HORUS

Third Year, Issue 25 March 20, 2002

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Bancassurance in Practice
Munich Re

Introduction

One of the most significant changes in the financial services sector over the past few years has been the appearance and development of bancassurance. Banking institutions and insurance companies have found bancassurance to be an attractive - and often profitable - complement to their existing activities. The successes demonstrated by various bancassurance operations, although not all of them have been successful, have attracted the attention of the financial services sector, and further new operations continue to be set up regularly.
The report discusses the various observed methods in use today under each of the following headings:

- Contractual relationships between bank and insurer
- Product ranges
- Sales channels
- Remuneration methods and training in bancassurance operations

The focus on Europe is deliberate since most developments in bancassurance up to the mid-1990s took place in Europe. This report is timely, however, because banks and insurers in other parts of the world, e.g. the USA, Canada and Asia, are now developing bancassurance operations. In doing so, they seek to learn from the experiences of European bancassurers.

Entering into bancassurance

2.1 Ways of entering into bancassurance

There is no single way of entering into bancassurance which is (best) for every insurer and every bank. As in all business situations, a proper strategic plan drafted according to the company internal and external environmental analysis and the objectives of the organization is necessary before any decision is taken.
There are many ways of entering into bancassurance. The main scenarios are the following:

- One party distribution channels gain access to the client base of the other party. This is the simplest form of bancassurance, but can be a missed opportunity.

If the two parties do not work together to make the most of the deal, then there will be at best only minimum results and low profitability for both parties. If, however, the bank and the insurance company enter into a distribution agreement, according to which the bank automatically passes on to a friendly insurance company all (warm leads) emanating from the bank client base, this can generate very profitable income for both partners. The insurance company sales force, in particular usually only the most competent members of the sales force, sells its normal products to the bank clients. The cooperation has to be close to have a chance of success. For the bank the costs involved - besides those for basic training of branch employees - are relatively low.

- A bank signs a distribution agreement with an insurance company,

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Dear Reader,

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under which the bank will act as their appointed representative. With proper implementation this arrangement can lead to satisfactory results for both partners, while the financial investment required by the bank is relatively low. The products offered by the bank can be branded.

- A bank and an insurance company agree to have cross shareholdings between them. A member from each company might join the board of directors of the other company. The amount of interest aroused at board level and senior management level in each organization can influence substantially the success of a bancassurance venture, especially under distribution agreements using multidistribution channels.
- A bank wholly or partially acquires an insurance company. This is a major undertaking. The bank must carefully define in detail the ideal profile of the targeted insurance company and make sure that the added benefit it seeks will materialize.
- A bank starts from scratch by establishing a new insurance company wholly owned by the bank. For a bank to create an insurance subsidiary from scratch is a major undertaking as it involves a whole range of knowledge and skills which will need to be acquired. This approach can however be very profitable for the bank, if it makes underwriting profits.

Whatever the form of ownership, a very important factor for the success of a bancassurance venture is the influence that one party management has on that of the other. An empowered liaison between respective managements, with regular senior management contacts, as well as sufficient authority to take operational and marketing decisions, is vital. Regular senior management meetings are also a vital element for a successful operation. There must be a strong commitment from the top management to achieving the aims in the business plan.

2.2 Reasons for banks to enter into bancassurance
The main reasons why banks have decided to enter the insurance industry area are the following:

- Intense competition between banks, against a background of shrinking interest margins, has led to an increase in the administrative and marketing costs and limited the profit margins of the traditional banking products. New products could substantially enhance the profitability and increase productivity.

Financial benefits to a bank performance can flow in a number of ways, as briefly outlined below:

- Increased income generated, in the form of commissions and/or profits from the business (depending upon the relationship)
- Reduction of the effect of the bank fixed costs, as they are now also spread over the life insurance relationship
- Opportunity to increase the productivity of staff, as they now have the chance to offer a wider range of services to clients

- Customer preferences regarding investments are changing. For medium-term and long-term investments there is a trend away from deposits and toward insurance products and mutual funds where the return is usually higher than the return on traditional deposit accounts.

This shift in investment preferences has led to a reduction in the share of personal savings held as deposits, traditionally the core element of profitability for a bank which manages clients money. Banks have sought to offset some of the losses by entering life insurance business.
Life insurance is also frequently supported by favourable tax treatment to encourage private provision for protection or retirement planning. This preferential treatment makes insurance products more attractive to customers and banks see an opportunity for profitable sales of such products.

- Analysis of available information on the customer financial and social situation can be of great help in discovering customer needs and promoting or manufacturing new products or services. Banks believe that the quality of their client information gives them an advantage in distributing products profitably, compared with other distributors (e.g. insurance companies).

- The realization that joint bank and insurance products can be better for the customer as they provide more complete solutions than traditional standalone banking or insurance products.

- Banks are experiencing the increased mobility of their customers, who to a great extent tend to have accounts with more than one bank. Therefore there is a strong need for customer loyalty to an organization to be enhanced.

Client relationship management has become a key strategy. To build and maintain client relationships, banks and insurers are forming partnerships to provide their clients with a wide range of bank and insurance products from one source.
It is believed that as the number of products that a customer purchases from an organization increases the chance of losing that specific customer to a competitor decreases. M. Pezzulo of the American Bankers Association quoted the following odds against losing a customer:

- Current account only 1-1
- Deposit account only 2-1
- Current and deposit account 10-1
- Current, deposit and loan 18-1
- Current, deposit and other financial services 100-1

2.3 Benefits from bancassurance for insurance companies
Insurance companies have identifed a number of benefits from involvement in bancassurance:

- Source of new business - previously unreached clients: the bank client base may well be (virgin territory) for the insurance company and so a new source of business. Possible reasons:
  - Geographic: the bank clients are in a territory where the insurer has only a limited presence (if any), e.g. because the insurer agency structure there is limited.

- Demographic: the bank clients may form a very different group (e.g. by age, sex, purchasing habits) to the one which the insurer has previously courted.

For example, an insurer who previously concentrated on high net worth individuals (HNWIs) can now gain access to a wider range of customers who will not all be HNWIs.

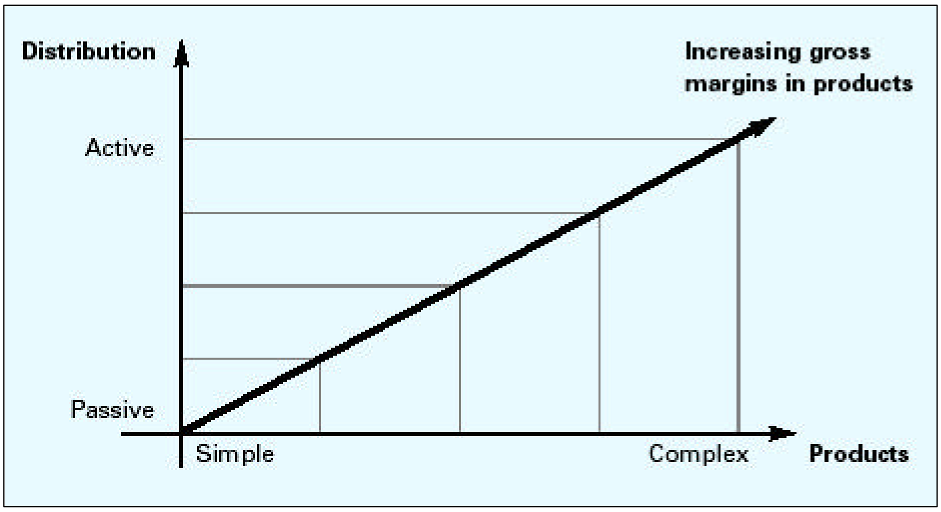
- Source of new business - wider range of products (including banking products): the insurance company hopes to attract further business, from both existing and new policyholders, because of the fact that it can offer a wider range of services than before, i.e. it can give its customers access to banking as well as to insurance services.

- Source of new business - products not otherwise feasible: the economics of the bancassurance operation may allow the insurer to offer products which are not feasible through the insurer existing channels. For example, sales costs incurred under existing channels may force premium rates for a product to be uncompetitive, so the product is not sold. The costs via the bancassurance channel may be low enough to make it feasible.

- Administration - economies of scale: the insurance company can offer to carry out the adminstration activities of the bancassurer business, if for example the bancassurer is a separate company. Combining the bancassurer business with the other business of the insurer can produce economies of scale in administration costs (including capital expenditure). This in turn allows the insurer to improve profitability and to price future products with narrower margins, which helps to make the insurer products more competitive.

Bancassurance products

All life insurance products are by nature products, which belong to the wider financial services sector. For a bancassurance operation in particular, however, the decision on the types of insurance products, which it wants to sell, is very closely bound up with the methods of distribution which it plans to use. This is because
the effort and expertise needed to sell a given product must be appropriate to the skills and cost base of the chosen distribution method. A product, which is very hard for the available distribution channels to sell, is not going to be successful for the operation, whether in terms of sales volumes or of profits.



Apart from the traditional insurance products, bancassurers have developed special products in order to fulfil certain needs, which emanate from banking transactions, or to improve certain products in order to make them more attractive and useful to the customer. These products can be broken down into three categories:

- Finance and repayment products
- Depositors products
- Simple standardized package products

Distribution channels

4.1 Types and characteristics

Some bancassurers started out by selling simple products which could be sold in large volumes but which usually had low margins to cover expenses and profits.
If we compare how products and distribution are related to the profits of an organization, we will come to the conclusion that the more complex the products sold are, the higher the required margins will need to be. The above Figure shows this relationship.

Bancassurers make use of various distribution channels:

- Career agents
- Special advisers

- Salaried agents
- Bank employees
- Corporate agencies and brokerage firms
- Direct response

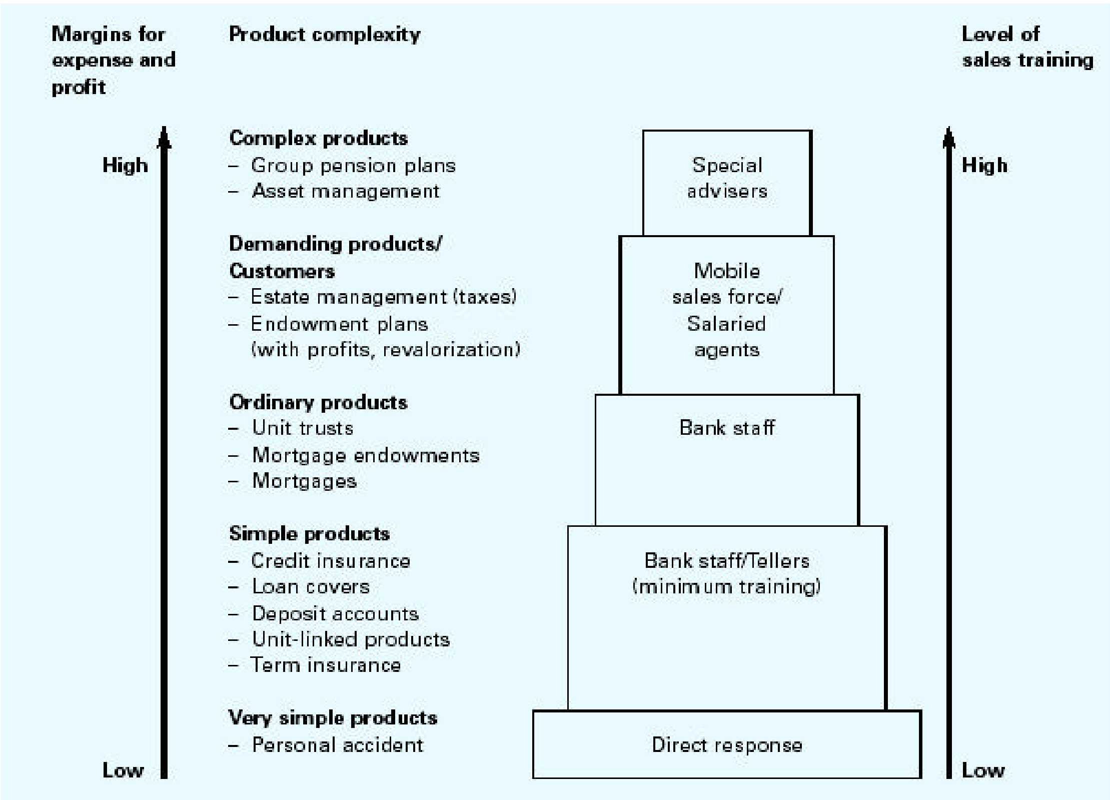
Career agents with suitable training, supervision and motivation can be highly productive and cost effective. Moreover their level of customer service is usually very high due to the renewal commissions, policy persistency bonuses, or other customer service-related awards paid to them.
However, many bancassurers avoid this channel, believing that agents might oversell out of their interest in quantity and not quality. Such problems with career agents usually arise, not due to the nature of this channel, but rather due to the use of improperly designed remuneration and/or incentive packages.

- Special advisers: special advisers are highly trained employees usually belonging to the insurance partner, who distribute insurance products to the bank corporate clients. Usually they are paid on a salary basis and they receive incentive compensation based on their sales.
- Salaried agents: salaried agents have the same characteristics as career agents. The only difference in terms of their remuneration is that they are paid on a salary basis and they receive incentive compensation based on their sales.
- Bank employees: bank employees can usually sell simple products. However, the time which they can devote to insurance sales is limited and a limited target market, i.e. those customers who actually visit the branch during the opening hours.

In many set-ups, the bank employees are assisted by the bank financial advisers. In both cases, the bank employee establishes the contact to the client and usually sells the simple product whilst the more affluent clients are attended by the financial advisers of the bank which are in a position to sell the more complex products.

- Set-up/acquisition of agencies or brokerage firms: In the US, quite a number of banks cooperate with independent agencies or brokerage firms whilst in Japan or South Korea banks have founded corporate agencies. The advantage of such arrangements is the availability of specialists needed for complex insurance matters and - in the case of brokerage firms - the opportunity for the bank clients to receive offers not only from one insurance company but from a variety of companies. In addition, these sales channels are more conceived to serve the affluent bank client.

Product complexity, distribution channels, training and margins



It seems very difficult for a single distribution channel to successfully reach the bancassurer goals and specific target markets. Many bancassurers are using multiple distribution channels.
Multiple distribution channels provide another valuable feature. They enable the enterprise to offer customers multiple options for access.
However, conflicts may arise among the various channels and also within channels under a multi-channel system. To avoid this it is necessary that

- it is clear to all which products each channel may sell;
- colleagues within a channel are motivated to cooperate;

- there is communication of the importance of every link in the distribution process;
- cultural differences are communicated and respected;
- the goals of every partner in the distribution process can be fulfilled by the process;
- the specific role and performance expectations of each channel member are clearly stated, understood and accepted;
- communication between channels is encouraged;
- Channel leadership is strong and committed to success.

4.2 Cultural issues in distribution
The managers of banks and of life insurance companies can come from quite different cultures. There may be differences in the way of thinking and business approaches of bankers and managers of insurance companies. These differences create a communication and implementation problem in bancassurance operations.
Banks are traditionally demand-driven organizations with a reactive selling philosophy. Life insurance organizations are usually need-driven and have an aggressive selling philosophy.
As a result the team spirit is negatively influenced and, since this is a crucial factor for the success of any operation, it has to be confronted.
Cultural differences between the banking and the insurance industries must be understood, respected and lived with in order for the bancassurance venture to succeed.
The development of a single culture is another possible solution but this requires a very strong commitment from the top management. This commitment must be continuously conveyed to all bank employees and life insurance agents.

- By eliminating the sales force, bank employees are forced to cross borders to a different profession where different skills are required
- The products that bank employees offer are usually simple packaged products or pure investment products
- Using only bank employees to sell insurance can severely limit the success of the bancassurer. The bank target market is then only the customer-base of the bank accessible to bank employees,
- Customer service offered in conjunction with the insurance policy is likely to be relatively poor since it is limited to banking hours.

Remuneration packages and incentive schemes

5.1 Objectives of remuneration and incentive schemes
To raise productivity and lower costs in today competitive economic environment, organizations are increasingly setting compensation objectives based on a pay-for-performance standard.
the designer of the remuneration package should seek to develop a package which helps each one in the distribution channels to feel that they get a fair reward for their contribution.

Before proceeding to the design of the compensation package, an organization must consider the following:
The compensation package is perhaps the most important element in a sales organization which will influence the volume of business, the costs, the profitability, the productivity and the customer care.

- financial services providers need to be sure they have the right people, in the right jobs, with the right skills, and at the right price.
- A package therefore needs to be designed to attract and retain the kind of people the company needs in order to develop the kind of sales organization the company wants.
- In developing this package an organization must have clearly in mind the vision of how it wants to be in the future, not just now.
- Before its implementation the package must be clearly communicated and explained to every single person involved in the bancassurance venture.

5.2 Remuneration of agency forces and agency management
Remuneration tools for agents of a bancassurer are commonly similar to those used for other insurance agency forces:

- Initial commissions to encourage sale of new business
- Renewal commissions on persistent business
- Other fringe benefits pension, health insurance
- Guaranteed salaries (e.g. percentage of last year commission)

For managers of agency forces, whose role is not to sell business but to get their agents to do so profitably for the organization, remuneration packages can include further items which reflect this role. Examples include:

- percentage of commissions earned by the agency team,
- persistency bonus (e.g. share of renewal commissions),
- rewards when members of the agency team reach specified targets

In setting benefit levels, distinctive features of a bancassurance operation which need to be remembered are:

- The package needs to be one which will attract agents to work for the bancassurer.
- The bancassurer must be able to explain to the agent the reasons for the particular structure

- For a bancassurer with several channels, the terms must be considered for each channel separately to make each channel attractive to both potential agents and to the operation. One aspect in looking at terms for each channel is to bear in mind the opportunities each channel has for selling business and generating income.
- Some (at least) of the business sold by the agency force is due to warm leads provided by the bank. In turn, the agent has to do less prospecting - and less work - to make the sale. The initial commission paid to the agent should reflect this. The proportion not paid to the agent can be used, among other things, to reward the bank branch and its employees for their effort in making the sale.

5.3 Remuneration of bank employees

Any commission payable by the insurance company is, as a principle, to be credited to the bank profit centre for the bancassurance operation. The bank management sets the commission level for each manager and employee engaged in the bancassurance operation.

- Selling in the bank branches (by employees or by financial advisers):

For simple packaged products: employees could be rewarded with gifts and/or salary increments based on their selling performance in promoting both banking and insurance products. Such performance could be quantified via the use of a points system where by the various products are allocated as a number of points.

- Warm leads:

In return for providing warm leads, the bank will get a share, say 50%, of the normal first year commissions.

A basis is needed for allocating this amount between branch staff (who provide the warm leads) and the bank owners. A possible basis would be:

25%
25%
50%

The structure shown above generates benefits as follows:

- Financial rewards for employees who generate warm leads
- Financial rewards for managers and other staff of the bank branch who have supported bank activities while the assurance business was being generated.

Group awards or bonuses are more desirable when the contribution of the individual employee is either difficult to distinguish or depends on group cooperation.

Training

6.1 Sales force training for bancassurers

a) The sales force will need to have (at least) basic knowledge of the banking products sold by the operation and of the range of distribution channels in force

b) Building up a relationship with bank staff:

The sales agent needs to learn to cooperate with bank employees and must learn how to build effective relationships with people whose job motivation may be very different to his/her own.

c) The bank expectations of customer service: the sales agent and sales manager must understand and be prepared to meet the standards for customer service which the bank expects in respect of its customers.

6.2 Bank employee training for bancassurers

The bank employees will need to be trained in the following aspects of the insurance business:

- Features of the insurance products sold
- How to identify and approach a potential customer
- Basic insurance needs
- Handling basic objections
- Other distribution channels and products
- Expected roles
- Procedures
- Remuneration and incentive schemes
- Cultures
- Customer service

6.3 Continuous training and supervision

Apart from initial training, there should be further training to support the development of the agent or employee. Some ways in which this can be done are:

- Agency meetings
- Bank branch meetings
- Area banking meetings
- In-house magazine
- Training circulars
- Area sales seminars
- Company library

- Video tapes
- Certified courses
- Lectures
- Training material booklets

A training activity record is a vital element for the manager of staff in a Bancassurance operation,

6.4 Quality customer service

Quality customer service refers to every single activity that the company, its employees and the distribution channels undertakes for its customers. In all cases the objective of every person in the company should be to give added value to every transaction or communication, providing additional incentives to customers
and enabling the company to

- distinguish itself from competitors,
- improve its image among customers,
- keep its existing customers,
- attract new customers, and
- Create additional sales among existing customers.

In a Bancassurance venture quality customer service is even more important because the bank refers its customers to the insurance company. The bank relationship with the customer can be damaged by poor service from the insurer.
For this reason bank employees must be well informed about the customer service standards set by the insurer when they refer them to their customers. At the same time the insurance company staff (including the administrators who will deal with the customers questions in future) must be aware of the standards expected by the bank on behalf of (their) clients. These service standards should be written down and agreed upon between the bank and the insurance company.

Protection & Indemnity
Market Review 2001 / 2002
Report by: WILLIS

Overview

The unforeseen factor was probably quite the extent of the deterioration in the level of investment income. In the event investment income was almost negligible. Inadequate investment income combined with a declining underwriting result led to an extremely large overall deficit for the market in 2000/01.

The global slowdown and events of September 11 have significantly reduced any optimism from the Clubs financial directors that the Reduction in investment income was a relatively short term phenomenon The forthcoming renewal in February 2002 will therefore be vitally important to the Clubs as they again attempt to push up premium levels to address not just the underwriting deficits but also the likelihood of similar investment income results for the next reporting period(s).

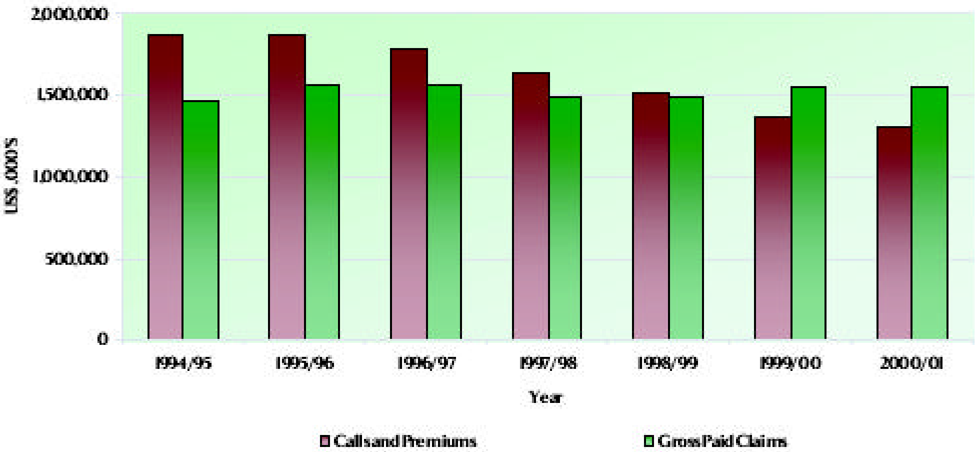
Underwriting results continue to deteriorate

The gross claims levels across the International Group have remained relatively stable over the last seven years. There is evidence of a slight increase in gross claims over the last two reporting periods, which offers some support to the comments from individual Clubs regarding increasing claims trends. Certainly there seems to be some consensus that the size of claim awards are rising even if the number of claims remains relatively consistent.

Premiums paid into the market have decreased year on year over the same period. The gross underwriting deficit seen in 1999/00 has consequently worsened in 2000/01.

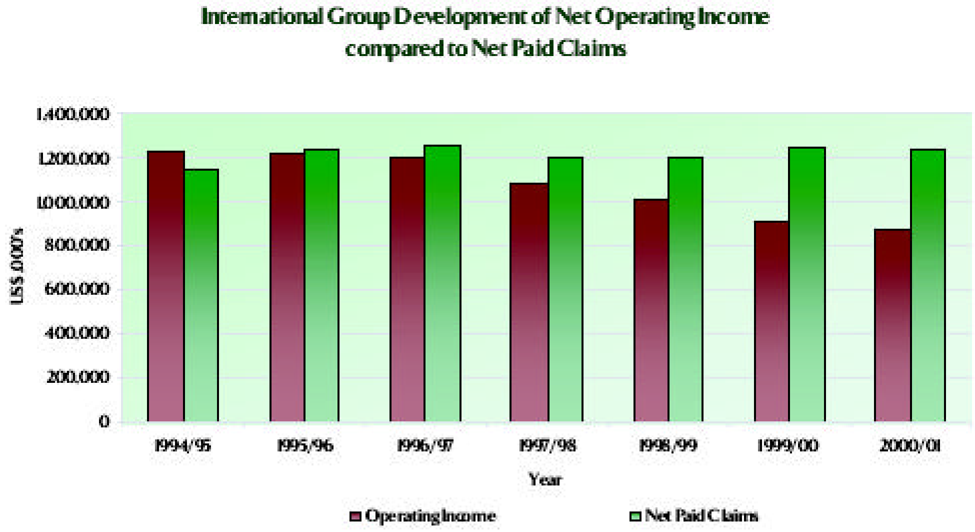
The following graph shows this trend, comparing paid premiums to gross paid claims for the whole market over the last seven reported financial years (gross underwriting result)

International Group Development of Calls and Gross Paid Claims



The net underwriting result shows the impact of the deficits more clearly. This net underwriting result is obtained by deducting operating costs and reinsurance costs from premiums (to give the net operating income and by subtracting reinsurance recoveries from gross paid claims (to give net paid claims).

The following graph shows the development of net operating income compared to net paid claims net underwriting result). Clearly the adverse trend of increasing net underwriting deficits has continued in 2000/01.



Investment income of limited help

At the mid-year stage last year, the investment income result for 2000/01 was expected to be around the same sort of disappointing level as 1999/01. The actual result was significantly worse. Some Clubs reported negative investment income and even the best performing Clubs showed only nominal returns.

Future Trends

Whilst overall claims costs have been relatively stable over recent years, there is a consensus from the Clubs that the quantum of individual claims is increasing. There is also evidence emerging from the financial results that the overall market levels of claims are edging upwards. We do not anticipate a dramatic increase, but we do expect a continued gradual increase in total claims.

The renewal at 20th February 2001 showed the first signs of a hardening market. Premium increases varied from Club to Club, but overall they were in the 2.5%-5% range. We would therefore expect the nderwriting result for the current, 2001/02 year to show a marginal improvement on the 2000/01.

The events of September 11 appear to have significantly reduced the possibility of an early recovery in the financial markets. The majority of Clubs has amended their investment strategies in an attempt to deal with the current world financial climate. Consequently, we anticipate that better investment income results will be achieved in 2001/02 than the previous year. This improvement will be minor and there is no expectation that investment income will return to the same sort of levels seen in the mid to late 1990s, for the foreseeable future. The marginal improvement in both underwriting and investment results will not be sufficient to prevent the 2001/02 year also showing an overall market deficit. We would expect this overall deficit to be less than in 2000/01.

The P&I market at the forthcoming renewal will also face increasing reinsurance costs. The International Group reinsurance programme is discussed. In summary, it is anticipated that the overall cost of this programme will increase by up to 30% at the coming renewal. In addition to this market-wide programme, a number of Clubs protect their retention with individual reinsurance programmes. These individual Club reinsurances will face even larger rises, which in turn will squeeze the Clubs retained incomes

The Clubs will be looking for very significant rate increases at the renewal in February 2002. Early published general increases are in the region of 20%-30%, with increases in International Group Reinsurance costs in addition to these levels.

The P&I market needs to address the financial results at the forthcoming renewal and the levels of increase suggested are logical. However, with an adverse economic climate, poor freight market and increasing costs from other areas already impacting on ship owners incomes, such premium rises will be fiercely resisted.

DEVELOPMENTS IN THE P&I MARKET

War Protection and Indemnity Risks

Following September 11 and under pressure from the commercial market, the Clubs redefined the extent of cover they offer in respect of war P&I claims.

Basic Club cover has always excluded P&I claims arising from a War Peril. In the 1980s the Clubs introduced an optional extension which gave US$50 million (later increased to US$100 million) of War P&I cover in excess of the amount recoverable from the Owners Hull War Policy. This extension was routinely agreed by the Clubs without additional premium.

Although a minimum excess point of US$50,000 was specified, when the extension was introduced it was originally understood that a P&I war loss would be recoverable from H&M War Risks underwriters and the Club would only be involved excess of the ships value. Over time the Clubs expectations became somewhat vague and by 2001 it would have been very difficult for any Club to reject a war P&I claim using the argument that they were purely excess Insurers The explicit clarification of cover in Autumn 2001 removed any ambiguity. Although Club Boards retain discretion on war P&I claims, Owners will now have an excess applied to any war P&I claim equivalent to the Hull and Machinery value of the vessel, irrespective of whether they can recover this from their Hull War Insurance.

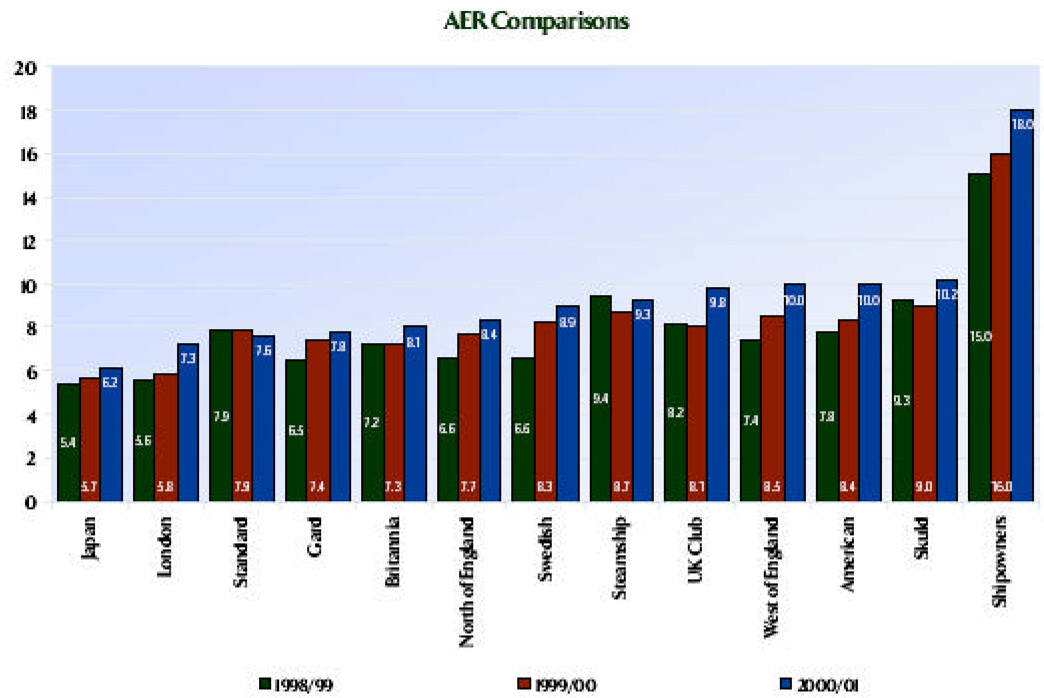
For most Owners this should not pose difficulties, as their Hull War cover will indemnify them up to hull value for P&I losses. There is however, a fairly sizeable minority of Owners with a potential problem. These are Owners who do not have any P&I cover within their Hull War insurance, or the cover is subject to a combined single limit. The re-statement of the Clubs position on War P&I could leave these owners with an unrecoverable loss if they do not amend their current Hull War Insurances.

AVERAGE EXPENSE RATIO (AER) COMPARISONS

Average Expense Ratios (AERs) were introduced in 1999 following agreement with the European Commission. The intention behind AERs was to enable direct comparisons to be made regarding the cost efficiency of different Clubs.
All Clubs are required to follow exactly the same format when calculating their AER figure. The Average Expense Ratio is a five-year average of:

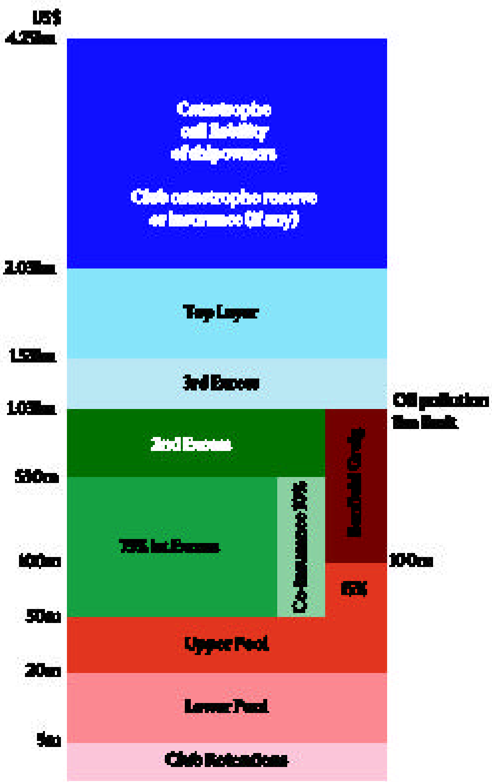
$$\frac{\text{Operating costs x 100}}{\text{(premium income + investment income)}}$$

As mentioned in our previous reviews, direct comparisons are difficult in this area. It would be too simplistic to state that the Club with the lowest AER was the most efficient and the highest the most inefficient. For example, a Club with a high level of premium or investment income will produce a lower AER; whilst Loss Prevention programmes, which nearly all Clubs now consider critical to reducing the overall cost of insurance, will force up the AER.



INTERNATIONAL GROUP REINSURANCE

When the International Group (IG) last negotiated their main reinsurance programme prior to the renewal in 2000, they obtained a two year programme with a further one year option on the main primary layer. Subject to the Groups claims figures remaining within specified targets, the first US$1 billion layer of reinsurance cover had the option to be renewed subject to a premium rise of up to 20%. The IGs claims figures are well within the set criteria and the expectation prior to September 11 was that the renewal for 2002 Policy Year would be achievable with an overall rise in reinsurance costs of below 20%.
Following the events on September 11 and the impact of all sectors of the market, any optimism that an increase less than the full 20% could be achieved evaporated.
Initially there was some discussion that the Clubs may waive their renewal option and voluntarily agree fully to renegotiate the terms from 20 February 2002. The rationale behind this was twofold:
1) The same underwriters will be on other reinsurance facilities placed on behalf of the Clubs.
2) This is a one year extension only.
In both cases, the concern from the Clubs was that if the reinsuring underwriters were sufficiently aggrieved over the IGs approach it could have a negative impact on these other policies and the main reinsurance renewal in 2003.
Despite these fears, the IG have opted to take the third year option as originally offered. There may be a need to replace some of the current market as all the capacity will not be available in 2002. At this stage it is not expected to result in the Clubs themselves having to take a larger co-insurance than their current participation.



The excess layers above US$1 billion are subject to normal negotiation. Although these layers have never experienced a claim, the reinsurers will require significant increases in premium if they are to continue to offer this cover. Fortunately the cost of these excess layers, per gross ton, is relatively small.

A 30% rise in the overall reinsurance programme would equate to an increase in total P&I premiums of about 6%. These costs will not have a uniform impact on individual Shipowners.

For example, large tanker operators will be affected to a greater extent than operators of dry cargo vessels (as the proportion of their premiums paid to reinsurers is much greater for tankers).

FIXED PREMIUM MARKETS

The developments in the fixed premium P&I market have been dramatic.

the autumn of 2000 there were seven international insurers (rated by a recognised rating agency) offering fixed premium P&I cover. This has reduced to a total of four. Of last years seven companies, four could offer cover for larger ships; currently this has reduced to only one.

The withdrawal of Chubb, Dragon, HIH/Cotesworth, QBE and JL Jones over the last two years has done little to enhance confidence in the fixed premium market.

Most shipowners have directly or indirectly benefited in the short term from the fixed premium P&I market. The introduction of so many facilities offering a huge increase in P&I capacity inevitably added competitive pressure, whether real or perceived, on the traditional Clubs. The whole market softened faster and further than otherwise would have been the case.

The challenges are surmountable and the trends in the overall P&I Market present immediate opportunities for the fixed sector.

Following announcements from American Club, Skuld and Steamship Mutual, there is currently more concern about un-budgeted supplementary calls than there has been for nearly ten years. The market will also harden rapidly, raising rating levels significantly.

We anticipate new fixed premium facilities emerging in the next twelve months.

Although there may be a more cautious approach, for certain types of vessels and trade the fixed premium market will remain an attractive alternative to the mutual system.

Terrorism - dealing with
The new spectre
Report by: Swiss Re

Terrorism and terrorism risk

The phenomenon of terrorism is difficult to define in unambiguous terms. It cannot be readily distinguished from other forms of violence, such as vandalism, rebellion, civil war or war, since its manifestation is highly diverse in terms of its instigators, motives, dimensions, targets and outcome. The definition Swiss Re currently uses in its reinsurance contracts focuses more on the effects than on the motives of this phenomenon:

Terrorism means an act or threat of violence or an act harmful to human life, tangible or intangible property or infrastructure with the intention or effect to influence any government or to put the public or any segment of the public in fear.

History and loss experience shows that terrorism is in no way a novelty for the insurance sector. Most previous events in loss history, terrorists were members of the target country or society.

They attacked prominent persons, functions and facilities with the intention of altering established power structures.

International terrorism, in which perpetrators act across borders and beyond national jurisdictions, is not a new threat either.

However, 11 September has brought to light a new dimension of international terrorism, with a staggering, previously inconceivable scale of threat scenarios and loss potentials.

Terrorism risk in many ways closely parallels natural catastrophe risks such as earthquakes, storms and floods. In both cases, enormous inherent loss potentials make diversification difficult to achieve.

Moreover, individual events can affect entire economies, and the incurred damage may be spread across many different insurance lines of business.

And yet, there are also very significant differences: unlike terrorist attacks, natural hazards occur randomly and without intent, and their probabilities and consequences can be modeled and quantified with scientific data and methods.

Table 1: The worst terrorist acts in terms of casualties

Date	Country	Location	Event	Fatalities	Injured	Estimated Economic loss US$ m (2001 price levels)	Insured property Loss US$ m (2001 price levels)
11 Sep. 01	USA	NYC. Wash. DC	Terror attacks against WTC and Pentagon by hijacked airliners	3,122	2,250	90,000	19,000
23 Oct. 83	Lebanon	Beirut	Bombing of US Marine barracks and French paratrooper base	300	100		
12 Mar. 93	India	Bombay	Series of 13 bomb attacks	300	1,100		6
21 Dec. 88	UK	Lockerbie	PanAm Boeing 747 Crashes due to bomb	270	0		138
07 Aug. 98	Kenya	Nairobi	Two simultaneous bomb attacks trigger damage in and around US embassy complex	253	5,075	169	
19 Apr. 95	USA	Oklahoma City	Truck bomb attack on government building in Oklahoma city	166	467	757	145
23 Nov. 96	Comoros	Indian Ocean	Hijaked Ethiopian Airlines Boeing 767-260 ditched at sea.	127	0		45
13 Sep. 99	Russia	Moscow	Bomb explosion destroys apartment building	118	0		
04 Jun. 91	Ethiopia	Addis Ababa	Arson in arms warehouse	100	0		
31 Jan. 96	Sri Lanka	Colombo	Bomb attack on Ceylinco House	100	1,500		6
18 Jul. 94	Argentina	Buenos Aires	Bomb attack on building of Jewish organisation	95	147		

Table 2 : The worst terrorist acts in terms of Insured property losses

Date	Country	Location	Event	Insured property Loss US$ m (2001 price levels)	Estimated Economic loss US$ m (2001 price levels)	Injured	Fatalities
11 Sep.01	USA	NYC. Wash. DC	Terror attacks against WTC and Pentagon by hijacked airliners	19,000	90,000	2,250	3,122
24 Apr. 93	UK	London	Bomb explodes near NatWest tower (city)	907		54	1
15 Jan. 96	Uk	Manshester	Explosion of IRA car bomb near shopping mall	744		228	0
26 Feb. 93	USA	New York	Bomb explodes in garage of world trade center	725	1,311	1,000	6

10 Apr. 92	UK	London	Bomb explodes in financial district	671	2,874	91	3
24 Jul. 01	Sri Lanka	Colombo Int. Airport	Rebels destroy 3 airlines, 8 military aircraft and heavily damage 3 civilian air craft	398		15	20
09 Feb. 96	UK	London	IRA Bomb attack in South Key Docklands	259	271	100	2
19 Apr. 95	USA	Oklahoma City	Truck bomb attack on government building in Oklahoma City	145	757	467	166
21 Dec. 88	UK	Lockerbie	PanAm Boeing 747 Crashes due to bomb	138		0	270
12 Sep. 70	Jordan	Zerqa	Hijacked Swissair DC-8 TWA Boeing 707 and BOAC VC-10 dynamited	127		0	0
06 Sep. 70	Egypt	Cairo	Hijacked PanAm B-747 dynamited	111		0	0

Terrorism risk insurance before 11 September 2001

Historically, fire insurance covered fire and explosion damage regardless of its cause, with the exception of damage caused by war, civil war or civil commotion.

Since terrorism in most countries was not part of the war exclusion clause, fire or explosion damage resulting from a terrorist attack was covered.

Tables 1 and 2 provide an overview of terrorism losses between 1970 and 2001. For some particularly exposed countries, special regulations or solutions are in place, and are outlined in Table 3.

The new challenge after 11 September 2001

Total insurance losses of the 11 September attack on the World Trade Center are still difficult to quantify. In December 2001, Swiss Re issued a preliminary *sigma* review of the year 2001 catastrophe losses, with a WTC loss estimate of USD 19 bn for property and business interruption, and an overall economic loss estimate of USD 90 bn. The available estimates for the loss total in all lines of business, ie including casualty, aviation and life, still vary widely. Table 4 shows current loss ranges per line of business. Swiss Re own best estimate for the overall insured loss is some USD 38 bn.

Table 3 : Specific terrorism risk solutions in various countries (before 11 Sep. 2001)

Country	Terrorism Risk Insurance Provider	Details
UK	Pool re	The international reinsurance market withdrew capacity as a consequence of IRA terrorism in the 1990s, which, in turn, led to a state-supported solution: Limited private cover with additional excess cover made available for insurance companies to cede to Pool Re (which sets rates and terms). The English government acts as Pool Re reinsurer of last resort, in case of insolvency.
Spain	Consorcio	CCS (Consorcio de Compensaci n de Seguros) is a state insurance facility guaranteeing cover for extraordinary risks such as earthquake, volcanic eruption, flood, storm, terrorism and civil commotion. This cover is integrated into policies issued by private insurance companies which collect premium on behalf of CCS. After deregulation in 1990, it became possible to insure these risks privately, whereupon CCS provided subsidiary cover only and in accordance with the legal minimum. However, policyholders must pay CCS premium in any case and thus maintain the solidarity principle for catastrophe risks.
South Africa	SASRIA	In 1979, South Africa particular political situation led to the creation of the national institution SASRIA (South African Special Risks Insurance Association) for the (voluntary) insurance of political risks. While the political situation has improved considerably in recent years, SASRIA still exists.
Isreal	PTCF	Terrorism is excluded from standard property policies but the private insurance market grants cover by separate endorsement. Reinsurance coverage is provided by catastrophe excess of loss treaties. In addition, the state of Israel covers losses triggered by politically motivated violence (including terrorism) through the Property Tax and Compensation Fund (PTCF) which was established to cover property losses resulting from war and war-like activities.

Both the severity and frequency of loss exposure have become virtually immeasurable.

An entire society can be the target, and the whole world may be affected to some extent. International terrorists act across borders and beyond national jurisdictions. Their intention may not be to alter societal structures so much as to actually destroy them. Their motives remain obscure, ranging from aspirations for global domination to salvation through martyrdom in the struggle against perceived evil.

In future, terrorist acts may cover the entire spectrum from the well-known and frequent minor incidents to medium- scale events, such as assassinations, hijackings and car bombings, to rarer and cataclysmic acts, such as the co-ordinated action on 11

September, which involved four commercial airliners and targeted key US facilities. The potential extent of fatal and disruptive effects is compounded by various factors. First, modern technology and extremely effective and lethal weapons -including chemical, biological, or hazardous nuclear materials-are available to terrorists. Second, terrorists will be ready to sacrifice their own lives to maximise damage, disruption, horror and the number of fatalities. Third, the size, complexity and vulnerability of certain targets-such as densely overbuilt downtown areas or economic centres with high-rise buildings, thousands of workplaces and a multitude of technical systems and infrastructure networks -enable perpetrators to achieve staggering consequences with relatively simple concentrated attacks.

New terrorism and insurability

Since that date, new dimensions of terrorism have prompted a surge in genuine and legitimate demand for insurance protection against this type of threat. At the same time, the insurance industry is compelled to fundamentally review its risk acceptance position, and to reduce and limit coverages granted to avoid unmanageable exposures in the future. In fact, the question whether terrorism risk is insurable at all must be fundamentally reviewed. The necessary criteria for the insurability of risks in general need to be examined first:

1. Assessibility: The probability and severity of losses must be quantifiable to facilitate calculation of the required premium and the potential extent of loss occurrences.
2. Randomness: The time at which the insured event occurs must be unpredictable, and the occurrence itself must be independent of the will of the insured.
3. Mutuality: Numerous persons exposed to a given hazard must join together to form a risk community in which the risk is shared and diversified.

Table 4: Estimated insurance market losses per line of business (preliminary status 31 Jan. 2002) in USD bn for the World
Trade Center attack, New York, 11 Sep. 2001 (source: Tillinghast-Towers Perrin)

Line of Business	**Range**
Property	10-20
Business Interruption	3.5-7
Workers Compensation	3-5
Aviation	3-6
Liability	5-20
Other Lines (Non Life)	1-2
Life & Death	4.5-6
Total	30-58

4. Economic feasibility: Private insurers must be able to charge a premium which is commensurate with the risk, giving them a fair chance to write the business profitably in the long run.

Obviously, terrorism risk does not readily meet all these criteria. The available data and statistics from past events reveal little or nothing about the future risk. Although terrorists do not act randomly, but strike by surprise and purposefully maximise effects, their attacks are random for their victims.

Mutuality is difficult to achieve given the major differences in terrorist hazard exposure between landmark risks- eg high-rise buildings in large cities of certain countries-and most other buildings. The tremendous loss potentials and the risk of co-ordinated terrorist actions throughout the world hamper diversification. And finally, with the apparent uncertainties regarding the risk quantification, the economic feasibility of the business is extremely doubtful.

State involvement

In view of such difficulties, a quick conclusion-and an understandable immediate reaction of insurers to the shock of 11 September -was to exclude terrorism from insurance policies altogether. This could lead to the government stepping in to provide insurance, as is the case with the schemes listed in Table 3.

Some major hurdles to insurability can be overcome through state involvement.

First, the state as the insurer of the last resort is in a better position to deal with extreme loss potentials than private insurance companies with their limited capital and capacity. Second, government can declare terrorism insurance mandatory, eg by automatic inclusion in property policies against an additional premium. This would greatly expand the risk community and spread the risk throughout an entire society. If everyone contributes, the necessary additional premium rate remains small and may be either uniform for all insured objects or graded according to the size, type and location of the risk. Pricing uncertainty is not a major issue, since premiums can be easily adjusted to loss experience in the course of time. Simultaneously, this approach generates significant funds permitting even large future losses to be covered. Cover for a country peak or landmark risks remains available and affordable.

Solutions of this kind are both feasible and effective. They are commonly applied in many markets for natural catastrophe risks such as earthquakes or floods, which present similar problems of insurability. Moreover, they are in line with the prevailing political stance that terrorism is a public problem, to be addressed by a national solution and borne by the country as a whole In addition to the countries in Table 3,

France recently also established a pool for terrorism exposures: effective1 January 2002, France set up GAREAT (Gestion de lAssurance et de la ce des Risques Attentats et Actes de Terrorisme), a pool with a state guarantee for terrorism coverage. Direct insurance company members will cede to the pool terrorism coverage regarding physical damage or business interruption for risks with a sum insured in excess of EUR 6 m. The business ceded to the pool consists of material damage and loss of profit from fire and engineering insurance.

The pool function is based on annual aggregate losses. The primary EUR 250 m is retained by direct insurers, whereby the retention of each pool member corresponds to its share of ceded business. The EUR 750 m layer in excess of EUR 250 m is placed in the international insurance and reinsurance market. The next EUR 500 m is guaranteed by the French government without any initial premium. However, the direct insurance industry will be requested to remunerate any amount falling into this layer over a period of 10 years. Finally, the layer unlimited in excess of EUR 1500 m is fully placed with the wholly state-owned CCR (Caisse Centrale de Reassurance). CCR is the institution reinsuring French insurance companies against events which are declared as (natural catastrophes) according to French law.

Consequences for insurers and reinsurers

Regardless of the degree of state involvement, the challenge of terrorism calls for an appropriate response by the private insurance sector, especially from reinsurers with their global scope of business. Terrorism risk must be treated on the basis of established principles of risk assessment and management: identify threats, define perils and covers properly, limit exposures, quantify risks, price risks adequately, grant cover separately or exclude terrorism risk altogether if these criteria cannot be fulfilled.

Terrorism cover can be offered only on a limited, selective basis against payment of an additional premium which reflects the individual risk. Unless solidarity is imposed through some form of state involvement, landmark risks will inevitably be subject to high premium rates. Cover conditions - ie deductibles and cover limits on the direct insurance and reinsurance level-must ensure that risk sharing among the insured, direct insurers and reinsurers is well-balanced, and that overall exposures are kept within predefined limits.