manufacture and distribute insurance products or securities firms package and redistribute insurance risk. As a result, it is sometimes argued that classifying intermediaries by the functions they perform (e.g. risk transformers) is more meaningful than using traditional industry classifications (e.g. insurers).

Despite this blurring of boundaries, each type of FI retains distinctive characteristics that differentiate it from the others. The evolving pattern of financial services includes growing competition and collaboration among intermediaries. FIs have adopted a variety of strategies in serving their increasingly sophisticated clientele. Two examples of the collaboration among FIs, in evidence throughout the world, are bancassurance and the acquisition of asset management firms by insurance companies.

Bancassurance, the provision of insurance products through banks, has developed into a major insurance distribution channel in Europe, where regulatory barriers are less restrictive than in other markets Life products are more easily sold through banks than non-life products.

FIs have pursued a variety of bancassurance strategies, from loose alliances, to joint ventures, and to fully integrated operations. Allianz recent acquisition of Dresdner is one notable example. European banks such as Fortis and ING are trying to replicate their success in other markets. Bancassurance will grow steadily in importance as a distribution channel outside of Europe, notably in emerging markets.

The growth of bancassurance reflects several broad industry trends, discussed below, including: growing competition; a desire to expand existing distribution networks through cross-selling; banks desire for diversification; financial deregulation; and the pursuit of cost efficiencies.

In recent years, insurers have concluded many sizeable acquisitions of asset management companies to enable them to tap into the wealth management market. Major deals include Allianz acquisition of Pimco Advisors and Old Mutual acquisition of United Asset Management.

### Major acquisitions of investment advisors by insurers, 1995 -2001

Date	Target	Type	Acquirer	Assets Under Management US\$ billion
11/9	Pimco Advisors L.P.	Institutional	Allianz	256
06/00	United Asset Management	Diversified	Old Mutual	188
06/97	Scudder, Stevens & Clark Inc	Diversified	Zurich Group / Kemper	120
06/00	Sanford Bernstein & Co.	Institutional	Alliance Capital Mgmt. L.P	86
03/00	Gartmore investment management	Diversified	Nationwide Financial Services	86
04/95	Kemper Corporation	Mutual Fund	Zurich Insurance	65
09/00	Phoenix Investment partners	Diversified	Phoenix Home life Mutual	61
11/97	Oppenheimer Capital (67%)	Institutional	Pimco Advisors L.P	60
02/97	Oppenheimer Capital (33%)	Institutional	Pimco Advisors L.P	48
10/00	Alleghany Asset Mgmt.	Institutional	ABN AMRO Holding NV	45
10/00	Nicholas Applegate Capital Mgmt	Institutional	Allianz AG	43
08/00	MasterLink Securities Investment Trust	Diversified	Prudential Co. of America	42
08/98	Frank Russell Company	Institutional	Northwestern Mutual life	41
12/00	Foreign & Colonial Mgmt.Ltd	Institutional	Eureko NV	38
03/00	Bankers Trust Australia group	Diversified	Principal Mutual Holding	26
04/01	Conning corp.	Institutional	Swiss Reinsurance Co.	20

It is interesting to note that eleven of the deals listed in Table 13 are cross-border. Of these, eight are the purchase of a US asset manager by a European insurer. This is in sharp contrast to the largest FI mergers, which include just three cross-border transactions. Two forces appear to be at play. First, because the US asset management market is large and well established, it is a logical destination for European insurers seeking to diversify internationally and across product lines. Second, these acquisitions may represent the purchase of equity market skills needed to compete more effectively in response to the growing equity culture in Europe.

### What is driving change?

#### Financial disintermediation

Ours is the age of (equitisation). Financial innovation, declining costs of securitisation, and the increasing sophistication of market participants have enabled securities issuance to displace bank lending as the major source of capital for large corporations. Increasing demand for securities by pension and mutual funds has stimulated securities issuance. Between 1998 and 2000, worldwide debt and equity issuance exceeded USD 4 trillion each year. Although the pace of issuance has slowed in late 2001, nearly USD 2.5 trillion was raised in the first half of the year Issuance in recent years is double what it was in the early 1990s.

#### Deregulation

Regulatory changes shape financial market developments and are shaped by them. Many countries have pursued regulatory reform to facilitate the development of the financial services sector. Quite often, however, regulatory reform lags behind changes that have already occurred in the marketplace. The recent removal of vestiges of the Depression-era Glass-Steagall Act in the US, for example, came after many of the longstanding boundaries between different financial industries had already

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been dismantled. FIs have repeatedly exhibited the ability to circumvent regulatory barriers.

The development and liberalization of Japan financial markets provides an example of how deregulation affects market efficiency and the pace of innovation. With the removal of restrictive regulations, market competition has increased steadily and transaction costs have declined. The forces of change have also induced a major realignment of FIs in the market.

### **Globalization**

Deregulation has been instrumental in the globalization of financial services and the convergence of financial service provisions in certain industry sectors. The IMF defines globalization of finance and financial risk in terms of four characteristics.

1. Technology-empowered precision finance - the ability to unbundle, repackage, price and redistribute financial risks;
2. integration of financial markets and players into a single global marketplace;
3. blurring of boundaries between financial institutions; and
4. Formation of global financial conglomerates that provide services that cut across sectors.

The globalization of risks and markets has accelerated in recent decades. National boundaries, time zones, and geographical distance are less of a barrier to international capital raising and capital allocation than they once were. Technological progress and the relaxation of capital controls have allowed corporations to invest and raise funds overseas more readily. Global foreign direct investment (FDI) flows grew at an annual average rate of 17.2% between 1982 and 1999, resulting in an eight-fold increase in the stock of FDI. This is nearly triple the 5.8% annual growth rate of world output over the same period. Against this backdrop, financial institutions have moved across regional and sectoral boundaries to serve the needs of their international clients and to tap into new markets.

FIs are taking advantage of deregulation to enter other financial industries, to cross-sell products, and to provide more customer-orientated rather than product-focused services. Financial convergence has several dimensions. From a product perspective, convergence takes place at both the retail and the wholesale level. The introduction of insurance-linked securitisation is an example of wholesale convergence of capital market and insurance products. Bancassurance, on the other hand, illustrates the use of an established retail network to cross-sell additional financial products.

The growth in the number and size of cross-sectoral mergers over the past decade is both a consequence and manifestation of convergence. The emergence of broad financial groups such as Citigroup, HSBC, ING, Zurich and Allianz also reflects the forces of convergence. Convergence is not restricted to M&A activity. It can also entail partnerships and joint ventures, which allow financial institutions to cross-sell products, offset risk profiles, share services and gain access to multiple distribution channels. Engaging in multiple activities enables a FI to allocate capital in a way that offers better risk-return characteristics.

### **Technological progress**

Technological developments, including the introduction of web-enabled solutions, have multiple impacts on the provision of financial services. Both the cost and efficiency of service delivery are improved.

Technological progress also makes possible new financial instruments, enabling corporations and financial institutions to re-design their balance sheet exposures. The ability to unbundle and repackage financial risks offers an institution more flexibility in adapting itself to its preferred risk profile. Technology also makes national boundaries less relevant. Virtual financial institutions (e.g. banks, insurers) already exist and could grow increasingly prominent.

E-initiatives are attracting increasing attention in corporate boardrooms. New business platforms can re-engineer financial companies value chains to lower cost and improve efficiency. According to one study of direct insurers, modern information technologies offer cost savings in the range of 12% for personal lines and 9% for commercial lines. The potential to create a niche market to service one part of the value chain for other FTs could encourage some companies to specialize.

### **Wealth accumulation**

Ageing populations and a growing accumulation of wealth around the globe have focused FIs attention on the business of asset accumulation. As noted above, mutual funds and private pension funds have been able to sustain strong growth over the last decade as a result of the swelling pools of savings. This is because individuals have perceived a growing need for private pensions in view of governments inability to finance public pension plans adequately. Opportunities to manage household assets underlie many recent mergers.

The competition to manage household financial wealth has intensified over the last decade. As a result of financial innovation and deregulation, the spectrum of products available to households has widened. Bank deposits are losing appeal as a savings vehicle while mutual and pension funds are gaining in importance.

A number of forces are redefining the competitive landscape in global financial markets, and the roles of FIs. Here are some key developments:

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## Prospects: What lies ahead?

A number of forces are redefining the competitive landscape in global financial markets, and the roles of FIs. Here are some key developments.

### **Declining relative importance of banks as allocators of capital**

Securities (debt and equity) issuance will continue to grow in importance as a source of funds for corporations, while commercial banks broaden their revenue bases to include more income from fees and services. The squeeze of loan margins will remain a major deterring factor for bank lending. Large commercial banks are also increasingly active in underwriting securities, thus competing directly with investment banks.

Is the equitisation trend due chiefly to the long bull-run of the global stock markets? While cyclical factors have played a role, we think a structural shift has occurred as well, due to: (1) increased information and transparency that allows investors to better understand new securities issues; (2) corporations keen to diversify their sources of funding; and (3) commercial banks seeking more fees and service income to strengthen and diversify their revenue streams.

### **Globalization strategy rethink**

Global economic integration will continue to deepen. The V/TO accession of China, for example, will likely perpetuate the pace of globalization. However FIs will become increasingly dubious about the efficiency of cross-border/ cross sector mergers and acquisitions as a strategy to position themselves globally. If the past pattern of development holds, many of the recent financial sector M&As will prove unsuccessful. Financial and technological innovations are, meanwhile, making it easier to operate globally without engaging in costly M&A activities.

### **Financial convergence - narrowly focused**

The strong value propositions maintained by different FIs suggest that convergence will not happen at all level of financial services. In fact, the overlapping of FIs value propositions is taking place in only a few areas. We expect that competition among FIs will be most intense in (1) underwriting of securities (including risk securitisation) and (2) asset management business. On the other hand, FIs will cooperate mainly in retail distribution of financial products through each other distribution networks, particularly for the purpose of asset accumulation.

The insurance industry will retain its dominant role in risk underwriting, while other FIs (particularly investment banks and reinsurers) will help corporations in risk financing and insurers in redistributing their risk portfolios. Retail distribution of financial products (e.g. bancassurance) will be another area where convergence will have an impact.

### **Unbundling of manufacturing and distribution; origination and risk carrying of financial products**

As convergence progresses, the manufacturing and distribution of financial products will increasingly be separated. At the same time, the risk underwriting business will see increasing incidences where origination and risk bearing by insurers will be unbundled. Examples include bancassurance and securitisation of insurance risk. The main themes revolve around the re-engineering of FI value chains and the adoption of a suitable risk profile. Future FIs will be more customer-oriented and adopt open architecture rather than proprietary systems.

There is a basic distinction between liquid and illiquid financial assets and risks. Liquid assets and risks can be readily off-loaded from the balance sheets of FIs and traded on exchanges. Illiquid assets and risks, on the other hand, tend to be produced and distributed by the same institution and retained on its balance sheet.

### **Financial centre developments gear towards expected growth in asset accumulation and disposal**

The ageing population of developed markets will continue to bolster the asset management business. All FIs are geared towards offering services in asset management. Looking ahead, product developments and business strategies will increasingly focus on retail asset management. One contributing factor is the fact that pension and asset management are significantly less capital-intensive businesses than investment banking and P&C (re)insurance.

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# An Insurance Market Overview

## Report by AON

### Property Insurance

The Property Insurance Market is one of the most deeply scarred segments of the overall insurance industry in the aftermath of the events of September 11, 2001. As the physical damage and time element losses continue to mature from the World Trade Center loss, the outer limits of Maximum Foreseeable Loss estimates upon which many coverage programs were designed are now being re-evaluated by underwriters. As first party insurance, the timely and equitable settlement of claims will be crucial to the recovery - and in some cases the continued existence - of businesses that are now in deep financial distress as a result of the disaster.

In an effort to get back to (normal ) many carriers have taken the position (business as usual) and (open for business.) Although comforting on the exterior, the marketplace is far from (business as usual) and many notable changes are underway. The following summarizes the more significant developing issues and trends that are re-defining the Property Insurance Marketplace:

### Pricing

Prior to September 11th , property rating was hardening substantially. Current market conditions suggest post September 11th rating may be the hardest the global property arena has ever witnessed. For insureds with catastrophic exposures, insurance carriers are relying on complex modeling to determine adequate program rating. Many insurers and reinsurers alike are refusing to release capacity for risks where such rating can not be done.

(Expiring) base rating is no longer perceived as a legitimate (benchmark) for pricing; most major accounts are being totally re-underwritten. New business opportunities are now being quoted on a case-by-case basis. In the post-disaster market, rate increases have varied widely from 30% - 300%. Coverage areas not directly affected by the World Trade Center events, such as catastrophe earthquake and coastal windstorm, are also experiencing rate increases greater than were imposed pre-September 11th as carriers attempt to re-price their entire book of business.

### Capacity

All major insurers and reinsurers are reviewing their capacity positions closely. Where incumbent carriers have provided substantial positions in expiring programs, significant capacity reductions should be anticipated at renewal as insurers have lost both facultative and treaty support.

The availability of both retail and reinsurer capacity can be summarized as a function of three primary drivers: adequate /remaining treaty capacity of major retail insurers following the September 11<sup>th</sup> tragedy, the availability of facultative reinsurance, and ultimate risk quality.

**Treaty Capacity:** Several large retail insurers who exhausted their treaty insurance are only willing to offer either a substantially reduced net line capacity (i.e., IRI only \$10 million dollars) or have filled their treaty holes and once again offering their capacity on select occupancy classes (i.e., Zurich) The cost for replacement capacity is at multiples of expiring rates while, at the same time, terms and conditions of cover are more restrictive with exposures such as Terrorism being either excluded entirely or severely sub-limited. These increased costs and coverage restrictions are being passed along to the ultimate, base-line consumer - insured

**Facultative Capacity:** In an understandable (flight to quality,) many retail insurers have limited their purchase of facultative reinsurance to only the most financially stable reinsurance providers meeting stringent (security acceptance) measures. In many instances this position has forced retail insurers to offer only (net line) capacity as pricing for quality reinsurance is either prohibitive or the capacity is simply not available from qualified resources. As with treaty capacity, carriers purchasing facultative reinsurance on either a risk exposure specific basis or for an internal layer, are passing on the significantly higher costs and imposing coverage restrictions such as Terrorism into the policy

**Risk Quality & Catastrophic Exposures:** Retail and reinsurer capacity authorizations are now, more so than ever before, directly tied to the quality and availability of the underwriting data presented to carriers for their review and consideration. Similarly, the amount of catastrophic exposure (i.e. California earthquake; Japanese earthquake; coastal wind; etc.) plays a substantial role in capacity authorizations as support for these perils in the retail and reinsurance community has been reduced

The availability of (Blanket) limit capacity has been virtually eliminated following the September 11<sup>th</sup> attack. Although this capacity was dwindling before the World Trade Center tragedy, it abruptly disappeared in the wake of the disaster. Similarly, large loss limit quota share programs are also under substantial review as both insurers and reinsurers seek to isolate their capacity lines to those areas where they feel most comfortable (i.e., Primary, Excess of loss, etc.). As such, large quota share placements are being replaced in favor of layered structures.

### General Underwriting Issues

While all underwriting issues have been subject to increasing scrutiny as the market has hardened over the first three quarters of 2001, in the current market the following topics are of primary concern:

- ◆ **Underwriting Data** The need for comprehensive and accurate underwriting data is more acute than ever since the September 11<sup>th</sup> tragedy. Accurate reporting of exposures is absolutely essential as carriers are likely to either deny or substantially limit their participation on risks where an accurate picture of the exposure base can not be ascertained. Time

element exposures represent a particular focal point as underwriters now request Business Interruption worksheets on a location-by-location basis

- ◆ *Manuscript Forms*: Broker manuscript forms are under review and some carriers (i.e., FM Global, Zurich) are now mandating utilization of company forms as a condition for capacity to be authorized *Sublimits*. All traditional sublimits are under review with insurance carriers seeking legitimate rationale to support high limits requested. Time Element exposures continue to be a focal point with Contingent Business Interruption now receiving special attention as well as Civil Authority

Terrorism and Cyber Liability

- ◆ *Deductibles*: Carriers are pressing insureds to increase retentions across the board by issuing coverage authorizations with significantly higher deductibles and broader exclusions.

### **Terrorism Exclusion**

As insurers and reinsurers are establishing formal positions on the treatment of terrorism, the market generally appears to be following one of two methodologies

- ◆ exclude terrorism outright or
- ◆ substantially sublimit the exposure

Several major insurers and reinsurers have advised their intent to impose Global Terrorism exclusion on all new and renewal business going forward. Smaller insurers/reinsurers are expected to follow the lead of the major carriers as they finalize their 2002 renewal Treaty negotiations.

For those carriers not excluding terrorism outright, insureds are being offered terrorism coverage subject to a specified sublimit (i.e., IRI and FM Global) or via a separate policy dedicated to this specific exposure.

Sabotage and Terrorism coverage is available in the private marketplace as well. Limits of up to \$150 million are currently available in London and are accessible.

### **Fronting**

Carriers willing to provide fronting services for insureds with global exposures are limited in number

Before September 11, these carriers were already in the midst of reviewing their fee-based structures to ensure adequate administrative fees are being charged for an often detailed, time consuming and cumbersome process. Following the September 11<sup>th</sup> tragedy, several carriers placed a moratorium on fronting any new business due to concerns about insurers and reinsurers credit ratings as a result of the World Trade Center loss. Similarly, fronting carriers are now restricting their list of (acceptable) reinsurers to only the most financially secure capacity providers. A notable trend is also developing where some fronting companies will no longer accept retail capacity providers as reinsurers for global placements.

### **Alternatives to Traditional Risk Transfer Methods**

As the Property Market has sustained a (market altering) event that has substantially impacted the traditional risk transfer methods, insureds should be aware that alternative risk transfer methods will likely become increasingly more available. The following summarizes several of these venues

### **Capital Markets**

As an alternative to traditional Property Insurance markets at catastrophic risk levels, capital markets can offer substantial capacity, collateralized limits, multi-year terms and, depending on the Risk-Linked Securities structure, a formulaic claims recovery processes. Because the capital markets offer capacity at catastrophic risk levels, it is important to view such products as a supplement to traditional placements, rather than as a substitute for an entire property program. As the catastrophic layers of risk can be more difficult to place than other segments of a property program, capital markets are well positioned to address some of the key concerns that are likely to arise in the months ahead.

### **Finite Risk**

The use of finite risk insurance in property structures has increased over time, particularly in areas where losses are relatively predictable and where the commercial market simply does not provide the breadth of coverage desired by the insured - a condition that may become more pervasive as time passes. Finite risk structures by their very nature are multi-year products, which are therefore particularly attractive in a hardening Property Insurance market.

### **Captives**

Although tax minimization / deferral has been one of several reasons for forming a captive insurance company, typically these risk financing/risk transfer vehicles are primarily formed to provide coverage for their parent organizations at acceptable prices for various good economic reasons, such as:

- ◆ the unavailability of coverage associated with (hard market) conditions;
- ◆ insuring the uninsurable;
- ◆ risk management cost reductions
- ◆ (smoothing) of historical and potential future losses;
- ◆ cash flow benefits
- ◆ unbundling of conventional services
- ◆ consolidating treatments of global exposures; and
- ◆ Reduction of government regulations and restrictions.

Most, if not all, of these potential captive benefits are especially valuable in the context of the anticipated marketplace

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## Aviation Insurance

### Pricing

The aviation market continues to harden. Rates have jumped dramatically and many classes of business are finding it difficult to renew their expiring limits of liability available at any price. Product accounts are seeing increases from 80% to 300%. Type of product, loss history, and related issues will play a role in how the pricing increases. Airlines are facing up to 100% increases in rates and additional expenses with regard to surcharges. Airports are now able to buy back the war risk exclusion for limits up to \$150,000,000; however, the pricing is still very high and few have purchased the coverage. A proposal currently under the consideration of the IATA is for an insurance fund to provide airlines with a 3rd party liability coverage for incidents of war and terrorism. Airlines would be able to buy war risk liability policies from the fund providing \$2 billion per occurrence limits. The pool would be responsible for the first \$300 million of loss with reinsurance provided by the FAA paying the remainder.

Airport renewals are expected to reach 200% increases. General aviation is experiencing 40% to 60% increases. Commercial business has a wide range of increases based on the type of business.

The market changes weekly and the numbers cited here should not be used as definite renewal targets

### Terms

Aviation markets are still trying to finalize language with respect to war risk liability. The war risk liability write-back has a limitation for third party liability of \$50,000,000 annual aggregate, or the policy limit, whichever is less. At this point only one carrier is including expenses in the sublimit. No other market has indicated that they will follow this practice. While all markets are now quoting again for renewals and new business, many of the coverages that had been provided at no charge now have a cost associated with them.

Airlines have the FAA insurance program available for excess third party liability. There are a number of groups currently lobbying Congress for similar programs. These groups include the National Air Transportation Association, Airports Council International, American Association of Airport Executives and the Airline Owners and Pilots Association

### Capacity

Excess war risk liability programs are now available for airlines, industrial aid fleets and airports. None is currently available for ground handlers

Risks are being underwritten on an individual basis. AIG Aviation typically leads those programs with heavy participation by the European markets. The only markets offering excess third party war today are USAIG, AIG and London. We expect that others will follow

Security will be an important issue going forward, as we anticipate there will be a number of Lloyd syndicates that withdraw from the Aviation market voluntarily and involuntarily

## Marine Insurance

### Marine Cargo

The most obvious impact of the September 11 events for Cargo insurance buyers continues to be in the cost of war risk coverage. Simultaneously, Cargo policies extended to include storage protection are seeing restrictions similar to those in the Property insurance markets due to the storage cover reliance on Property reinsurance. Many underwriters endured very difficult treaty reinsurance renewals characterized by increased retentions and dramatic cost increases. The increased cost of reinsurance is expected to affect virtually every renewal, with increases of up to 100% for those carrying what the underwriters consider unacceptable loss records.

### Hull & Liability

Basic annual hull war rates have increased significantly. Prior to September 11, annual hull war rates averaged .0125-.025%. Post September 11, rates have generally increased .05%. Quotes for Cruise vessel rating have gone from the same level as general hull war, (.0125-.025%) to a new range of .15-.28%.

Vessels trading in the latest excluded areas are being required to pay additional per-voyage premiums as well.

In addition to the likely changes to terrorism coverage for cargo risks, we are expecting hull and liability insurers to further amend their positions in regard to terrorism. Again, these changes are driven by reinsurers. As a further update on the mutual P&I club status, there have been further official general increases announced:

Britannia: +28%

Gard: +25%

UK: +20

These general increases are in addition to reinsurance increases that are still being negotiated. The primary two reinsurance layers are automatically renewed as the final year of a three year program (+20% for 2002), but the top layers are still being negotiated. For P&I, there are expectations of further Supplemental calls on back years for some of the clubs. We expect formal announcements by the end of November

While markets for this cover are still available, the reduced capacity will inevitably put further upward pressure on pricing for this vessel owner coverage.

Cruise vessel accounts are suffering substantial penalties as well. Underwriters are imposing combined single limits for Hull War and War P&I. This, of course, effectively results in a halving of current limits and impacts bank financing/lease agreements requiring full limits for Hull War and P&I War to vessel value

### **Mutual P&I Clubs**

The Clubs provide War Risk cover for P. & I. risks for US\$100,000,000. This cover is free of cost to members and is assumed to be excess of the vessel Hull War Risk Policy (with the P. & I. War risk extension clauses). The word (assumed) is important; the language employed differs from Club to Club.

While most Clubs agreements at least infer that there is underlying coverage, few make it mandatory.

Indeed it can be fairly construed from some Clubs rules that the Club cover is primary (with a \$50,000 deductible) if there is no other primary cover or DIC/Excess where there is a primary cover.

This ambiguity has been brought into sharp focus in the insurance aftermath of the September 11 catastrophe. London underwriters writing the direct war account also write the Clubs War Risk P. & I.

reinsurance. Those underwriters became highly concerned about:

- ◆ their inability to issue notice of cancellation prior to 20<sup>th</sup> February, 2002
- ◆ potential difficulties with Club constitutions if Rule changes were demanded
- ◆ the probability that vessels trading into excluded areas were relying on their Club War risk P. & I. For primary cover without AP
- ◆ the possibility of owners with high value vessels (e.g. cruise ships) being unable to find capacity and introducing Combined Single Limits (CSL) into their Hull War Risk and War Risk P. & I. policies.

As a result, the International Group P&I Clubs, under considerable pressure from their reinsurers, issued 7 days notice of cancellation as of October 17. The language of the notice varies slightly from Club to Club (reflecting the lack of consistency between Clubs in the cover) but the intent is to reinstate cover for all vessels automatically, provided that the vessel has underlying War P&I cover to Hull value.

The reinstatement of cover is, at least for now, without cost and as of this writing there is no introduction of excluded areas

While it is fair to say that there remains an element of ambiguity in the requirement for underlying cover and differing approaches (and levels of flexibility) amongst the Clubs, we anticipate such ambiguity will be resolved at the February 20, 2002 renewal of the International Group of P&I Clubs common reinsurance program. This may also include specific language resolving issues that have arisen due to the Club coverage treatment of Terrorist acts (as against Acts of War).

Some clubs have already announced plans for additional supplemental calls for the year 2000 account.

We expect other clubs will make similar calls, especially if the investment markets do not return shortly

### **Energy**

The events of September 11<sup>th</sup> have heightened the continued decline of the energy insurance market. With rates steadily climbing for all energy classes coupled with newly announced coverage restrictions, the market will remain unstable until at least the early part of 2002 when the terms of supporting reinsurance programs are put into place. In the interim, new and renewal energy business can expect to be written as one class with little if any credits being granted for loyalty and for that matter good loss history. To further exacerbate the situation, losses have been above average for the year. Take, for example, the physiological and monetary Petro-Bras offshore platform loss not to mention the large petrochemical explosion in France and the myriad of refinery mishaps throughout the world. As a result, a number of insurers are actively re-balancing their exposures to energy and in certain instances exiting the business altogether

Accordingly, insurers are restricting coverage, increasing retentions and raising premiums. The turn-about comes on the heels a historically soft insurance market for the energy business. In addition, the correction is likely to be more sustained this time in light of the increased presence of corporate capital, especially the London market. Consequently, investors are demanding a fair rate of return on their money. Arguably this is understandable, but in order to achieve this, a majority of the energy insurers are requiring that each business class deliver these returns.

Understandably, there continues to be a fairly high turnover within the underwriting ranks. Underwriters who were once considered a mainstay with a particular market have unceremoniously been let go. In many instances, these terminations have led opportunities elsewhere in the insurance community.

However, past allegiances are no longer a guarantee to favorable treatment. Simply put, underwriters recognize that they are now in a position to be able to pick and choose who and how they insure. This way of thinking has clearly tightened the market.

Perhaps the worst hit this past year and more notably the circumstances of 2001 is the offshore energy construction market.

Merely, there is a lack of market leaders for offshore construction and for that matter capacity. For example, it has not been out of the ordinary to witness premium and deductible increases of 500-1,500 percent and 200-500 percent respectively. Additionally, it is the exception to have an (open) policy for new construction projects, but rather that these projects are to be individually written based upon their own merits. Furthermore, underwriters are requiring actual physical loss when considering faulty workmanship.

Besides offshore construction, many other areas of energy have and continue to be afflicted with premium increases such as, control of well (up to 1,000%); offshore property (up to 800%); onshore property / construction (up to 600%); mining (up to 500%); mobile drilling (up to 500%); power generation and utility (up to 400%); and, onshore construction (up to 300%). In all cases sabotage and terrorism coverage have been deleted with strict restrictions on war and terrorism clauses. As respects to onshore property coverage, it is not out of the ordinary to have witnessed - on average - a doubling or tripling of premiums.

Concerning liability placements, onshore excess liability renewals have observed increases upwards of 400% This can be explained by virtue of minimum premium requirements being raised plus an unwillingness to undercut one another. In addition, underwriters are seeking to quantify worst case scenarios. For instance the employment of company assets against itself or a third party. Another case is the rise in worker compensation rates for sites where there are more than 100 workers. Along these lines, fleet auto rates are rising where tanker trailers come into play. Here and again, energy underwriters are thinking differently about the extent of havoc that could transpire.

In the aftermath of September 11, there continues to be a great deal of consternation among underwriters regarding terrorism coverage. Underwriters classify terrorism exposures into three territory types: 1) high-risk territories with state sponsored terror insurance; 2) high- risk territories with no state terror pool; and 3) other territories. By and large, energy policies attaching in 2002 will exclude terror regardless of the territory whereas any of the run- off covers should expire by the end of 2002. Consequently, the energy insurance market has been in a decline since the summer of 2000, but the tragedy of September 11<sup>th</sup> has only complicated the marketplace. The conclusion of the January 1, 2002 reinsurance renewals should provide a clearer picture as to which markets will continue to write energy business and what capacities they will offer. It is fairly evident that a number of the January 1 renewals are not yet complete in light of the conversations we have had to date with the leading underwriters in the respective energy disciplines.

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## 2001 TOP STORIES

### A.M. Best Review

Almost everything that happened in the insurance industry in 2001 was cast or recast by the Sept. 11 terrorist attacks. Property/casualty insurance, life insurance, reinsurance, underwriting, claims handling--nearly every aspect of the industry was profoundly affected. Concerns and developments that seemed significant before the disaster faded into the background after the attacks.

But a majority of last year most compelling stories described the industry in the aftermath of the attacks. Only a few stories were not directly connected to the disaster, and two of those--initial public offerings and mergers and acquisitions--could not be told without considering the effects of the Sept. 11 events.

News of mounting losses by insurers was foremost for weeks after the disaster and will continue to make headlines in 2002. Questions of whether the destruction of the World Trade Center in New York was one insured loss or two and how the federal government will respond to insurers plea for a national reinsurance pool in case of another terrorist attack were examined and re-examined. According to MIB Group Inc., the number of life insurance applications in October 2001 in the United States and Canada rose by 8.6% over those in October 2000 and by 26% over September 2001, and the hardening property/casualty market solidified almost overnight.

Insurance analysts and underwriters estimated workers compensation losses from the catastrophe could range from \$1 billion to \$6 billion, making it one of the hardest-hit insurance lines and forcing underwriters from now on to consider the likelihood of job-related injuries and disabilities resulting from terrorism. The reinsurance industry was stunned by Sept. 11 losses on policies that included no additional premium to cover terrorist acts.

#### **WTC Disaster: One Insured Event or Two?**

The insurance world is watching to see how the courts answer the \$3.5 billion question: Should the destruction of the World Trade Center be considered one insured event or two

Swiss Re, which is responsible for 22% of the claims on the center, filed a lawsuit in U.S. Federal Court for the Southern District of New York in Manhattan to confirm that the collapse of the trade center should be considered one loss, which it said would limit liability to \$3.55 billion. Larry A. Silverstein, who signed a 99-year-lease on the World Trade Center in July, filed a counterclaim, saying the destruction counted as two events, which would raise the total liability to \$7 billion.

The lawsuit (is extremely important in its own right, because \$3.5 billion is at stake, and it is the first lawsuit to be filed,) said Robert Hartwig, chief economist with the Insurance Information Institute. (However, insurers are not waiting for the outcome of the lawsuit. Insurers are already sharpening the language in property policies all across the country to prevent this dispute from arising again.) The debate is deceptively simple. On one side, Swiss Re contends events of Sept. 11 should count as a single loss. On the other side, Silverstein said the complex was destroyed when two separate airplanes from two separate airports were hijacked and intentionally crashed into two separate buildings.

Complicating the case, both sides disagree on what contract paper binds them

There was not a formal insurance policy in place at the time of the disaster. Swiss Re maintains that it agreed to bind itself on the basis of a policy form provided by Willis Inc., the broker that wrote the World Trade Center business. That form, WillProp 2000, provides that (occurrence shall mean all losses or damages that are attributable directly or indirectly to one cause or to one series of similar causes. All such losses will be added together, and the total amount of such losses will be treated as one occurrence irrespective of the period of time or area over which such losses occur.)

Silverstein law firm, Wachtell, Lipton, Rosen & Katz, said that when Swiss Re signed the binder on July 9, Swiss Re twice struck out proposed language and replaced it by hand with language saying the binder would be subject to wording agreeable to Swiss Re. These alterations were (material,) the Wachtell firm argued, meaning the coverage was not pursuant to the WillProp 2000 form. Silverstein maintains that the agreement is bound by a Travelers Insurance binder, which did not define occurrence.

Jacques Dubois, a member of Swiss Re executive board and chief executive officer and president of Swiss Re America Holdings, denied that Swiss Re ever committed to the Travelers form. (We signed a binder that would use the Willis form,) he said. (We did not reject the Willis form on July 9. It wishful thinking on their part. You are bound by the form you sign. We signed according to the Willis prop form.)

Dubois added that regardless of what form the binder is based upon, case law in New York would interpret the catastrophe as one insurable loss.

But Wachtell argued that the leading and controlling case in point is a 1959 decision by the New York Court of Appeals in Arthur A. Johnson Corp. vs. Indemnity Insurance Co. That case involved two adjacent buildings owned by a single property owner that were damaged when walls protecting the adjacent basements collapsed 50 minutes apart as a result of a single rainstorm that flooded a construction trench in front of the buildings. The court ruled there were two accidents and, hence, two policy limits.

Swiss Re also maintained in its complaint that the lessees had knowingly underinsured the World Trade Center property. According to the complaint, Willis had recommended at least \$5.05 billion in coverage, but the lessees had originally chosen to insure for \$2.32 billion before subsequently increasing coverage to \$3.5 billion.

#### **P/C Hard Market Becomes Reality**

During the first half of 2001, the property/casualty industry pricing cycle already was turning to a hard market, with rate increases going into double digits. But as the industry was experiencing sparks of a hardening market, the events of Sept. 11 were like pouring gasoline on a brush fire. (Now you have a full-blown forest fire, where we are seeing renewals coming in at 50% increases,

even 100% or more for various commercial properties,) said Robert Rusbult, chief executive officer of the Independent Insurance Agents of America.

Despite the hardening market, insurers still face nagging issues, such as rising jury awards, weakening economic development, reserve deficiencies and rising loss costs, said Michael L. Lewis, an equity analyst with UBS Warburg.

Because reinsurers were responsible for paying about 60% of the insured losses for the Sept. 11 terrorist attacks, reinsurance prices rose, while capacity dwindled, causing primary insurance rates to increase. (Basically, it a conservative industry that even more so now. [Reinsurers] are sitting on top of something everyone wants--which is capacity--and are evaluating how to protect themselves and still be a viable partner,) said Norm Tardif, president of the management group NiiS/Apex Holding Group.

To assess the impact of the Sept. 11 attacks on Jan. 1 renewals and the future market, the Council of Insurance Agents and Brokers conducted a benchmarking survey of its members. According to survey results, 23% of respondents saw increases of 30% to 50% for medium-sized accounts, and 35% said large accounts rose 10% to 30% on average since last year. Survey respondents also reported that primary carriers had imposed more restrictions and higher deductibles as well as eliminated blanket limits for some lines. One broker disclosed that a customer who paid \$45,000 for \$5 million in trucking coverage last year is paying \$157,000 at renewal.

Brown & Brown vice president, Jim Henderson, said not only are prices going up, but insurers are withdrawing capacity on layers, making it necessary to sell numerous parts of big deals. For example, one public entity faced a renewal increase of 30%. On top of that, the \$500 million insurance deal would typically be split among five players, each taking a \$100 million slice. (Now it taking eight companies to provide the cover in small amounts,) Henderson said.

In its (Insurance Market Overview) for 2002 for the U.S. casualty market, Willis saw more headaches ahead for workers compensation lines. (Workers compensation, already under pressure due to increasing claim severity and deteriorating underwriting results, may now face price increases, carrier demand for higher deductibles and a change in underwriting strategy,) according to the report. (Some insureds renewing workers compensation catastrophic treaty coverage are being required to detail all locations with head counts of over 100.)

Industry leaders see business continuing to harden for the next few years. UBS Warburg Lewis said the current market environment may be the hardest in memory. Brian Duperreault, chairman and chief executive officer of Ace Ltd., said this hard market encompasses the entire property and casualty market and is global in scope. Chubb Chairman and CEO Dean O'Hare said 2002 will be a transition year for his company, and the full impact of the current hard market won't be realized before 2003.

### **Reinsurance Markets Uncertain**

Global reinsurance markets were in turmoil at the end of 2001. Already reeling from two years of soft markets and weak pricing, many reinsurers were staggered by the blow delivered Sept. 11, when terrorists hijacked four airliners, crashing two into the World Trade Center and one into the Pentagon.

Warren Buffett, chairman and chief executive officer of Berkshire Hathaway, told shareholders in a letter that Berkshire insurance and reinsurance subsidiaries were (foolish) for not pricing for (man-made mega-cats) before Sept. 11. (In effect, we and the rest of the industry included coverage for terrorist acts in policies covering other risks--and received no additional premium for doing so,) he said. (That was a huge mistake, and one that I, myself, allowed.)

Berkshire estimates its losses related to Sept. 11 at \$2.28 billion, a number that is still a guess, said Buffett. (Important questions of liability will likely remain unresolved for years,) he said. (Consequently, neither we nor other industry participants can be reasonably precise now as to final losses.)

About \$1.7 billion of the company loss is attributed to its General Re subsidiary, and another \$575 million to Berkshire reinsurance group, Buffett said

As Jan. 1 reinsurance renewals began to roll around, industry observers said that it may be some time before the market situation is clear

David Mair, risk manager for the U.S. Olympic Committee, said the current reinsurance market is somewhat like the capacity crunch in the 1980s, but terrorism has added a big twist. (You have got a finite resource in insurance company capacity or surplus, facing an infinite potential for loss, and worse than that, an infinite uncertainty of the potential for loss,) he said.

(Everyone is waiting to see what the federal government is going to do, and that will help the market shake itself out a little bit,) Mair said. (The events of Sept. 11 have caused what was an already-firming market to go through some more significant underwriting and price increases )

### **Life Insurance Applications Increase**

While the terrorist attacks on Sept. 11 triggered huge claims on property/casualty insurers, they only slightly diminished the capital position of life insurers. They also seem to have stimulated renewed interest in life insurance.

According to Tillinghast Towers-Perrin, the World Trade Center disaster added about 9% to the volume of claims that life reinsurers had anticipated in 2001, including accidental death and dismemberment lines. That compares with about 12% more than expected in the workers compensation line, 14% in the liability line, 75% in commercial property and business interruption lines, and 458% in the aviation line, said Stephen P. Lowe, principal in the company Hartford, Conn., office.

Lowe estimated that total claims from the trade center disaster will fall within a range of \$32 billion to \$56 billion. But Timothy W. Clark, director of Standard & Poor Financial Services Ratings, said the life reinsurance industry liability will be only about \$2.5 billion. Those losses will be divided among 26 companies, he said. Direct writers ceded to reinsurers 64% of the mortality risk of life insurance written in 2000, according to the Society of Actuaries, a trend that intensified over the past decade.

The annuity business already was down during the year as the falling stock market scared away variable-annuity prospects though the fixed-annuity business improved. Sept. 11 at first caused a further dip in life and annuity sales, but then the life business rebounded strongly in October. According to the first MIB Life Index, released in November by the MIB Group Inc., the number of life insurance applications in the United States and Canada rose by 8.6% from those received in October 2000 and by 26% over

September 2001. U.S. insurers underwrote more than 1.4 million life applications in October. Before October dramatic gains, the trend for life policies had been flat or declining, MIB said.

Part of the reason for the gains may have been the life industry quick and public response to the Sept. 11 disaster. Sy Sternberg, the head of New York Life Insurance Co. and chairman of the American Council of Life Insurers board of directors, publicly testified that this was a time for the industry to make good on its promises, to be compassionate and to give assurances that it had the resources to pay. When authorities were unable to issue death certificates on victims at the World Trade Center, insurers acted quickly to accept affidavits from employers instead. Many insurers made an extra effort to contact families or check to see whether those who worked in the trade center had any life insurance of which surviving family members may not have been aware.

There may be other repercussions in the life industry besides the public rejuvenated interest in mortality-protection products, said John DesPrez, head of Manulife Financial Corp. U.S. operations in life, annuities and pensions.

DesPrez said Sept. 11 will cause life insurers and other companies to significantly improve their business-continuation plans. He also predicted that insurance buyers will be more likely to seek out companies that are financially stronger as indicated by their ratings and that this attention to financial strength could accelerate mergers and acquisitions in the industry.

### **Workers Comp Underwriting Changes**

When hijacked jetliners crashed into the World Trade Center on Sept. 11, the disaster did more than alter the landscape of Lower Manhattan. It also brought about fundamental change to the way workers compensation insurance is underwritten

Insurance analysts and underwriters estimate that workers comp losses from the catastrophe could range from \$1 billion to \$6 billion, making it one of the hardest-hit insurance lines.

Price hikes, more self-insurance and an increased use of captives can be expected in the workers comp line, said Christopher Swift, a partner at professional services firm KPMG LLP and its national industry director for insurance.

The wide range in the loss estimate takes into account the long-tail nature of workers comp benefits. The family of a worker killed Sept. 11 in New York, excluding police and firemen, would be entitled to \$10,000 for funeral expenses. A surviving spouse and each surviving child, if any, would be entitled to \$400 a week for the rest of his or her life, unless the spouse remarries, in which case, the benefit is cut off after two years. Children receive the \$400 a week until they turn 21, but the benefit would continue under certain exceptions, such as if the surviving child is in school or disabled.

New York police and fire departments have their own compensation system, but most of the city rescue workers, including emergency medical services, are entitled to workers comp in New York.

Before Sept. 11, the traditional basis for evaluating a risk profile for workers comp was the type of work the business did and the task being performed by employees. This applies in every state, whether it a professional athlete or a janitor, said Scott Harrison, a KPMG LLP partner and head of its insurance regulatory practice. Actuaries look at the likelihood of physical injury or disability that could result from a particular occupation.

Until Sept. 11, the location of the business was a limited factor in workers comp underwriting, and was taken into account when cost of living and medical expenses were factored into workers comp benefit calculations, he said. (Medical costs are higher in New York, than Topeka, Kansas.)

Now, risk analysis has to consider the increased likelihood of job-related injuries and disabilities resulting from acts of terrorism, Harrison said.

(Those risks exist without respect to job classification. Now every employee and every employer is a target for terror and for injuries on the job site related to some act of terror. That was not the case prior to Sep 11<sup>th</sup>) Harrison said. (Actuaries will have to assign some risk-based premium or rate based on that.)

Assessing concentration of risks also is important, William D. Smith, president and chief operating officer of Kemper Insurance Cos., said in November during a PricewaterhouseCoopers conference in New York. (We as underwriters are faced with underwriting concentration of risks,) Smith said. (Most have lost that skill.)

Kemper is asking customers for more information than it did before, such as how many people are employed and where they are employed, he said.

### **Expect More IPOs**

Several significant initial public stock offerings among insurers last year set the stage for more demutualizations and start-ups in 2002.

(There a lot of new companies being started up by existing companies, both in reinsurance and in some primary companies,) said M. Evan Lindsay, senior partner, insurance and financial services, for Heidrick & Struggles. On the property/casualty side, (rates are hardening, and there lots of capital pouring into new company start-ups. I suspect those companies will be taken public after a decent period of time.)

Looking ahead, many insurers will take advantage of the post-Sept. 11 hardening market, characterized by a (significant loss) in capacity, said John S. Scheid, chairman, Americas Insurance Group, PricewaterhouseCoopers LLP. (We are now seeing significant capital raising for new company formations,) said Scheid, alluding to Lindsay comments. Many companies are starting offshore underwriting units, he said, including some notables:

### **M&As Create New Competencies**

Insurance industry mergers and acquisitions that led the news in 2001 placed a lot of emphasis on market share and distribution, but that emphasis is likely to change. The most notable deal for 2001 were American International Group Inc. \$23 billion acquisition of American General Corp.

The AIG-American General deal was (a very significant acquisition) for AIG, said M. Evan Lindsay, senior partner, insurance and financial services, for Heidrick & Struggles. (It gave them a leadership position in the life insurance market in the United States and made them a player in the distribution of annuities through banks.) Early in 2001, American General chief executive officer claimed that the deal would eventually create the No. 1 life insurance Company in the world.

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Lindsay said there were other significant mergers and acquisitions during 2001 that could have gotten lost in the wake of the AIG-American General deal

- ❑ Bermuda-based White Mountains Insurance Group Ltd. \$2.17 billion acquisition of CGU Insurance Group, the property/casualty subsidiary of the United Kingdom-based CGNU plc. With the sale, CGU Insurance, with 2000 revenues of \$4.4 billion, assumed a new name--OneBeacon Insurance Group.
- ❑ XL Capital Ltd. acquisition of Winterthur International for \$600 million in cash, in a deal that boosts XL European operations and expands its worldwide risk-management business.
- ❑ Hartford Financial Services Group Inc. \$1.12 billion cash acquisition of the individual life insurance, annuity and mutual fund businesses of Fortis Financial Group Inc. The deal makes Hartford the third-largest writer of variable life insurance in the United States, the company said.
- ❑ Swiss Re \$2 billion acquisition of the life reinsurance unit of Lincoln National Corp

Mergers and acquisitions are likely to take on a whole new look--and meaning--because of the Sept. 11 terrorist attacks. (Well-capped companies will try to acquire expertise in underwriting and reinsurance,) Lindsay said. (Companies that donot have a strong reinsurance business will look pretty seriously at acquiring reinsurance operations, because of hardening rates and the amount of capital that available) to do these deals, he said.

Another expert agreed. The so-called (flight to quality) takes on more dimensions, since the terrorist attacks had such a (profound impact) on virtually every aspect of the insurance industry, said Clint Harris, vice president of insurance research and publications at Conning & Co., who authors Conning mergers and acquisitions reports.

Two of the questions insurance company executives will have when determining whether a merger or acquisition would be a good fit in 2002 and beyond, Harris said, concern the impact the merger or acquisition would have on the financial strength of the company and whether it would enhance the ability to accept risk.

Another expert offered other prognostications on mergers and acquisitions for 2002.

(I would expect to see a trend of continuing investment from foreign players in the U.S. marketplace,) said John S. Scheid, chairman, Americas Insurance Group, PricewaterhouseCoopers LLP, who pointed to an increasing number of European players entering the U.S. market, such as Aegon, ING and Allianz. He expects this to occur not only in the property/casualty segment, but in asset accumulation and annuities also.

Mergers and acquisitions also will take on a slightly different facade in future years. (Rather than the classic acquisition, many companies will be looking at acquisitions of capabilities, very much like a strategic alliance,) he said. (They wonot exchange stock, but partner to get a certain expertise they donot have now.)