

## Index

**Global Non-life insurance in a time of capacity shortage**  
Swiss Re P.1

**Global insurance Industry trends – What are the implications?**  
PryceWaterHouse P.7

**World Insurance 2002**  
Financial Times P.10

**Retrocession Market Review**  
Benfield Greig's P.17

**Insurance Market Overview**  
Jardine Lloyd Thompson JLT P.19

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## Global Non-life insurance in a time of capacity shortage

### Swiss Re

#### The deterioration of underwriting profitability

Non-life insurance markets are suffering from the effects of a long and severe soft market. Profitability is still low, but the underwriting conditions are improving. During the soft market, rising insurance capacity and fierce price and market-share competition led to widely available coverage and low premium rates. Underwriting results declined in all major markets. Net investment results, including realized capital gains, increased through 1 998 in most major markets, bridging the gap between deteriorating underwriting profitability and providing a small improvement to net income. Investment returns worsened after 1 999 as interest rates bottomed out and stock markets stalled, setting the stage for the hardening of the market.

As equity markets began to decline sharply in 2000, non-life insurers came to a simple realization — underwriting results needed to improve in order to maintain profits. The rising dependence on investment income could no longer be sustained, and the industry's capital base contracted, reducing the total capacity that could be provided to insurance clients. Commercial-lines and reinsurance premium rates began to improve in late 2000, with rates rising and terms and conditions tightening.<sup>1</sup> After September 11, the hardening of the market accelerated. The price increases have been substantial and profitability is expected to be restored in 2002, provided losses for the year are average. The key to insurers' profitability in the late 1990s was extraordinary investment performance. At the beginning of the decade, interest rates were high by historical standards, but declined during the decade, producing capital gains. The equity markets, with the exception of Japan, boomed. Investment income increased in importance to insurers, with net investment results rising from about 13-15% of net premiums in 1 995 to about 18-20% in 1 999/2000. Strong investment performance fueled both excess capacity and aggressive pricing, a classic case of "cash-flow underwriting."

By the end of 2000, non-life insurers in most major markets needed to improve their underwriting performance by 9 to 14 percentage points, depending on the market, to achieve an average return on equity without realizing capital gains. Insurers were smoothing underwriting results via reserves policy and reinsurers. Commercial-lines and reinsurance rates were deficient by some 30-50%, depending on the market. Prices had declined even more in some small market segments like aviation.

The year 2001 was for many markets one of the worst years (or even the worst year) in insurance history. Profitability suffered due to a combination of weak investment results, inadequate rates, the need to strengthen reserves, and unprecedented catastrophe losses. In 2001, the US insurance industry experienced its first net loss since market data have been collected - a period of

over 100 years. European insurers' decline in investment results mostly outweighed improvements in the technical results. The only exception is the UK market, where the strongly improving underwriting result enhanced the overall profitability. The 2001 results of the European non-life markets would look much worse if they included reinsurers, due to the reinsurers' share of the September 11 claims.

## Changes in the environment

Non-life insurers have emerged from the recent soft market facing a different environment. (1) The industry's capital funds have diminished dramatically, probably by USD 180 billion, which implies a capital shortage in commercial-lines insurance and reinsurance. (2) The investment climate has changed for the foreseeable future from high yields during the 1990s to low yields that are not sufficient to support underwriting losses of the magnitude of the late 1990s. (3) The post-Enron world of accounting and regulation demands transparency and does not favor overly complex transactions. (4) International terrorism has become an additional exposure, challenging the limits of insurability.

### Depletion of capital

The soft market, the accumulation of major losses (including September 11), and the decline in equity markets have reduced the industry's capital base in all major markets. Solvency ratios had already started to decline in 1999 in the UK and in most other markets by 2000. The US non-life industry's capital funds declined in 2001 by USD 27 billion or 8.5%. In 2001, non-US insurers are estimated to have lost about USD 60 billion in capital funds due to losses in their equity portfolios. As a result, worldwide non-life capital decreased by about USD 90 billion in 2001. With the current stock market performance, 2002 looks set to be the third consecutive year of capital decline. By August, US insurers' capital funds were down some USD 36 billion due to losses in equity investments. We estimate a loss of EUR 40-50 billion in European insurers' capital funds in 2002 so far. European insurers suffer more from a bear market - on average - due to their higher shares of equity investments. All these losses add up to an estimated decline of currently USD 180 billion or 25% from the peak of global non-life capital funds of USD 700 billion reached at the end of the year 2000.

The insured loss from the WTC attack on September 11 could be as much as USD 40-50 billion. About 40% of this loss will be borne by North American primary insurers and reinsurers. European insurers will bear about 50% of the loss - with reinsurers shouldering most of this burden - and Bermuda insurers the rest.\*The global reinsurance market could be liable for about 60% of the total loss, with the remaining 40% falling to the primary insurance sector. In 2001, the combined ratio of the largest global reinsurers rose to 134%, while the combined ratio of US reinsurers rose even higher to over 140%. Like primary insurers, reinsurers also suffered from the stock market crash and declining interest rates. Only a few of the major reinsurers were not forced to show negative overall profits from their reinsurance activities in 2001. Despite various capital-raising and capital-saving initiatives, the shareholder's equity of top insurers decreased on an overall basis.

Capacity is particularly tight among commercial-lines insurers and reinsurers. A few (eg, Swiss Re) raised fresh capital from the capital markets, others followed capital-savings strategies like selling minority stakes (eg, SCOR sold Coface) or suspending dividend payments (eg, Hannover Re). Similar to the early 1990s, there is also another trend towards spin-offs or demergers. Some capital-restricted companies have decided to divest themselves of units that are active in capital-intensive lines of business like commercial lines or reinsurance, in order to focus their capital funds on a smaller operation. Zurich has successfully spun off its reinsurance carrier Converium and others are planning to follow suit (eg, AXA, Gerling, and St. Paul).

The tight capital situation is reflected in the increasing number of downgrades of major insurers by rating agencies. In the US, the share of AAA-rated capital funds has declined to 19%, from 38% two years earlier. Two examples are the loss of AAA ratings by State Farm and Firemans Fund. The reinsurance market has also experienced a series of market exits and downgrades of some prominent players (Gerling, Employers) by rating agencies. Downgrades of existing players will continue to reduce top-quality capacity.

The prospects for a rapid improvement in investment results are uncertain. In the major insurance markets, interest rates are low and are unlikely to rise or fall much over the near term.

In 2001, investment income contracted sharply in the major markets, reflecting low interest rates and the poor performance of the stock markets. For 2002, further declines are expected. To restore profitability, insurers will need to increase investment results, improve underwriting results, or lower expenses. Improving investment results will be difficult as long as equity markets are weak and interest rates remain low. Increasing operational efficiency is a permanent challenge to the industry, however, the short-term scope for reducing expenses is limited. Hence, the main task for insurers remains to improve underwriting results.

Although the non-life industry's overall exposure to credit risk appears to be manageable, the recent surge in highly visible corporate defaults (Enron, K-Mart, WorldCom, etc) has caused a reevaluation of the industry's credit exposure. This affects both insurers' bond portfolios as well as the credit risk embedded in their products, eg, credit and surety insurance, derivatives, and the credit risk in finite (re)insurance deals. Credit risk was frequently not adequately compensated during the last soft market. With insurance prices improving and defaults at a high level, some insurers will reduce their exposure to

credit risk even though the reward, compared to the risk, is probably rising now. Others, who have the expertise in evaluating credit risk and the capital to back it, will continue to take on credit risk.

#### **Tougher regulatory environment post-Enron**

The US non-life industry reported only USD 600 million in Enron securities, however, there is additional substantial exposure arising from surety bonds (USD 2 billion), and liability covers to Enron (about USD 450 million). The majority of the insurance liabilities are being contested by the insurers in court based on allegations of financial misrepresentation. The exposure might expand beyond that to Enron's auditor Arthur Andersen, advising law firms, investment banks, etc. Meanwhile, larger bankruptcies have occurred. Fox-Pitt, Kelton estimates that the exposure of the US non-life industry to problem/watch-list securities remains below 1 % of capital funds.

The larger impact on the non-life industry may stem from a changing regulatory environment and investors' higher expectations regarding corporate governance. Recent events in the global financial markets may alter the general attitude towards complex financial transactions with earnings-smoothing propositions. This particularly affects finite (re)insurance. Some insurers have failed due to their involvement with finite (re)insurance. For example, finite covers played a role in the collapse of Fortress Re, and were also the core business of the two Bermuda reinsurers. Overseas Partners and Scandinavian Re, which shut down operations early in 2002. What is more, in the wake of accounting scandals, the attitude of clients, reinsurers and regulators towards finite solutions has changed. There will be lower demand from corporations and a greater focus on risk transfer and disclosure. Particularly in the UK, the FSA has expressed concern about the use of financial reinsurance for the purposes of regulatory arbitrage. Transactions that are more geared toward arbitrage will face increased scrutiny.

Despite these problems, demand is increasing rapidly for transactions with unambiguous economic advantages due to the current hardening of the commercial market. Clients are being forced to increase their deductibles substantially because of capacity constraints in some lines of business. At the same time, clients also want to increase their deductibles in order to keep their total insurance premiums within their budgets during times of rising premium rates. Finite solutions are in demand to provide some cover for these increased deductibles. Corporate clients and banks are finding off-balance-sheet earnings smoothing less acceptable, given the current climate for accounting transparency. Solutions will shift towards pure risk transfer or committed-capital-type transactions.

#### **The new exposure to terrorism risk**

In most countries, terrorism was usually part of the standard fire and business interruption policy, with no additional premium actually being calculated for it. This reflected the risk management assessment that this type of loss was only of very minor importance as far as frequency and severity were concerned. Following September 11, however, these estimates had to be fundamentally revised. Traditional measures of loss severity — eg. Probable Maximum Loss (PML), and Estimated Maximum Loss (EML) — are currently under discussion. These measures quantify maximum loss under "normal" conditions, ie the basis used when calculating premiums is normally not the total loss of a building or plant, as the loss can usually be offset to some extent by preventive measures (eg, fire protection walls). Risk analysis and premium calculation are therefore usually based on a lower loss severity than a total loss. This helps the primary insurer and reinsurer to estimate their maximum exposure, while it also means that the insured pays lower premiums as the probability of a total loss occurring can be all but excluded. The malice involved in the September 11 attack that destroyed the WTC and the complete disregard for human life it revealed were something new to insurers and called into question established insurance practice.

Before asking whether new risk-management concepts are required to cover the threat of terrorism, it must be ascertained whether terrorism risks are insurable at all. The insurability of risks is assessed according to their ease of quantification, lack of correlation with other risks, mutually shared interest of insureds in the risks, and the economic feasibility of placing them with private insurers.

As opposed to natural catastrophes, historical data and statistics give little or no indication of the frequency and severity of future losses from terrorism; however, terrorism is indeed uncorrelated with other risks. The mutual interest of insurers is also difficult to establish since symbolic or famous buildings and institutions are under much greater threat than ordinary ones. Economic viability is also questionable, since it is difficult to balance the risk due to the severity of the recent loss and the coordinated attack at several locations. Therefore, at least in the short term, primary insurers and reinsurers can offer terrorism cover only on a limited basis.

It will be crucial, and a matter of urgency, for the insurance industry to develop models that are at least able to estimate the severity of loss resulting from terrorism risks. This would be a decisive step towards quantifying the risk and the most important condition for making terrorism risks insurable in the private market. Innovative solutions involving pools, new forms of insurance (eg, finite treaties) and the financial markets are required to achieve a broad risk spread. The government will also be called upon to act as reinsurer of last resort, at least in the short to medium term. If insurers were required to provide terrorism cover at a regulated price, terrorism would trigger a wave of bankruptcies. The resulting economic cost would be enormous and considerably higher than the cost of the state acting as insurer of last resort on a temporary basis.

## The Industry response

How did the non-life industry adapt to the changed environment? (1) The hardening of the market accelerated and has now reached all lines of business and regions. (2) About USD 30 billion in new capital was raised for a handful of Bermuda startups and some established players. Independent of the success of the individual investments, the new capital was not sufficient to replace lost capacity. (3) The capital strength of commercial-lines insurers and reinsurers increased in importance to clients and investors. Insurers with lower ratings face difficulties in writing attractive business and cannot fully benefit from the cyclical upturn. (4) Insurers' investment strategies have changed in order to reduce investment risks and match the overall risk exposure to the diminished risk capital. (5) The product mix has changed - particularly for large commercial risks - in reaction to the rate increases and reduced availability of coverage. Products are thriving that make better use of the more limited capacity.

### Hardening of the market accelerated after September 11

The insurance cycle had begun to turn in 2000/2001, prior to September 11. Commercial-lines and reinsurance rate increases led the market, while personal lines lagged behind by one or two years. The catastrophic results of 2001, coupled with the fall in capacity, accelerated the price increases in the commercial-insurance and reinsurance market. The 2002 renewals brought rate increases in the order of 5-20% for commercial lines and proportional reinsurance, and 10-25% for non-proportional reinsurance business, with Japan and Europe at the lower end and the US at the upper end of the range. In smaller, highly exposed sectors — for example aviation — the price increases were significantly higher. In addition, terms and conditions were tightened.

The results for the first quarter of 2002 indicate good news regarding underwriting profitability of the US non-life industry. Net premiums written were up by 10.3%, which is a result of the widespread rate increases. Earned premiums outpaced incurred claims, improving underwriting profitability.

In major European markets, premium growth in personal lines gained momentum in 2000/01, especially in motor and accident insurance. Combined ratios improved, primarily due to price increases and a decline in loss frequency in the motor lines.

The decline in reinsurance capacity and primary market solvency, coupled with poor profitability, forced commercial-lines insurers in all major European markets to increase their premium rates considerably in 2002. In August, the widespread flood damage in Central Europe put additional stress on European property lines.

On a calendar-year base, major reinsurers showed an average combined ratio of 109 in the first quarter of 2002, which is only slightly below the combined ratio of 2000. This reflects the adjustments in WTC September 11 losses and liability (particularly Asbestos and Environmental (A&E)) loss reserves. The full-year combined ratio for 2002 is expected to be below the first-quarter result. The hardening of the market is expected to last longer than in previous cycles, given the global shortage of quality capital, increased risk exposures, and lower investment returns. Some years of above-average profitability are necessary to rebuild the reserves of the global reinsurance industry.

Over the next few years, we expect further price increases and tightening of terms and conditions. The momentum in rate increases seems to have shifted towards long-tail lines. Many insurers will continue to be in financial distress, as their balance sheets have been hit hard over the last couple of years. It is also likely that the industry will need to put up additional reserves for September 11, directors and officers (D&O), medical malpractice, workers' compensation, and asbestos losses. In addition, rating agencies will ask for more equity since their risk models will interpret the growing premium revenues as increased exposure, despite the rate increases.

### The role of new capital

The twin shocks — stock market declines and large losses — reduced global non-life insurance capacity by about USD 90 billion in 2001 and by approximately the same amount in 2002. Reinsurers and the London market were particularly impaired, given their propensity for excess of loss covers. Some companies exited the market others were downgraded by the rating agencies, still others divested themselves of their reinsurance units. As prices hardened, particularly after September 11, new capital entered the market to take advantage of the improved potential for profitability.

New players raised capital funds of about USD 7 billion. They are exclusively located in the Bermudas and all are rated A- to A+. Most of the new players were not in a position to fully capitalize on the January renewals due to lack of staff, infrastructure, and rating. Also — unlike in 1993 — attractively priced programs faced a sufficient supply of capacity from traditional players. Most of the new players' business was proportional, to a large degree written out of the London market. Among the new players, the broker-sponsored Axis and Endurance appear to be the most successful in attracting business. The startups' longer-term success will depend on their ability not only to win business from established onshore reinsurers, but also to establish themselves against offshore players with similar business models. In this respect, the startup generation of 2001 will have a harder time than the 1992/93 generation. But despite their currently limited market share, the presence of the new players has generally kept the rate increases within reasonable ranges. Extreme price hikes, such as those post-Andrew, did not occur.

The new capital has not filled the gap left by lost capital. New capital completed and announced so far amounts to USD 30 billion, which is far from sufficient to close the gap. As stated above, the estimated decline in capital funds of

established players since year-end 2000 is now about USD 180 billion. Also, the new capital is mostly rated below top-secure. Only Swiss Re and AIG raised AAA-quality new capital. The reinsurance market saw a series of market exits and downgrades of some prominent players (Gerling, Employers) by rating agencies. Downgrades of existing players will continue to reduce top-quality capacity. In the longer run, a rebound of the industry's overall capital funds will be the key to limiting the magnitude and length of the hardening of the market. The longer-term development of the global capital base will depend more on the valuation of established players' invested assets than on the stream of new money from investors.

#### **A shift in the product mix**

The swing from excess to scarce capacity also affects the limits of insurability. Apart from the reemergence of many exclusions in traditional commercial insurance policies, this occurs through a substantial shift of gear in the ART market. The alternative risk transfer (ART) market has been profoundly affected by the hardening of the traditional market. ART products can be divided into those that provide extra capacity for risks that are hard to transfer, and those that include new risk classes and drive the convergence of insurance and financial/commodity markets.

During times of tight capital funds, there is a need for extra capacity and hence the ART products developed during this phase tend to make better use of insurance capacity. Examples of products that were developed to increase capacity include captives, finite insurance and catastrophe-related capital market solutions, or catastrophe bonds. During soft, excess-capacity insurance markets, insurers look for opportunities outside their traditional business lines and venture into credit, weather and other structured product markets. In this section, we briefly explain some ART products that developed in response to the different phases of the insurance cycle.

During hard markets, many corporations experience difficulties in obtaining insurance. As a result, some decide to buy less coverage. Others opt to insure themselves. A popular way of doing this is to form captives, which are insurance or reinsurance companies owned by a company or group of companies with no active role in the insurance business itself. A captive's primary business purpose is insuring the risks of its parent. The number of new captives and the capacity provided through captives is accelerating worldwide, fueled by hardening commercial insurance premium rates and the limited availability of capacity in some lines. Growth in the captive market is coming from a more intensive use of existing vehicles and by a wave of new captives. The middle-market companies will most likely opt for group captives and segregated cell companies. This pattern resembles the first waves of captive formations during the hard markets of the 1970s and 1980s.

Another ART product that has been developed to mitigate capacity restrictions is finite (re)insurance. With tax laws and accounting rules encroaching on pure reserves-discount transactions, prospective finite products are now primarily multi-year covers with recognition of loss experience and/or investment performance. These types of solutions gained attention during the last hard market of the early 1990s, when the price of insurance was high and cover for certain lines of business was not available. As the terms of finite reinsurance are fixed for several years, coverage — as well as pricing — is less a function of industry price cycles due to exogenous shocks in the industry, but rather depends on the client's risk experience.

Despite the problems of increased regulatory scrutiny and tighter accounting rules for corporate clients, the hardening market is accelerating demand for finite products. For example, finite solutions are in demand to provide some cover for these increasing deductibles on (re)insurance programs, which can reach up to hundreds of millions of dollars in some cases. Finite covers are well suited for lower layers, if there is a high probability that there will be some loss occurrence over the course of a multi-year program.

The last hard market of the early 1990s stimulated the demand for capital market insurance solutions as a substitute for cat reinsurance. Just as these solutions began to develop in the mid-1990s, however, there was a shift towards excess capacity in the (re)insurance markets. As a result, reinsurance premium rates declined to levels so low that capital market insurance solutions were less competitively priced. With the hardening of the market in 2001 and 2002, demand for these instruments has again improved and the issuance of insurance-linked catastrophe bonds is on track to double this year, compared to last year.

During the 1990s, some (re)insurers started offering and investing in credit derivatives. Since then, the share of insurers in the credit derivative market has been increasing. While there were several insurers with experience in underwriting credit risks, many others invested in this new risk class driven by excess capacity. The non-life market had excess capital to invest in the mid-1990s when the credit derivative market was booming.

Investors in the credit markets have suffered losses due to the recent increase in defaults, CDO downgrades and large bankruptcies. At the same time, insurance rates are increasing, providing better opportunities for most insurers. In the short run, these developments may dampen the growth of insurers' participation in the credit derivative market. However, in the long run, it is likely that insurers with the expertise to manage credit risk will resume greater participation in the credit derivative market.

Another financial risk class where insurers' interest has cooled down to some degree during the current capacity shortage is weather derivatives. The insurance industry's involvement with weather derivatives is quite recent, just starting during the last soft market. Deregulation of the US power markets in 1996 created severe competition among electricity providers. This increased earnings volatility in the industry and created demand for solutions to hedge the weather. In response, several financial instruments such as weather derivatives emerged. Over the last few years, there has been a significant increase in weather derivatives. Since their inception in 1997, more than USD 11.8 billion in capacity has been created. In 2001, about USD 4.3 billion of capacity was created. Insurance companies have been offering crop and natural catastrophe insurance products that protect against weather-related phenomena. Hence, entering the weather derivative market can be seen as a logical extension of this business. Since 1997, some insurers have been offering products using weather derivatives to protect corporate earnings.

Currently, the weather market is illiquid and not well diversified. Most of the business is concentrated in the US energy industry — though the share of the rest of the world is increasing steadily and non-energy sectors are showing interest in these products. As a result of the current lack of capacity, even a local shock can severely affect the market participants. This is what happened in 1997-99 when there were several consecutive mild winters. Many insurers that had sold warm-weather protection to energy companies suffered losses and exited the market. The US weather market is presently troubled by the defaults of many of its major players. Nevertheless, demand will continue to increase in the long run. Structural change occurs in waves. Insurance cycles can be seen to have a direct impact on the emergence and evolution of ART products. During periods of a hard insurance market there is a demand for products that increase insurance capacity. During soft insurance markets, product developments focus more on new risk classes in pursuit of higher returns and, consequently, the insurance industry expands the limits of insurability. Sometimes, by the time a new product develops in response to a phase in the cycle, the market reverses and the conditions that led to the emergence of the product no longer support it. This has slowed down the evolution of some products, such as catastrophe bonds. It may take at least a couple of cycles for some ART products to be successful and for others to be written off. Relative prices, investment opportunities and capital positions determine the attraction of certain products in the short term. In the long term, however, evolving client needs and industry knowledge will drive the development of new products and the insurance industry's move into financial market solutions.

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## **Global insurance Industry trends – What Are the implications?**

### **PryceWaterHouse**

Understanding global insurance industry trends and what they mean for the Americas is important. But the real winners are likely to be those who can successfully implement change.

Over the past few years it has become apparent that the global insurance industry is being shaped by a small number of well-defined external drivers of change. These are commonly identified as:

- Increasing consolidation, convergence and globalization;
- An evolving socio-economic and political context;
- Changing consumer concerns and buying behavior;
- Rapidly developing technology;
- Broadening distribution patterns; and
- Shifting regulations. While each of these drivers of change is still relevant, viewing the industry against this backdrop can now provide only a superficial view. The world is moving on. In this article, we have attempted to identify ten of the most important current issues facing the industry globally and venture an opinion in relation to their implications for the Americas. We have not presented the issues in a particular order of importance and, indeed, there may well be other issues we have not considered. Nevertheless, they provide a starting point from which to plot the future.

#### **Beyond consolidation, convergence and globalization**

For some time, size seems to have been viewed by many insurers as an objective in itself bringing with it market power and reduced costs. It is true that the cost of new technology and the desire for economies of scale continue to drive consolidation – no more so than in the drive to get cost efficiency in personal lines. In our judgment, however, the reality is that as markets increasingly deregulate, few groups will have the required capital to achieve global dominance, and still fewer will be able to successfully obtain the management skills to be winners in all lines of business in a more open competitive environment. US and European insurers moving into Asia, Latin America and other developing markets face particular challenges in managing cross-cultural issues.

This was nicely put by Mr Zhou Yan Li, Commissioner of China's Insurance Regulatory Commission in Shanghai at the China Rendezvous conference earlier this year when he said, "Although foreign companies have certain advantages in some aspects, our domestic companies are in the same market with the same language, culture and legislation.

It is easier for domestic companies to contact each other. In these aspects, the foreign companies are no match at all". Add to this that the cost of acquisitions are becoming increasingly prohibitive as suitable targets become fewer – many acquirers will be shown to have paid too much and will be at risk if stock markets continue to fall –and the case for a strategy that is not based predominantly on acquisition becomes compelling.

So, if the old thinking was get bigger to get more cost effective, the new thinking must be get more specialized. Multi-line global insurers present management challenges of significant scale.

Successful companies will focus, with some getting out of any activity where they are not best in class. We can expect to see more outsourcing of non-core activities and more strategic alliances with both financial services and non financial services companies as insurance groups move to operate in a flexible alliance model.

#### **The Internet is not just for selling**

It has been said that the Internet will do for services what the production line has done for goods. What does this mean for insurance? Some commentators have proclaimed the Internet as the final solution to the insurance distribution problem. Such a simplistic answer could hardly be further from the truth as it only addresses a small part of the question. Yes, the Internet will become a strong distribution channel for simpler products but no one should underestimate the power of the agent or adviser. The bottom line is that customers will always self-select distribution.

In an Internet world no one can own the customer – the customer is empowered by knowledge. As far as distribution through the Internet is concerned, there remain many unanswered questions. How to deal with channel conflict? How to prevent margins from being eroded? And most fundamentally, if you build a website will customers find it and buy from it?

The good news about the Internet is that its real power is as a driver for complex business models which integrate all methods of distribution, as a facilitator of straight-through processing in policy administration and claims management and as a reducer of procurement costs.

Business costs will fall dramatically; for example, AXA has estimated that policy management costs will drop by 98%.

All the major global insurance companies are spending billions of dollars on their e-business strategies. The winners will be those that target their spending most effectively. On-line selling may be a legitimate priority for sellers of personal lines but even they need to be careful they do not get too far ahead of demand.

As Bill Gates put it in his book, *Business @ the Speed of Thought*, “we always overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten”. For most insurers the priority should be to use the Internet firstly to re-engineer business processes,

secondly to enhance existing distribution channels and only after that to create new distribution models. Traditional insurers with large, often part-time, agency forces face particular challenges in channel enhancement but also have much to gain. A more professional and productive agency force will be a logical outcome of insurers adopting modern Internet driven business models.

#### **People are living longer.**

**Where they were concerned about dying too early, they are now concerned about outliving their finances**

Continued withdrawal of governments from social security is providing huge opportunities in retirement savings and long-term health care around the world.

Developments in retirement savings will encourage a further uncoupling of savings and risk products. Although traditional life products still dominate many markets, we can expect to see a rapid increase in wealth management products giving consumers a wide investment choice. Insurers, banks and brokerage firms are directing more resources towards wealth management, including alternative investment products; which are marketed to both institutional and high-net-worth investors, and separate accounts for wealthy individuals.

The future of life insurance in the Americas will become closely linked to investment choice and successful funds management. Consumers will have an ongoing need for advice and life insurers will be faced with transforming life agents to personal financial planners.

#### **Regulation is shifting**

Deregulation worldwide is encouraging the emergence of universal financial services organizations, like Zurich Financial Services, to replace stand alone banks, insurers and brokerage firms. It is also enabling new and non-traditional players, such as Virgin of the UK, to enter the market. Overall, this promises to be a new test for bancassurance models. This trend is already affecting Asia where the Malaysian and Singapore industries are classic examples of the deregulatory forces at work. Big Bang in Japan is another. The conference for Emerging Insurance Markets in Kuala Lumpur earlier this year confirmed this trend will continue.

At the same time, this deregulation is being countered by increasing controls over the way products are delivered and sold to consumers.

Market conduct is an emerging issue in many countries well beyond just the UK and US.

There is a shift from regulation of what is sold by a particular institution to regulation of how it is sold. To meet this new situation, new regulators are emerging – like the Financial Services Authority in the UK and APRA in Australia – supported by new consumer protection legislation which typically sets out how an insurer can deal with its agents and its customers. This legislation covers matters like agent authorization and training as well as the way in which advice can be given to consumers.

In the United States, in order to enforce Grams-Leach-Bliley Act mandates on privacy, state legislatures and regulators are promulgating laws and/or regulations to implement all or part of the new model privacy regulation adopted by the National Association of Insurance Commissioners. In some state legislatures, the insurance industry is vigorously opposing proposed legislation to the extent that it

varies from the national uniform standards or would restrict the sharing of information for business purposes. An implication for insurers is that their customers will become more demanding as they become better educated and have access to better remedies. Successful insurers will increasingly need to pay close attention to corporate governance issues including privacy and the market conduct.

### **Breaking down the value chain**

The value chain is breaking down. The traditional view of a business as a provider of fully integrated service delivery is obsolete. Distribution, underwriting (manufacture), administration and funds management are becoming increasingly dis-aggregated (just like they have been for years in many non-financial services companies). As companies seek to meet customer needs, they will need to place emphasis on multiple channels and multiple relationships rather than providing all the products and services themselves.

Distributors will seek to provide customer convenience and greater value by bringing together a range of products, theirs and other peoples, in one offering designed to deliver wealth creation. In this context, savings products, life risk and property risk are all points on the same continuum. Customer convenience is the key. The battle will be for the opportunity to serve customers in tomorrow's market.

Examples of how the value chain is breaking down are provided by Skandia which is a pure manufacturer of variable annuity and mutual funds for third party providers. Similarly, AXA Financial in the US sells not only through its own agents but also through broker dealers like Merrill Lynch while offering third party health funds to its customers. In fact, Merrill Lynch is simultaneously AXA Financial's biggest competitor, supplier and customer.

### **The collapse of national borders**

Although regulators and customer reluctance may restrict cross border selling, national borders are already becoming increasingly unimportant as a result of the Internet. One effect will be that we can expect to see labour intensive tasks being performed in low wage countries.

The Canadian dollar/US dollar exchange rate is offering companies a favorable opportunity to lower processing costs via transferring service centers north of the US border. Claims management, policy administration, accounting, and underwriting are all suitable for relocation. There are real opportunities for Canadian companies to act as processing hubs and with the language and cultural diversity in such cities as Toronto suggest call center potential as well. Several European insurers are establishing, or have already established, back-office capability in countries such as India. In some cases, these insurers will establish their own processing facilities. However, we can also expect to see these tasks being increasingly outsourced to specialist providers.

### **Do brands matter?**

The answer has to be yes. Increasingly we live in a lifestyle society that buys the image as much as the product. As we see an uncoupling of the value chain, distributors will need strong brands to attract customers.

Strong brands will provide opportunities for both insurers and a whole range of non-financial services companies – Telcos, retailers etc. – to distribute financial services products. For manufacturers, strong brands will be needed to get access to independent distribution channels.

Generally, financial services brands have yet to be exploited in the same way as consumer products brands like Nike and Coca Cola but the trend is emerging.

On the surface, global companies have advantages in building brand awareness. For this reason global groups like Allianz, AXA and ING are changing the names of their operations around the world to their own. There are obviously many insurers with strong domestic brands – Sun Life in Canada, Northwestern Mutual in USA, HSBC in Hong Kong, Cathay Life in Taiwan, Samsung Life in Korea and Tokio Marine & Fire in Japan, to name just a few – but the challenge remains for an insurer to build a global or at least pan-North America/pan-Asia brand before existing global brands take over.

A conclusion to be drawn from this is that we should not expect to see start-ups rising to prominence in insurance in the same way as we have seen in the technology sector unless they are backed by strong brands and extensive capital.

### **Too much capital is no longer enough**

It used to be true for insurers that too much capital was barely enough. This was because the whole emphasis of insurers was on maintaining statutory solvency rather than profitability.

However insurance companies, particularly in the US and Europe, are now recognizing that they compete for capital with other types of companies. Active capital management is needed to maximize shareholder returns.

Swiss Re is a good example of a company that has sharply increased its shareholder value by actively managing its capital. Storebrand and Chubb are others. Many insurers still have a lot of work to do in this area. Successful capital management in insurance companies requires a combination of actuarial and financial skills.

### **Big fish eat little fish**

This is a simple point. As global brands become increasingly important, as global companies learn to leverage their skills worldwide, as they centralize their back-offices in low cost jurisdictions, as funds are increasingly managed globally – it will follow that larger players with strong brands and quality management will have a clear advantage.

Asian and developing insurance markets presently are widely seen as opportunities for the existing global players. However it is a realistic expectation that strong Asian based global insurers will also emerge. For this to happen, regulators need to move quickly to adopt progressive policies to promote the growth of their domestic insurance industries.

### **Constant innovation is the key**

The very nature of work, organizations and management is changing. Tomorrow's insurer will choose where it sits in the value chain. Full service retailer or manufacturer, distributor or processor. If it is not best in class in any activity, it will not be doing it for long.

However, choosing a strategy is only a minor part of the battle. Most companies can develop strategies without much trouble. "What to do?" is no longer the ultimate question. The real question is "how to make it happen?" Implementation linked to constant innovation will be the true key to success. This means having not just a good leader to set the strategy but a cohesive team with strong project management skills to implement it and a working environment that encourages questioning the status

quo. Or as Bob Mendelsohn, Global CEO of Royal & Sun Alliance put it, "Companies that are successful will be those that learn fast, fail fast and recover fast".

## **World Insurance 2002 Financial Times**

### **Industry recovers from September's terrorist shock**

The September 11 attacks on the US sent shock waves through the global insurance industry that are still reverberating - and will continue to do so for many years.

At one level, insurers and reinsurers appear to have responded well to the resulting losses, currently estimated at \$40bn to \$50bn - by far the biggest ever.

The initial knee-jerk reaction of share traders to mark down all insurance shares was quickly reversed as the biggest insurers and reinsurers declared they would be able to pay the resulting claims, in spite of what happened to the World Trade Center being at the extreme end of their "worst-case" scenarios.

Yet this impressive response cannot conceal more worrying developments: a surge in premiums combined with a savage reduction in coverage that has left many businesses around the world paying a lot more money for a lot less protection.

Global property and casualty rates were already on an upward trend before September 11, as insurers realised that they could no longer rely on investment returns to conceal years of poor underwriting.

However, the attacks on New York and Washington removed any doubts about the need for a substantial increase in rates - not least because the international reinsurers who will bear the brunt of the WTC loss immediately stated their determination to rebuild their balance sheets by demanding higher premiums, often for greatly reduced cover.

Robert Hartwig, chief economist of the US Insurance Information Institute, says: "The amount of potential risk that can be pushed away from insurers and on to business owners and creditors is in the order of trillions of dollars."

Estimating there was \$11 trillion worth of property in the US, Mr Hartwig says: "As these policies renew without terrorism coverage, these trillions of dollars of risk are being pushed back on to businesses and to their creditors. Few people are aware of that. On the surface, everything seems normal. But below the surface, it is very turbulent."

The biggest doubt of all concerns the possibility of future terrorist attacks. Warren Buffett, the "Sage of Omaha" whose Berkshire Hathaway group owns General Re, has warned that terrorism could bankrupt the industry.

He said no one knows the probability of a nuclear detonation in a major metropolis this year - or even multiple detonations, given that a terrorist organisation able to construct one bomb might not stop there.

"Nor can anyone, with assurance, assess the probability in this year, or another, of deadly biological or chemical agents being introduced simultaneously - say, through ventilation systems - into multiple office buildings and manufacturing plants. An attack like that would produce astronomical workers' compensation claims."

Mr Buffett said that under a "close-to-worst-case" scenario, which could conceivably involve \$1 trillion of damage, the insurance industry would be destroyed unless it managed in some manner to limit dramatically its assumption of terrorism risks.

Mr Hartwig agrees that the true gravity of the situation will not be known until when or if there is another terrorist attack.

He says: "If insurers had adopted the same stance of excluding terrorism cover after the last bombing of the WTC in 1993, they might be paying in vicinity of \$10bn. That would have created \$30bn of unmet loss that the government would have been under pressure to finance."

The US General Accounting Office recently warned Congress that in the absence of terrorism insurance, another terrorist attack would dramatically increase direct losses to businesses, employers and lenders.

It is this threat to economic recovery that last month caused President George W. Bush to urge Congress to approve a federal safety net for terrorism insurance, even though the previous attempt was stalled last year in the Senate.

### **Business may seek litigation**

Processing of claims arising from the September 11 attacks on the US appears to be going remarkably smoothly - at least so far.

Early concerns that these claims, the biggest in the insurance industry have ever faced, would inevitably lead to a wave of litigation have not been fulfilled. This has not yet happened, but the concern remains.

To date, about 9,000 personal claims and 21,000 commercial claims have been filed with insurers, with a total value of about \$16bn.

Initial estimates of the loss confronting the industry exceeded \$70bn. Robert Hartwig, chief economist of the Insurance Information Institute, which speaks for the industry in the US, now reckons the final figure is likely to settle in the \$40bn to \$50bn range.

A complicating factor is that most analysts agree the biggest category of claims will be business interruption, which in many instances will last for a long time.

Steven Kessler of PwC, the consultants, says: "The period of interruption is a moving target for many companies. For some it could be six or seven years, or however long it will take to rebuild the World Trade Center [WTC]."

Some retail businesses and their insurers have already decided that, rather than wait for the location to be restored, they will establish two or three stores in different spots, such that their revenue will approximate to what they were receiving at the WTC.

Larry Silverstein, the WTC leaseholder, has started a \$7.2bn legal action against some of his insurers, who contend the attacks were a single event, worth \$3.5bn.

Last month several law suits were filed on behalf of about 30 victims. They name the two airlines whose aircraft were hijacked in the attacks, United Airlines and American Airlines, as well as three private security companies at the two airports where the terrorists boarded.

One of the most contentious areas is likely to be calculating the extent of business interruption, which PwC expects to account for more than 25 per cent of all the September 11 claims.

It says: "Unlike a hurricane, flood or explosion where the losses are generally regionalised geographically, the confluence of financial service, media and related companies created losses far outside of lower Manhattan, magnifying the economic impact of this catastrophe and making the calculation of the business losses more complex."

Particular difficulties will arise in working out the losses of broker/dealer businesses. After the New York Stock Exchange was closed for four days with little or no trading-related revenues, it re-opened in the week of September 17 to have four of its highest volume trading days.

### **Insurers of last resort get first look**

Germany's decision to back the creation of a €13bn "terror" insurance pool is the latest attempt by governments around the world to cope with rocketing premiums and withdrawal of cover by commercial insurers and reinsurers.

Under the agreement, German insurers will create a new company to cover claims between €25m and €3bn in any year. The government will provide an additional €10bn coverage. In return, it will receive a slice of insurance premiums paid by businesses.

France recently established a pool with a state guarantee for terrorism coverage. Direct insurers will cede to the pool terrorism risks exceeding €6m. Direct insurers will bear the first €250m "layer" of annual losses, with the next €750m layer placed in the international insurance and reinsurance markets.

The next €500m layer is guaranteed by the French government without any initial premium, although the direct insurers will be expected to pay for any amount falling into this layer over 10 years.

The final layer in excess of €1.5bn will be placed with the CCR, the institution that reinsures French insurers against events that are declared as "natural catastrophes" under French law.

Both the French and German models draw on the experience of Pool Re, the mutual insurer set up with the backing of the British government in 1993, after a bombing campaign by the Provisional IRA made insurers reluctant to offer cover to properties in the City and west end of London.

Pool Re, which covers buildings across Britain, has not paid out any claims since 1996, thanks mainly to the success of the Irish peace process. However, both the government and industry have had to reconsider the position since September 11.

Insurers and companies have been urging the UK Treasury to extend the range of Pool Re cover, which currently only applies to damage to commercial properties and business interruption. It does not cover liability for employees and personal injuries.

The Treasury has signalled it is willing to extend elements of Pool Re's cover that would not require legislation, such as including threats of flooding and biological contamination.

However, it is not minded to consider a change in legislation unless the commercial market is demonstrated to have failed - and ministers seem in no rush to make that judgment.

In Spain, the CCS (Consortio de Compensacion de Seguros) is a state insurance facility that guarantees cover for "extraordinary risks" such as earthquake, volcanic eruption, flood, storm, terrorism and civil commotion. This cover forms part of policies issued by private insurance companies that collect premium on behalf of CCS.

South Africa's particular political situation in 1979 led to the creation of the South African Special Risks Insurance Association for the voluntary insurance of political risks. While the political situation has improved considerably in recent years, the association still exists.

In Israel, terrorism is excluded from standard property policies but the private insurance market grants cover selectively. The state of Israel also covers losses triggered by politically motivated violence - including terrorism - through the Property Tax and Compensation Fund, which was established to cover property losses resulting from war and war-like activities.

These state initiatives - in the UK, Spain, South Africa and Israel - were all set up to deal with particular threats, and must now adjust to the more complex threats posed by events such as September 11.

### **'Immense opportunities'**

When China signed up to the World Trade Organisation (WTO) last year, one of the loudest cheers was from the insurance industry who view the Chinese market as one of the remaining greatest prizes.

In the past it has been difficult for foreign insurance companies to penetrate China. Since 1950 a handful of state-owned firms have controlled more than 95 per cent of China's insurance market.

China opened its insurance market to foreign companies on a limited experimental basis in 1992. But the overseas insurers have largely been restricted to certain regions, such as Guangzhou and Shanghai and usually must form a joint venture with a Chinese company.

By 2000, only 17 foreign insurance companies had been granted permission to operate some form of insurance business in China.

But since China signed the WTO, all this is set to change. With entry to the WTO, China has extended the list of cities in which it allows foreign-backed ventures to operate and within three years all geographic restriction will be removed.

Within five years restrictions on the type of products that non-domestic insurance companies can sell will also be eliminated.

There is certainly everything to play for. By 2005, the total business volume is expected to reach \$33.82bn. Insurance premium income was up by 10.2 per cent in 1999 to \$17bn (139.3bn yen), according to PwC, the professional services firm.

And the potential for growth is there. In 1999 insurance premium insurance in China was around 1.5 per cent of total GDP. The average for a developed country is 8 to 10 per cent of GDP whilst for a developing country the average is around 3.5 per cent.

Even Lloyd's of London, the global insurance market, is planning to develop its role in China and has held talks about seeking a licence in China to write on-shore reinsurance business.

China's population has little education about insurance and there is also a lack of a sound legal environment particularly in areas like enforcement.

### **Looking after Number 1**

Increases in insurance and reinsurance premiums since the terrorist acts of September 11 have prompted many companies to consider providing the cover purchased in the insurance market from their own resources.

While self-insurance has been an option for some years, its use was constrained by the cheap insurance and reinsurance cover that was available in the second half of the 1990s.

According to Philip Stamp, chairman and chief executive of Aon Captive Services Group: "We are seeing a huge amount of activity and level of interest in terms of people reassessing retentions and how to finance them."

Corporations considering self-insurance have several options. They can introduce a so-called "deductible" whereby they pay the first proportion of each claim. Alternatively, they can choose to retain risk by not purchasing insurance. This means they must bear the cost of claims.

One way to manage retained risks is to set up a captive insurance company. This is a company established by a non-insurer to cover particular risks. Companies can also pool risks with other companies, setting up group-owned captives. This so-called "mutualisation" allows companies to retain risk across a broader industry segment and generate premium income for the captive.

Risk management experts and insurers say self-insurance makes most sense when risks are highly actuarially predictable, and when claims are of a high frequency but low severity. Proponents of self-insurance point to the advantages of this type of cover. These include the possibility of generating cost savings when premiums in the conventional market are high.

"It should in times of a hard market save you money," says William Anderson, global head of the power and heavy industry practice at Swiss Re.

Supporters of self-insurance also point out that a proportion of every dollar paid to an insurance company includes expenses and acquisition costs. And any underwriting profits that are generated by a captive are attributable to the corporate parent, and not to an insurance company. Self-insurance can increase the financial flexibility of companies, while captives can have tax advantages.

Finally, captives can provide direct access to the reinsurance markets, something that is not normally open to non-insurers.

But there are drawbacks. By self-insuring, companies assume the risks previously borne by the insurer. However, they can put in place programmes, typically structured reinsurance arrangements over several years, to smooth losses over time.

Self-insurance is less suited to low frequency, high severity, or "catastrophic" risks, for which conventional cover is still required. Self-insurance also requires management time and capital. The programmes can be complex and time-consuming to finalise.

Captives need to be managed once they are up and running, while corporations that self-insure take on the administrative tasks associated with claims handling and processing, although these can be outsourced to specialist providers.

John English, a partner at JLT Risk Solutions, part of insurance broker Jardine Lloyd Thompson, estimates the cost of establishing a captive, from feasibility to formation, at £40,000 to £50,000. The cost of managing a captive, including management costs, audit and directors' fees, is estimated at between £50,000 and £75,000 a year.

Greater interest in self-insurance has been noted since the middle of last year. But the sharp increases in premiums across a wide range of classes of conventional cover in the wake of the September 11 terrorist attacks, brought the possibility of self-insurance more sharply into focus.

The question for risk management experts and insurers is whether this trend will continue.

Graham Pewter, president and chief executive officer of Commercial Risk Partners, the Bermuda-based arm of Scor, the French reinsurer, says that many corporations did not have sufficient time fully to consider retaining exposures during the January 1 2002 renewal season, as rate increases manifested themselves very late in the process.

"I would expect to see an increasing use of retention management techniques as we move towards 2003, because risk managers and reinsurance buyers will have had the time to assess their strategies in the light of rate increases that were imposed on them in 2002," he says

Mr English says JLT's captive management division was established two years ago, and now has 65 clients, and is approaching \$1bn in premium income.

If current trends continue, he says, JLT would expect this to increase by 25-50 per cent by the end of this year.

"Given our expectation of a continued hard market we will continue to see interest in the captive sector. The key question is what the time period until it turns is. It may well be beyond two years," he says.

### **Industry forced into complete overhaul**

No one would put the Enron scandal on a scale of seriousness with September 11, but for the insurance world, which lost hundreds of lives in the World Trade Center (WTC), both have nonetheless proved to be watersheds.

Enron has left investors with a mass of worries. Insurance companies, with some of the most opaque books in corporate life, are under the microscope. The share price of multinationals, with complex and diverse operations across the globe, have swung about on the slightest of troublesome rumours.

September 11 will be responsible for over \$50bn in losses for the insurance sector. One more terrible event like that, and there will be many bankruptcies. The industry has been forced into completely overhauling the nature of what it covers and how much it charges, and into looking at how much money it set aside in the past to cover liabilities.

They are finding that reserves - money set aside to pay claims in the future on events that have already happened - have not been enough. In turn, investors are being reminded that the past and future reliability of insurance company earnings is not as easy to gauge as other sectors of the economy.

On their face, reserves are not meant to be viewed as cash in the bank, although less reserving is "jam today" and means higher reported earnings. Reserves are also, of course, invested and earn money until they have to be paid out, which helps investment income.

But insurers effectively set their own exam on the level of reserves and under-reserving is an age-old problem.

Sometimes that is no one's fault. The true scale of asbestos liability has become apparent only in the past few years, and insurers have been setting aside billions to cover payments only more recently. There are more old liabilities emerging, on toxic mould for example, that are demanding the set-aside of billions more.

Even before September 11, there were worries over the level of reserves in the industry. And since then there have been some huge additions. Most analysts view this with a "kitchen sink" mentality: since so many insurers have been posting losses from the terrorist attacks, they have been taking the chance to add to reserves without creating much additional investor angst.

Warren Buffett, the billionaire investor and head of Berkshire Hathaway, had some typically honest views on the subject in his annual letter to shareholders, though as one of the more conservative insurers, he put it in a different context regarding Berkshire's main insurance operation General Re.

"When it becomes evident that reserves at past reporting dates understated the liability that truly existed at the time, companies speak of "loss development", Mr Buffett wrote.

"In the year discovered, these shortfalls penalise reported earnings because the "catch-up" costs from prior years must be added to current-year costs when results are calculated.

"This is what happened at General Re in 2001: a staggering \$800m of loss costs that actually occurred in earlier years, but that were not then recorded, were belatedly recognised last year and charged against current earnings."

Mr Buffett believes under-reserving is a common problem, and more so for other companies in his industry.

"Major under-reserving is common in cases of companies struggling for survival," he says. "A company experiencing financial difficulties - of a kind that, if truly faced, could put it out of business - ,seldom proves to be a tough [calculator of reserves]. Who, after all, wants to prepare his own execution papers? Difficult as the job may be, its management's responsibility to adequately account for all possibilities. Conservatism is essential."

With the prospect of being able to increase premium rates in the new post-September 11 environment, companies have had an extra opportunity to put themselves on a sounder financial footing.

Tom Cholnoky, analyst at Goldman Sachs, has estimated that of 47 property/casualty companies surveyed, \$7.5bn was added to reserves in 2001, reversing a trend of \$1bn or more releases from reserves every year since 1993.

"Most insurers are now paying the price for writing under-priced business over the past several years," he says. "Five of the nine most recent accident years show significant deterioration? We would not be surprised to see companies continue to strengthen the late 1990s accident-year reserves as we move through 2002.

"The need to repair capital deficiencies remains the critical driver to the pricing turn," says Mr Cholnoky. "Any future reserve deficiencies should put additional pressure on surplus? We continue to believe that the industry is in the midst of a longer, more drawn-out pricing cycle that could ultimately create a wider gap between the stronger and weaker companies."

Customers of the strongest companies are already giving them more business, mindful of the need to be with someone who has a greater perceived ability to pay. In that context, conservatism on reserves is likely to be rewarded, too.

## RETROCESSION MARKET REVIEW

### Benfield Greig's

Memories of the impact of past major losses on the retrocession market added to the general uncertainty following September 11, with some observers making dire predictions of the market's collapse. However, the market has proved robust and flexible, and continues to provide significant capacity. Clearly WTC had a major immediate impact, but its longer term consequences are likely to be greater than even a devastating hurricane or earthquake, because WTC affected so many classes of business in such an unexpected way. WTC has already influenced everything from slip terms to the whole manner in which some companies write and manage their portfolios with, among other things, accumulations and application and size of PML's on single risk exposures being subject to close review.

A key issue remains the facultative loss on the Twin Towers which was set at US\$3.1bn for a single event but is in dispute with the insured, Silverstein Properties, who estimate the total loss at US\$8.2bn and seek to claim recoveries as two separate events.

In the wake of WTC, terrorism was swiftly excluded from almost all reinsurance and retrocession treaties. Biological hazards and cyber risks were generally also excluded.

Additionally, reinsurers specified that catastrophe placements would now be limited to 'Natural and Named Perils' only. Prices rose significantly for 2001/2 but for the retrocession market at least, the percentage increases were not as pronounced as those being seen in the primary reinsurance market. This was because retrocession contracts had already experienced even higher percentage rises in 2000/1 and there was less room to manoeuvre without making meaningful retrocession programmes an uneconomical purchase.

Nevertheless, retentions did increase noticeably and this creates an area to watch for the future. Despite increased costs, informed buyers saw that their own margins had improved significantly and that second or third loss low-end cover could prove to be a very sensible purchase over the coming years.

There has been no shortage of retrocession capacity despite losses sustained in 1999 and 2001. Shortfalls remain very rare. However, there are still few leaders and the strength of a placement lies in the cedant's ability to secure the best terms from the right underwriters – if it is underrated the placement often stalls; if it is correctly rated it is likely to be oversubscribed.

The market that has emerged is more knowledgeable of the risks it is accepting and it demands greater clarity of information in return for vastly improved security and reliability. This new market offers an all-round professional service with significant capacity and it has achieved this without having to compromise its ability to secure the right price for the risks underwritten. For the buyer this sometimes means it is not a competitive market in the sense that buyers can 'shop around' for a leader.

Despite the influx of new capital, few of the new reinsurers have jumped into the retrocession arena and those that have are responsibly avoiding the temptation to undercut existing retrocessionaires.

Meanwhile, hard-market conventions apply. Price-led changes of leader fared less well as loyalty emerged as a key issue post WTC and the maxim of 'continuity' was revived. Informed buyers who prepared themselves for higher prices and retentions, whilst maintaining low credit-risk and economical terms, are the most likely to benefit when the next major catastrophe occurs.

The start of the last renewal season was the latest in memory with cedants seemingly reluctant to make the first move lest they attract the highest price increases as the market reacted to WTC. However, lower retrocession price increases than those in the primary reinsurance market meant that the gap between cedants' prices and their retrocession costs narrowed for the first time in ten years. Thus, as primary reinsurance rates rose faster than retrocession rates, some retrocession programmes had an effective adjustable-rate reduction despite increases in rates-on-line (ROL). The retention increases for 2002 meant that the majority of true first layers experienced deductible rises of 25% to 50%.

Some cedants responded by converting their first layer into second-loss protection. Minimum ROL's for top layers rose to approximately 12.5%, especially those with world-wide territorial exposure.

A notable feature was a fall in ROL for deductibles when expressed as a percentage of Estimated Premium Income (EPI) due to the rapid increase in primary reinsurance rates.

The table shows Benfield's assessment of price movements compared to 2001 and the average retrocession programme cost.

Territory	Average price movement	Average programme rate-on-line
Worldwide	+30.0%	27.5%
Worldwide exc. US	+30.0%	23.0%
USA	+35.0%	22.5%
Single territory	+15.0%	12.5%

Alternative Risk Transfer (ART) products saw an upsurge in demand following the Lothar and Martin storms. However, the 2002 renewal did not witness the same increase despite WTC. This reflects two factors. Firstly, non-traditional risk-transfer products have come under closer and more sceptical regulatory scrutiny following high profile failures such as Independent Insurance, HIH and Enron. The consequent demand for greater transparency could defeat the competitive advantage that might otherwise accrue from the use of non-traditional retrocessional products.

Secondly, many contracts sustained at least two and often three total losses over the 1999-2001 period as a result of Lothar, Martin and WTC. Whilst the mechanisms and the accounting treatment employed by ART underwriters caters for at least one loss over such a period, in sustaining three losses the 'Risk Transfer' element of such deals has been severely tested. Existing ART underwriters have clearly come under pressure to tighten up their underwriting, recoup the losses sustained over the last three years and charge more for the utilisation of their capital base. Newer ART reinsurers saw an opportunity to increase their margins and reduce the 'risk exposure', in the belief that buyers would have no viable alternative in the traditional market. In effect they ended up reducing the gap between their net pricing and that of the traditional 'full risk transfer' markets. This, coupled with concerns about regulatory intervention, has resulted in potential buyers of ART products opting to pay a little more for a conventional product guaranteed not to cause difficulties with auditors and regulators. Despite these factors, Benfield believes that ART will continue to form an essential and growing part of the retrocession market. The reasons for buying ART vary from cedant to cedant, but include the attraction of securing medium-term cover at a known cost, reduction of pricing volatility and the provision of protection when no alternative is available. Provided contracts are transparent and clear, and accrual issues pre-defined, concerns about regulatory scrutiny should be mitigated. A year after September 11, the retrocession market is proving itself to be robust, responsive and informed. The collapse of capacity vaunted by the market's detractors has not materialised, and the increases in terms and conditions have been exacted in a restrained and disciplined manner.

This restraint has even led to an improvement in the margin for those who write primary international reinsurance protected by their own retrocession programme and this responsible attitude can only benefit the market as a whole. ART is likely to become more important, but there is further work to be done in ensuring that stricter accounting procedures are catered for, and that ART retrocessionaires continue to demonstrate the skilled approach they have adopted in the past. We remain confident that retrocession will continue to provide significant and secure protection, and that the increasing professionalism demonstrated by retrocessionaires will ensure the durability of this market.

## **Insurance Market Overview**

### **Jardine Lloyd Thompson JLT**

#### **Direct market conditions over the first nine months of 2002**

##### **Rate increases**

Commercial insurance rates have increased across all classes of business. In some cases these have been extreme, with rates more than doubling in specific classes. In others, notably marine and latterly mainstream energy, rises have been much more modest.

One possible scenario is that the rate rises already seen in the direct insurance market will be accompanied by higher reinsurance premiums for the remainder of 2002 and into 2003, after which the influx of new capital into the market might curtail any further increases.

##### **Coverage restrictions**

Across the board insurers are insisting on increased deductibles and the introduction of restrictive policy exclusions, with the maximum exposure to certain perils being capped via the introduction of sub-limits.

Again as for premium rate increases, there are cases where extreme restrictions in the coverage have been imposed eg: in the offshore energy construction market, deductible increases of between 200% and 500% have been observed.

In the aftermath of 11th September 2001, terrorism exposures have received the greatest scrutiny. Some markets have insisted on a blanket terrorism exclusion, whilst others have shown a more flexible approach based on careful risk evaluation on a case-by-case basis.

Even so, some underwriters are offering at best heavily sub-limited terrorism cover, whilst others are providing significant capacity, but only if the price is right.

Catastrophe exposures are being very closely monitored to ensure aggregations across underwriting portfolios do not unbalance accounts. As a consequence many insurers are unwilling to let any quote stand for longer than thirty days. With reinsurance protection being curtailed, many underwriters are unwilling to commit their capacity on quotes which are subsequently not taken up.

##### **Insurer security and the 'flight to quality'**

Over the last ten years, many market commentators have repeatedly suggested there will be an increasing interest in the financial security of the insurers with whom risks are placed.

This would manifest itself as a 'flight to quality' as insureds recognise the importance of the financial strength underpinning the insurance contract they are purchasing and seek to place their risks with the financially most secure insurers.

The perceived extra value, associated with insurers with a strong claims paying ability and potential future longevity in the market, would result in insureds, in some instances, being prepared to pay higher premium levels to maximise the security behind the insurance contracts they are buying.

Nevertheless, over the last ten years a number of insureds purchased their insurance cover from the insurer offering the lowest premium. This was the case even after the significant losses following hurricanes Hugo and Andrew, as well as the Northridge earthquake.

This was because historically the insurance industry has, with only a few notable exceptions, always met its obligations to pay valid claims. Although claims arose out of catastrophe events, they were paid promptly and their magnitude resulted in only a limited number of major insolvencies.

The scale of the losses following the US terrorism incidents has changed everything. The losses were of such a size as to cause concern about all but the largest and most secure insurers in the world.

##### **Policy limits**

There has been a substantial reduction in the policy limits being offered by underwriters, particularly so in the aviation and property markets.

The practice of offering 'full value' policies on major corporate business has virtually ceased, with underwriters now insisting on 'defined limit' placements. This allows them to monitor, determine and control their ultimate exposures. Where a defined limit has been applied to a placement in the past, we are often seeing lower policy limits.

##### **Reinsurance capacity restrictions**

Because of the record underwriting losses sustained by the treaty reinsurance market in 2001 the amount of available treaty reinsurance protection has shrunk considerably. Concurrently over the past six months there has also been a decline in the number of underwriters who are willing or able to offer facultative reinsurance protections and as a consequence direct underwriters are sometimes being forced to write on a 'net line' basis.

Prior to 11th September 2001, many syndicates within Lloyd's were reinsured using 'whole account' treaty protections. Many of these programmes have now become exhausted and underwriters are finding it difficult to renew them. The loss of the 'whole account' protections has severely affected the capacity available for certain specific classes of business, such as political risks and 'net line' underwriting has become common. Typically the cost of replacing exhausted treaty limits is many times the previous rate, with the accompanying terms and conditions of cover tending to be restricted, especially for terrorism, which if not completely excluded will have a sub-limit applied.

#### **Territory coverage restrictions**

The political uncertainty in the aftermath of the US terrorism incidents has led many insurers to consider carefully the territories where they are prepared to offer underwriting capacity. As a consequence the number and scale of 'war risk additional premiums' has risen dramatically and political risk underwriters are taking a very cautious stance in some areas of the world.

#### **Insurers backed with new capital**

The influx of new capital to the market, attracted by increased premium rates, tighter terms and conditions, together with the general demand for capacity has undoubtedly had an impact on the prevailing conditions in 2002. This subject is covered in greater detail in section seven.

There has been a number of new insurance and reinsurance start-ups in Bermuda since the US terrorism incidents. Backed by 'new capital' and unencumbered by prior losses, has allowed them to underwrite with a degree of confidence.

Another factor making these new insurance and reinsurance companies attractive is that in many cases they are backed or associated with already well regarded sponsors. This has bestowed them with immediate credibility in the market and strong security ratings.

Although the amount of new capital has been significant, it has still not yet replaced that which was lost and has left the market. Hence, although new capital has tempered the hardening of the market it has not yet reached such a scale as to result in the cycle entering soft market conditions.

#### **Decline in the number of 'fronting' insurers**

The number of carriers prepared to undertake fronting on global placements was already in decline prior to 11th September 2001. Now even fewer insurers are prepared to take on this role.

The widespread concerns over insurer and reinsurer credit ratings have led many carriers to decide either not to front at all, or alternatively to curtail their list of reinsurers to include only those companies with top grade security ratings.

#### **Increased use of finite risk insurance**

The use of finite risk insurance structures for property placements has increased during the first half of 2002.

This is particularly the case on risks where there is a large potential exposure and the risk potential can be regarded as straightforward, with a predictable level of attritional losses. It is expected that this trend will accelerate.

#### **Increased use of captive insurance companies**

The first six months of 2002 have seen a change in the way in which captives are being utilised. Increasingly they now:

- Accept a wider range of classes of risk than was previously the case.

- Accept higher retentions, so as to reduce the overall proportion of risk transferred to external carriers.

#### **Long-term contracts**

In general, underwriters are no longer offering to underwrite multi-year policies. Currently underwriters are offering placements with a twelve month duration and extensions to existing placements are proving very difficult to obtain.

#### **Mono-line contracts**

In order to permit the monitoring of risk exposure aggregations more effectively, underwriters are more reluctant to write package policies which cover more than one class of business under the same contract wording, preferring to write each class on a stand alone basis.

#### **Policy wordings**

Underwriters are increasingly requiring the use of their own policy wordings rather than accepting broker prepared manuscript policy wordings.

This has increased the complexity of programmes involving multi-layered placements, as each of the contracts may have a different policy wording, thereby increasing the likelihood of non-concurrency between the different elements in the placement and hence of a gap in cover.

Even when full agreement on a common wording is achieved, the amount of time taken to reach this position has increased significantly.

## Ongoing issues and developments in the market

### The continued convergence between the capital and insurance markets

#### *Factors driving convergence*

Over the past five years the insurance and capital markets have moved significantly closer together. A number of techniques and products have bridged the gap between the two markets and have been utilised to provide new solutions for the transfer of risk.

This convergence between the capital and insurance markets is being driven by a number of fundamental factors. These are: • A requirement for greater capitalisation within the insurance market.

- Investment opportunities.
- Holistic risk management, leading to a requirement for a wider range of risk transfer products.
- Convergence in distribution channels.
- Hard market conditions.

#### *Convergence and the hard market*

The severe hardening of market conditions in the last twelve months has resulted in many risk managers looking to find alternative solutions to their risk transfer needs. Clients are attempting to deal with a 'triple whammy' of:

- Large premium increases.
- Significantly higher deductibles.
- Reduced coverage and capacity for some types of insurance (in particular catastrophe perils).

The sudden hardening of the insurance market that immediately followed the US terrorism incidents in the latter part of 2001 and early 2002, resulted in many risk managers finding it difficult to quickly arrange alternative solutions, other than to make greater use of their captives or increase their risk retention levels.

Although ART means different things to different people, it can be defined in general terms as, "the use of alternative risk bearing solutions to manage operational and financial exposures of clients in all areas of their business". It is important to note, however, that many ART mechanisms are very specific as to their application and do not replace the traditional solutions afforded by conventional insurance.

The development of complex ART solutions tends to take more time and to be more focused on providing solutions to specific problems than traditional insurance.

#### *Increased use of self retention and captive insurance companies*

Over the last nine months captive insurance has continued to be the preferred tool for high levels of selfinsured risk retentions. There are now some 4,500 captive insurance companies in existence around the world.

According to rating agency AM Best, 2001 was the global captive market's strongest year of growth for over a decade.

According to regulators and other independent sources in captive domiciles, some 316 new captives were licensed last year and some 202 were liquidated, a net gain of 114. This record growth is expected to be surpassed in the current year.

Bermuda, the Cayman Islands and Vermont are the top three domiciles for new captives in 2001. Bermuda saw 91 new captives, Cayman gained 49 and Vermont 38 according to AM Best. The British Virgin Islands overtook Guernsey as the fourth most popular domicile for new captives, adding 33 captives compared to Guernsey's 22.

Hawaii and Ireland attracted 15 new captives each. The remaining 53 new captives were shared amongst 41 other captive domiciles.

*Other structures for financing self retained risks* In addition to captive insurance companies, there is also a range of other structures that can be used to finance self retained risks. These include:

- Current expensing of losses.
- Unfunded reserves.
- Funded reserves (also known as 'virtual captives').
- Protected cell companies.
- Mutuals.

#### *The hard market...how long will it last?*

#### *The link between capitalisation, market capacity and market cycle*

The overall capitalisation of the individual companies within the insurance market directly influences the amount of risk that the market as a whole can accept. There are a number of interacting factors that in combination make the investment of capital into the insurance market either more or less attractive. These factors can change gradually over time or suddenly as a result of a specific event, such as the US terrorism incidents.

The fluctuations in overall insurance market's capacity and willingness to accept risk is what is often described as the 'market cycle'. Over a period of time this appears as recurring changes in the market's conditions, which can be observed in terms of changing:

- Premium rates.
- Terms and conditions.

- Coverage availability.
- The launch of new insurance ventures.
- Withdrawals from the market.
- Underwriting results.

Higher interest rates influence market conditions and might for example allow underwriters to charge lower premium rates than might be the case if the interest rates were low. This is because there is an opportunity for insurers to earn investment income on the premium between its receipt and its payment away in claims.

Other influences include:

- Inflation.
- Exchange rates.
- Taxation

### **The changes in market conditions over the last twelve months**

Even prior to the 11th September 2001, the insurance market was showing signs of a gradual move towards harder conditions.

This gradual trend was observed with underwriters reporting poor trading results, a number of insurer insolvencies and in terms of actual conditions in the market place, such as the:

- Introduction of sustainable rate increases.
- Imposition of restrictive terms and conditions.
- Withdrawal of capacity from certain classes of business.

The US terrorism incidents on 11th September 2001, resulted in a dramatic acceleration in the rate of market hardening. This influenced market conditions over the whole of the remainder of 2001 and into 2002 and is still influencing risk renewals to date.

The investment opportunities presented by the hard market have attracted a substantial quantity of new capital to enter the market. However, despite the scale of this capital influx, it is still substantially less than the amount of capital that was lost to the industry as a result of the US terrorism incidents and other recent large scale losses.

Until the effect of the lost capital is reversed, hard market conditions will prevail. Hence, we expect hard market conditions to continue until beyond 2003.

In the absence of further catastrophe losses we anticipate rate increases will show signs of slowing over the remainder of 2002 and into 2003.

### **A two stage hard market**

One possible scenario for the future development of the hard market over the next year and a half is that activity will be divided into two stages.

Until mid to late of 2002, we will see the continued use of traditional insurance and reinsurance programmes for risk transfer. Thereafter we will see the re-appraisal of risk transfer programmes, including higher self-retention of risk and an increased demand for alternative risk transfer solutions, as buyers become intolerant of the high premium rates being charged in the market.

### **Conclusion**

Despite the influx of a significant volume of new capital into the market, hard market conditions are expected to continue beyond 2003 into 2004.

So far, evidence indicates this will be a two phase hard market. Over the last twelve months we have observed significant competition for underwriting capacity leading to higher premiums and narrower terms and conditions being offered. However, to date in the corporate sector, outside of the increases in the use of captive insurance, there has only been limited growth in finite risk, securitisation and other alternative risk transfer structures.

### **Market capitalisation and investment return**

In this section we look at the balance between capitalisation and investment return, as well as considering the movement of capital both into and out of the market that over the last twelve months.

#### **The balance between capitalisation and investor return**

An insurance company needs to balance the interests of the policyholders with those of the investors. Each group relies on the other to provide either the financial strength or the investment return and yet each group's interests are to a certain extent achieved to the detriment of the other.

#### **The interests of policyholders**

Policyholders are interested in the financial strength of the insurance company providing the promise to pay associated with the insurance policy they have purchased.

Financial strength is associated with a high solvency margin, which is achieved by an insurance company having sufficient risk-bearing capital to provide a buffer against claims by policyholders. It is the analysis of the financial information relating to the ultimate ability of an insurer to pay that forms the basis of the security ratings developed by the rating agencies.

### **The interests of investors**

Contrary to the interest of the policyholders, investors in an insurance company are interested in the return on capital invested that exceeds the cost of capital.

The return on equity needs to take into account the degree of risk associated with the investment. For an insurance company an adverse claims experience might reduce returns and if losses are sufficiently large the original capital itself may be eroded. To attract and retain investors the return needs to be greater than the investment return associated with a 'risk free' investment opportunity.

The more capital that is retained within an insurance company, the higher will be the company's solvency margin. However, conversely the effect of increasing the capital will result in a lower investment return. It is in meeting these two conflicting objectives that the balance must be achieved between the interests of policyholders and those of the shareholders and investors.

If the balance is not achieved, investors will direct their capital elsewhere and the financial strength of the company will decline. This in turn will make it more difficult for a company to raise new capital and thus to develop further.

### **Consequences of the decline in world stock markets and interest rates on the insurance market**

#### **The decline in stock market value**

The world's equity markets have shown a marked decline over the last three to four months. Over July and August 2002, many of the stock market indices recorded lows, below those that followed in the aftermath of 11th September 2001.

This comes on top of a longer term and more gradual trend of declining equity market value that stretches back over at least the last two years.

The loss of investor confidence over the recent past has arisen due to factors that are both internal and external to the market.

#### **Internal factors**

- Loss of confidence in reported financial information.
- Concerns over the US economy slipping into recession.
- Short selling of stock by hedge funds.
- Pension funds switching to bond and deposit investments in preference to equities.
- General caution over technology, media and telecom stocks.

#### **External factors**

- Ongoing military action in Afghanistan and the war against terrorism.
- The threat of war in Iraq.
- The Middle East situation.

#### **Decline in interest rates**

Interest rates around the world are lower than was the case at the beginning of 2001. This has resulted in the income earned on cash and bond investments declining over the same period.

There are numerous different indices that are used to measure interest rates; however, the general downward trend is illustrated below:

#### **Increased focus on 'underwriting for profit'**

During the recent soft phase of the insurance market, many insurers consistently made a loss on their underwriting portfolios. They were able to deliver profits to their shareholders year after year, as a result of the investment income they were able to earn from the investment of premium between its receipt and subsequent payment away in claims.

As a result of the decline in investment income, underwriters will increasingly be unable to mitigate a poor underwriting result and there will be an increasing focus on 'underwriting for profit'. They will need to price risks and impose terms & conditions in such a way as to ensure that a profit is consistently achieved before investment income.

#### **Other potential consequences**

##### **• A reduction in market capacity**

The capacity of the insurance market to accept risk is linked to its overall capitalisation. This in turn is made up of the aggregate total of the assets of each insurer. If the value of asset values on the insurance company balance sheets is reduced, it will in turn impact the volume of business that can be accepted across the market as a whole.

- **Insurers requiring to raise more capital**

Many insurers have weak balance sheets as a result of a number of years of poor underwriting results.

The recent decline in the stock market will further exacerbate any difficulties by reducing the value of the underlying assets and comes on top of what for many companies is an already difficult position.

As a result a number of insurers will consider raising additional capital to allow them to continue their underwriting operations and maintain their market position. This may be difficult to achieve in practice as the lack of confidence which has undermined asset values also makes investors unwilling to invest further in the market.

- **Declining insurer security ratings**

The decline in asset values on the balance sheets of many insurers will result in the rating agencies reviewing the financial strength of insurers. For some this could result in their security rating being downgraded.

- **Withdrawals from the market or from specific classes**

Where an appropriate return on the capital employed cannot be achieved insurers will either withdraw from the market totally or will make the decision to cease underwriting in specific sectors of the market.

### Reinsurance market trends observed in 2002

The information is listed under the headings:

- **Non-marine reinsurance.**
  - Property catastrophe.
  - Property proportional.
  - Property excess of loss.
  - Liability.
- **Marine reinsurance.**
- **Energy reinsurance.**
- **Aviation reinsurance.**

<b>Non-marine reinsurance</b>	
<b>Property catastrophe</b>	
Terrorism	In the aftermath of 11th September 2001, the London market sought to impose a blanket exclusion of all terrorism exposures. A more pragmatic approach was taken by many European reinsurers, due to the legal requirement in some jurisdictions to provide terrorism cover. As a result London lost market share, particularly with regard to European and Canadian business.
Cyber risks	A cyber risk exclusion clause was applied by all markets. (NMA 2915 or similar.)
Workers' compensation 'write-backs'	Retrocessional markets sought to withdraw cover for the 'write back' of workers' compensation coverage. This resulted in additional capacity issues in the workers' compensation market.
Extra contractual obligations	Attempts were made by reinsurers to exclude extra contractual obligations and payments in excess of policy limits from retrocessional placements; however these exclusions were eventually not applied.
Premium payment warranties	Reinsurers have sought to enforce strict payment terms on business, with premium payment warranties being introduced on many contracts.
Natural perils and man made catastrophes	Event definition in respect of natural perils and man made catastrophes has been more strictly applied than previously was the case.
Increased reinsurance requirements	In some areas, most notably Japan, companies purchased additional vertical coverage for events likely to have return periods in excess of 1 in 250 years. In addition, reductions in proportional capacity have resulted in cedants being obliged to purchase more reinsurance to cover their higher net retentions.

<b>Pricing</b>	
Rate increases	After the poor underwriting results of the past two years, pricing was already beginning to increase even prior to the US terrorism incidents. Rates and deductible increases have been seen across all territories. Price increases ranged from between 15% to over 250% where cedants came to the end of multi-year contracts. Retrocessional prices increased by about 25%. This was on top of increases in deductibles of between 20% and 30%.
Pressure driving rate increases	Price rises accelerated towards the end of 2001 and into 2002. Recently the momentum for rating increases has slowed; however pressure is expected to return as the 2003 renewal season approaches.
<b>Capacity</b>	
Availability	In general, capacity for property catastrophe reinsurance is available. Where the market failed to achieve an acceptable consensus on price, it tended to result in severe capacity shortages. Significant capacity was available for programmes that the reinsurance market considered to be adequately priced.
Bermuda	The new capacity from the Bermudian market featured on 'well priced' placements, but was often reluctant to quote competitively against the existing leaders on many treaty placements.
Security	Where risks were overplaced, cedants were extremely selective in respect of the allocation of their reinsurance orders. As a result there was a general 'flight to quality' when it came to allocation of shares.
<b>Property proportional</b>	
Capacity	Capacity for proportional business was reduced, with low investment returns failing to make up for inadequate original rates, especially in catastrophe prone areas. In some territories, such as the Caribbean, original rates are perceived to have risen to more acceptable levels.
Limits placed on natural perils	Reinsurers were successful in imposing further restrictions to the cession event limits applied to natural perils. This had the knock on effect of increasing the capacity that was required from the nonproportional reinsurance market.
<b>Property risk excess of loss</b>	
Capacity	In general, due to a shortage of capacity in the market, cedants were unable to maintain their gross lines and were forced to accept restrictions on the underwriting exposure they are able to accept.
Deductibles	Deductibles increased substantially, especially for those cedants whose gross to net gearing was seen as excessive. Deductible levels for retrocessional risk are now at approximately 20% of the cedant's gross line, although some lower level deductibles have been successfully negotiated albeit at substantial cost. Deductibles in the international market vary according to territory.
Terrorism	Terrorism coverage was excluded and some cedants chose to purchase coverage separately.
Definition of 'any one risk'	Within the market, there is still some debate as to the definition of what constitutes 'any one risk'. Many reinsurers have issued their own definitions; however, there is no clear consensus with regard to this issue. Most reinsurers are seeking a pre-defined approach that is understood by both cedants and reinsurers prior to inception, especially considering the disputes that have arisen as a result of the US terrorism losses.
Onshore energy risks	Despite early reservations concerning the inclusion of onshore energy business within property risk covers, reinsurers have been willing to cover these exposures, albeit at a cost. Reinsurers have required a considerable amount of underwriting information about the exposures involved.
Availability of 'risk attaching' coverage	The availability of 'risks attaching' cover has substantially diminished, with many cedants unwilling to accept the rates required for this type of coverage.

<b>Liability Reinsurance</b>	
<b>Coverage</b>	
Terrorism	<p>Post 11th September 2001, many reinsurers initially sought to exclude terrorism coverage.</p> <p>However, in practice many reviewed the situation on a case-by-case basis, depending on the class of business involved and the nature of the risk being proposed.</p> <p>Total exclusions tended to be applied to areas deemed to have significant exposure, such as security firms or stadium owners in respect of public liability reinsurance. For professional indemnity risks, cover was only given in respect of negligent acts. In general US based reinsurers have been more restrictive in their approach to offering terrorism coverage than reinsurers from other jurisdictions.</p>
Professional indemnity	Many professional indemnity covers now exclude losses arising from the activities of accountant and auditors.
Products liability	Reinsurance of products liability for the pharmaceutical industry has also been restricted, as losses in this sector especially from European companies have been significant.
Unlimited motor coverage	<p>Attention has been focused on the potential for losses arising out of territories where there is a legal requirement for unlimited motor liability.</p> <p>Reinsurance coverage for this area has been severely curtailed following the growing number of single person bodily injury awards, the catastrophic loss at the Selby rail crash and a series of tunnel fires in Europe.</p>
'Unbundling' of package liability placements	<p>There has been a general trend to 'unbundle' programmes, so as to strip out non-core products such as merger &amp; acquisition and e-commerce liability covers.</p> <p>In parallel with this, reinsurers have been largely successful in moving clients away from multi-year policies and line-slip placements.</p>
Financial institution	<p>For many years financial institutions' programmes have had unlimited reinstatements.</p> <p>These are now being capped.</p>
Workers' Compensation Act covers	<p>The workers' compensation reinsurance market was already hardening before the terrorist attacks as a result of the 'Unicover' problems. The US terrorist attacks have accelerated this process.</p> <p>Much of the US terrorism incident workers' compensation losses were reinsured by the life and accident &amp; health 'carve out' markets. The 'carve out' market, has for the most part disappeared at the end of the year, although a small number of underwriters have subsequently re-emerged.</p> <p>In reaction to the shortage of cover the Lloyd's market, lead by Faraday, formed a consortium to underwrite WCA catastrophe risks, providing cover up to a US\$20 million limit.</p>
Political risks	<p>The political risk reinsurance market remains limited.</p> <p>At the 1st January 2002, reinsurers were generally offering coverage excess of 25% of the cedants maximum line size, with an original policy term not exceeding 36 months.</p> <p>Strict country aggregations limits were applied to certain countries which were perceived to be high risk including Argentina and Pakistan, together with cover for credit insurance.</p> <p>At the 2003 treaty renewal period, it is expected there will be demands for a relaxation of some of the exclusions that apply to political risk reinsurance placements.</p>
Exclusion of toxic mould and contractors' defects	On a number of classes of business, mould and contractors' defect exclusions are being introduced.
<b>Pricing</b>	
Rate increases	Since 1997, the liability reinsurance market has sustained poor underwriting results and has seen its loss reserves deteriorate substantially. This has resulted in substantial rate increases being required.
Further rate increases	<p>Premium rates are still under pressure to rise further. At this early stage increases of between 10% and 15% are expected for 2003.</p> <p>However, reinsurers recognise that it is coverage issues that represent the greatest threat to profitability.</p>

Proportional treaties	On proportional treaties, even though underlying rates are now considered by many to be at acceptable levels, most London reinsurers wish to utilise their capital on an excess basis.
<b>Capacity</b>	
Capacity reductions	There has been a reduction in capacity, as reinsurers have failed over recent years to achieve adequate returns. The poor underwriting results have been exacerbated by declining investment rates of return. Very few of the new Bermudian reinsurers have offered any capacity to the liability classes. Those that have, concentrated on small amounts of US WCA business.
Effect of rating agency downgrades	Additional stress has been placed upon capacity, following a series of downgrades by the rating agencies. This has had the effect of increasing the perceived counterparty risk to many cedants on long-tail exposures.
Reinsurance for financial & professional lines	Excess of loss reinsurance capacity for London market financial & professional accounts has generally been available and as a consequence most placements were complete. The exception would be for accounts containing US directors' & officers' liability, where a lack of reinsurance has led to Lloyd's capacity being dramatically reduced. Proportional treaties came under severe pressure and this also led to reduced capacity for financial & professional lines. Lloyd's appetite for reinsuring US companies in financial & professional lines has shifted away from reinsuring the mega companies, where Lloyd's influence is limited, to seeking companies who operate in niche areas and where Lloyd's expertise can add value. Any cedant with an account of US listed D&O encountered severe problems in obtaining capacity. With a few exceptions, notably Arch, Bermudian capacity has been reluctant to become involved in financial & professional treaties. This may change in due course if Bermudian companies find that they need to expand their areas of operation in order to fully utilise their capital.
<b>Marine reinsurance</b>	
Terrorism	Most markets sought to exclude terrorism totally during the initial phase of the renewal season. Generally, however, the waterborne exposures were 'written back' into policies.
Political and onshore energy risks	Political and onshore energy risks were areas that reinsurers sought to exclude or limit within marine portfolios. A number of exclusion clauses that were prevalent during the hard market for the early to mid 1990's, have been reintroduced to the market.
<b>Pricing</b>	
Rating increases	Rate rises were universal across all lines of business. Retentions were increased and coverage issues were tightened or excluded. The composite products along with onshore energy and war policies saw very large rate rises. Other marine classes incurred increases of 10% to 50%, depending on retention levels and loss experience.
Retention levels	Retention levels increased to 10% of maximum line. Below this level, coverage was more difficult to purchase at a reasonable cost.
Rates	Subsequent to the main 1st January 2002 season, rating levels have stabilised as reinsurers have satisfied their premium income projections.
<b>Capacity</b>	
Primary reinsurance capacity	Covers with high loss frequencies and low excess points have become almost impossible to renew.
European reinsurers	European reinsurers have been able to increase their market share. In some cases this has been at the expense of the London market.
New Bermudian capacity	New Bermudian capacity has had little effect on pricing, capacity and coverage during the 1st January 2002 renewals. The Bermudian capacity is more focused towards the non-marine lines of reinsurance business. However, a number of marine underwriters are being employed and it is anticipated that they will play a more significant role during the latter part of 2002 and during 2003.

<b>Energy reinsurance</b>	
<b>Coverage</b>	
Terrorism	Terrorism coverage has been given, but on a 'write back' basis, using a 42B clause.
Refinery and political risk cover	Most markets would not offer this coverage. In general there was a very limited amount of coverage available.
<b>Pricing</b>	
Rate increases	Premium increases mostly followed the changes experienced within the direct insurance markets. Rating and deductible increases have been recorded ranging between 100% and 1,000%, with control of well OEE/CAR ('Operator's Extra Expense'/ 'Contractors All Risks') coverages showing particularly significant increases. Some markets appear to have relaxed their stance on offshore E&P ('Exploration & Production') renewals. High level XLs and TLO ('Excess of Loss' and 'Total Loss Only') placements are showing a relaxation in their pricing, due to the effect of competition.
<b>Capacity</b>	
Primary reinsurance capacity	There has been an excessive amount of capacity for certain classes of business. However, this is not the case for OEE/CAR. The presence of the Bermudian market capacity, in particular AXIS, is felt in the market.
European reinsurers	Reinsurers in Europe have been able to gain market share at the expense of the London market.
<b>Aviation reinsurance</b>	
<b>Coverage</b>	
Continued reliance on traditional reinsurance	Despite higher rates and premiums in the traditional market than was the case in previous years, the much predicted increase in the use of Alternative Risk Transfer (ART) solutions has yet to materialise.
Losses occurring basis of cover	The main change that took place at 1st January 2002 was the shift from coverage being arranged on a 'risks attaching' basis to placements being written on a 'losses occurring' basis. Although many clients chose to purchase 'losses occurring' cover, 'risks attaching' was available, albeit with a substantial differential in pricing.
Tightening of conditions and coverage	The major programmes that renewed at the beginning of the year were all subject to close scrutiny by reinsurers, resulting in a general tightening of terms and coverage. The main areas of focus were: <ul style="list-style-type: none"> <li>• War risks - reinsurance contracts were restricted to US\$50 million for third party exposures.</li> <li>• Non proportional reinsurance exclusion - the exclusion has been widened by some reinsurers to exclude facultative/risk excess business unless it aggregates with direct writings.</li> </ul>
<b>Pricing</b>	
Rate increases	As predicted, rate increases at 1st January 2002, as predicted were substantial. However, they were mitigated by clients purchasing the available 'losses occurring' covers rather than 'risk attaching' covers. Where 'risks attaching' cover was available it was very expensive. All areas of aviation reinsurance saw increases and despite good loss records, most programmes were subject to remedial price rating. Rate increases during the 1st and 2nd quarter reinsurance renewal periods are constant. There has not been any noticeable relaxation in the pricing or coverage available.
Increased retentions by cedants	Higher rates have affected the appetite of cedants to purchase reinsurance at the lower end of their portfolios, with cedants purchasing their cover selectively where they can achieve a reasonable level of risk transfer for a reasonable price.
<b>Capacity</b>	
Refocus on reinsurer security	Following 11th September 2001 and the realisation by underwriters that such catastrophic events could occur, there has been a re-focus on the financial strength of their reinsurance security. This has typically taken the form of either minimum required reinsurer capitalisation levels, or the application of a minimum AM Best or Standard & Poor's rating criterion. This is particularly true for long-tail liability business. In a number of situations it would appear that Lloyd's has lost business to AAA and