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Long-term investment trends continue to weigh on reinsurers despite 2014 improvements

A combination of lower rates and increased major loss activity at the same time as continued weak investment returns should worry reinsurers

Graham Village
Global markets editor

Reinsurers in Baden-Baden this week for the annual discussions ahead of the January 1 renewals will be aware any further softening in prices will cut into profitability at a time when the low-yield environment is putting significant pressure on investment returns.

Since the financial crisis, underwriting has been under pressure to contribute a greater proportion of reinsurers' and insurers' profits.

But while reinsurers have benefited from stronger investment income and, in some cases, a larger underwriting profit during the first six months of the year the the long-term trend is working against them, according to *Insurance Day*'s analysis.

The sample of 10 leading reinsurers, including market leaders Munich Re and Swiss Re, shown in the table, recorded an encouraging increase in both underwriting and investment profit for the first half compared with the corresponding six months of 2013. But looking back to before the financial crisis struck, the sample has since posted a generally downward trend in investment income while underwriting activities have been more volatile but mostly positive over the seven-year period.

Comparing 2007 with last year reveals a clear contrast in the relative importance of underwriting and investment activities. In 2007, underwriting profit was about 21% of investment income but by 2013 investment income had fallen to $17.5bn, while the contribution from the stronger underwriting profit of $8.54bn was 49% of investment income.

Table: Sample of 10 reinsurers*, historic investment income and underwriting result ($bn)

Year	Investment income	Underwriting result
2007	23.24	4.94
2008	17.05	1.77
2009	20.03	5.04
2010	19.62	1.58
2011	17.22	(5.86)
2012	19.33	6.73
2013	17.48	8.54
H1 2013	12.56	4.42
H1 2014	13.80	4.50

*Arch, Axis, Everest Re, Hannover Re, Munich Re, OdysseyRe, PartnerRe, Scor, Swiss Re and Validus
Source: Insurance Day/company filings

Tomorrow's Companies House section will look in full detail at the underwriting-investment income balance between the 10 companies shown.

Half-year figures show underwriting profit increased 1.8% this year, while investment income was up 9.9%, driven by particularly good performances at Munich Re and Swiss Re.

While reinsurers will be glad underwriting has produced good returns over the past two years, they should be worried at the possible combination of lower rates and increased major loss activity at the same time as continued weak investment conditions.

Analysing the US primary insurance industry's return on average surplus since the late 1970s, the Insurance Information Institute (III) has found a combined ratio of 100% generated a return on equity (RoE) of 5.5% in 2009 and 2010 compared with 10% in 2005 and 16% in 1979, highlighting the pressure for companies to produce significantly lower combined ratios to deliver the same RoE.

The III said different lines of business looking to maintain a constant RoE required varying reductions in combined ratio to offset a 1% fall in investment yield, ranging from just 1.8% for personal lines business to a cut of as much as 7.3% for reinsurers.

Although the industry's investment strategy remains generally conservative, certain companies have shown signs of adopting a more adventurous policy and some of the new reinsurers with links to the hedge fund community have the explicit intention of recording above-average investment income through those connections.

Several Bermudian reinsurers have announced tie-ups with specialist investment houses this year in an attempt to improve investment returns, the latest being Allied World's strategic partnership with Blue Vista Capital Management, a private equity company based in Chicago focused on property investments. Blue Vista will manage $225m of Allied World's investment portfolio.

NEWS

Barbican to launch rated reinsurance vehicle next year

Vehicle will not divert business from Lloyd's

Michael Faulkner
Editor

Barbican Insurance Group is planning to launch a rated reinsurer early next year as it looks to expand its underwriting capacity outside Lloyd's.

The Lloyd's-focused insurer and reinsurer is in the planning stages of the new vehicle, which will be domiciled in either Guernsey or Bermuda. Barbican already has an operation in Guernsey.

The vehicle, which will seek an A- rating, will write business that does not fit within Lloyd's risk appetite at present or which the group does not have the capacity to write through its syndicates.

Barbican has yet to decide on the type of business the vehicle will write or the scale of the new vehicle and how it will be capitalised.

One option is for a small-scale vehicle, with around £100m ($160.7m) capacity writing niche reinsurance lines. Such a vehicle would likely be capitalised by Barbican's majority owner, Texas-based hedge fund Carlson Capital.

Alternatively, the vehicle could be considerably larger, potentially with a capacity of £300m to £400m, which would require third-party capital.

It could use a so-called 'hedge-fund reinsurer' model similar to that employed by Arch Capital and Watford Re, using an asset manager to generate higher returns on the assets to allow a different risk profile of business to be underwritten.

St Peter Port: Barbican group's new reinsurer could set up home on the island, where the group already has an operation

© Kiev.Victor/Shutterstock

Jon Godfray, Barbican Insurance Group chief operating officer, told *Insurance Day*: "There is a lot of virtue for those considering a hedge fund-style play and you could source a significant amount of opportunities. A smaller vehicle may be considered less exciting as it limits the opportunities you can put through it."

He insisted the aim was not to take business away from Lloyd's. "We will not divert business we would expect to write in the syndicate. It would be business we can't write in the syndicate or business that doesn't match Lloyd's risk appetite."

No decision had been made on the nature of the vehicle. "It is a live project. We are building a business model. This year we will focus our plans and do it in early 2015," Godfray added.

Barbican is looking for ways to grow to reach what it sees as a critical mass of around £600m gross written premium under management. Barbican has a Lloyd's stamp capacity of £250m for 2014.

In the past two years it has launched two special-purpose syndicates (SPS). For the 2013 year of account it established SPS 6113, with the backing of names. This was followed in 2014 with the establishment of SPS 6118, a whole-account quota-share, backed by Malaysian carrier Labuan Re and another reinsurer.

There has been speculation that the group will set up another SPS backed by an asset-management firm, although Barbican has declined to comment on this.

SPSs provide a way to increase capacity using third-party capital. A new reinsurance vehicle would also extend the group's capacity.

Godfray said: "For long-term independence we need to be £600m of gross written premium under management. If we are looking at creating a materially larger model then we could look towards additional capital support from traditional markets."

Mapfre in London specialty lines push

Spanish insurance giant Mapfre will start offering a range of specialty lines of business from its London offices in 2015, *writes Michael Faulkner*.

The group's Mapfre Global Risks division will underwrite aviation, energy, marine, construction and engineering lines, it announced on Friday.

Mapfre has been operating in the UK for the past seven years, developing a portfolio of global risks business with a focus on property lines.

The property line will also be expanded geographically to other markets such as the US (subject to obtaining the appropriate licences), as well Asia, South Africa and the Middle East, the company said.

Alfredo Castelo, chief executive of Mapfre Global Risks, said: "To support this new strategy we are expanding our local team, building our capability in London while working closely with our colleagues in Madrid."

Mapfre is one of the largest multinational insurance groups in Latin America and one of the 10 largest insurance companies in Europe by premium volume.

Willis Re extends modelling partnership for flood analytics

Willis Re has expanded its strategic partnership with catastrophe modeller KatRisk and information visualisation and analysis provider SpatialKey to provide global flood exposure modelling, *writes Alexis Burris*.

The partnership will broaden the existing analytical platform for the US to cover the rest of the world.

Willis Re and SpatialKey are working to integrate KatRisk's global flood model, starting with Japan, China and southeast Asia.

Layers for Australia, Canada, Latin America and Europe will then follow.

Matthew Eagle, regional director of Willis Re, said: "Demand for a high-quality, high-resolution global flood solution continues to increase. Insurers need to leverage the latest science and analytical methods to evaluate and manage global flood exposure.

"The advanced science and accurate risk assessment provided by KatRisk's approach, delivered via our expanded partnership with KatRisk and SpatialKey, will enable a significant improvement in how Willis Re clients proactively manage their flood accumulations worldwide."

In April, catastrophe modeller AIR Worldwide integrated a number of third-party models into its Touchstone software platform, including KatRisk.

"The expanded global offering, as well as licensing the complete suite of AIR's probabilistic flood models, gives our clients access to a wide range of flood analytic solutions," Vaughn Jensen, executive vice-president of catastrophe management services at Willis Re, said.

PROFILE

Oliver Bäte: Allianz's financial troubleshooter needs a steady aim for the prize round

The successor to Michael Diekmann has some major challenges when he steps up to the top job next year, not least winning staff support

Herbert Fromme, Cologne
German correspondent

There were times when Oliver Bäte really got on many people's nerves at Allianz. At management board meetings he would parade his – admittedly extensive – knowledge on sundry subjects, a bad habit acquired during the 15 years when he worked as a consultant for McKinsey. Allianz's chief executive, Michael Diekmann, enticed him away from McKinsey in 2008.

Bäte is now Diekmann's designated successor. In May 2015 he will assume responsibility as chief executive of Germany's largest insurance group and one of the foremost global players in the field. Colleagues report he has since lost his tendency to be impertinent. This process was seemingly facilitated by the fact he is no longer chief financial officer (CFO) but has instead been responsible for Allianz' insurance business in France, Italy and other countries since the beginning of last year.

No-one would deny Bäte is competent and incredibly knowledgeable. His first career move was a full training period at a bank – the now closed down WestLB. After that, he went to university and studied business administration in Cologne and New York. In 1993 he moved to McKinsey in New York and later worked for the consultancy firm in Germany, where he became leader of the German insurance practice and later of the European insurance and asset-management sector.

He has shown his know-how in many crisis situations during which he advised companies. And yet it was quite some step from that position to the management board role at Allianz. "A future Allianz chief executive needs to know how the finances of such a company work," a colleague says. "Bäte certainly has this knowledge, not least since his time as CFO from 2009 to 2012."

But is he able to manage external and internal growth? Here, his friends point to the role he assumed in early 2013. Then, he took over responsibility for Italy, France, Greece, Turkey, Benelux and other markets in the Allianz organisation, in addition to global property/casualty (p/c).

Bäte organised the acquisitions of a book of business from Gan Eurocourtage in France, of Yapi Kredi Sigorta in Turkey and Mensura in Belgium. He managed to turn around the Greek subsidiary, which had problems resulting from the financial crisis.

In March this year, Bäte was the key manager in Allianz's takeover of the p/c arm of Unipol SAI in Italy and his friends in the Allianz headquarters say the merger of the companies in Belgium, the Netherlands and Luxembourg is his masterpiece in this respect. "In these countries, regional and ethnic conflicts dominate everyday politics and we managed to merge three companies across borders," one Allianz manager says.

Bäte is tall and slim, and polite and friendly in conversation. He does not appear to be arrogant, although he is obviously extremely self-assured. The central question that awaits him is whether he can win over the 148,000 Allianz staff members to support the enormous changes he is planning for the company and which in fact are due in the entire industry. Here, many of his critics have their doubts.

Bäte: will assume responsibility as chief executive of Allianz in May 2015

Bäte faces the task of overcoming the crises at the group's asset manager Pimco in the US, whose founder and star-investor, Bill Gross, two weeks ago went to work for Pimco's rival Janus amid great fanfare. This crisis will hit Allianz for some time – and Bäte will have to deal with it personally after Diekmann leaves.

The same is true for the restructuring of Allianz's US subsidiary Fireman's Fund, which is to be carved up – the private customer business is up for sale, and the industrial and commercial business will be run by Allianz Global Corporate & Specialty in Munich.

These are the public crises, but there are hidden dangers too. One of Allianz's key worries must be the economic future of Italy. Italy is Allianz's second-largest market following Germany; the company holds €29bn ($37bn) in Italian government bonds. The stalling of the Italian economy and the fact the Italians are increasingly fed up with the austerity policies followed by several governments must be alarming for Allianz and its future chief executive.

Low interest rates hit the life book across Europe, especially in its key German market. Allianz is gaining market share, but the question is at what price. Allianz's eastern European companies suffer from political instability or governments – such as that in Hungary – which have no problems using insurance funds as sources to refill depleted government coffers.

Then there are the mighty challenges of the digital revolution hitting the insurance industry. In this respect, Bäte can show the progress he made in this field in Italy, which serves as a model all over Allianz for its simple, fast electronic closing systems for private customers.

Bäte's friends at Allianz are convinced he can rise to the challenge and win the support of the staff. They mention his character as a native of the Rhineland (he was born near Cologne), as well as the almost silent ease with which he mastered the big restructuring projects. "He eats lunch in the canteen like everyone else and is well accepted," a colleague says. His choice of close colleagues also speaks in his favour – he chooses eager young people including many women, all of whom appear infected by his enthusiasm and energy.

His opponents think he is still very much the cold consultant and he lacks the Allianz DNA – in other words, he lacks a certain affinity to Allianz and its ways. Diekmann actually used to sell policies himself, while Bäte has never done this. Winning over the majority of the Allianz workforce is the main test. If he does not achieve that swiftly, Bäte could have a much shorter period in office than expected.

After six years with Allianz, Bäte will now finally be moving to Munich with his wife and three children. Until now, living in Cologne was very important to him, as is being able to ride and enjoy contemporary art. The move will hardly be difficult for him given that he is now at the pinnacle of his professional career. ■

SPECIAL REPORT/ BADEN-BADEN

Evolutionary road: riding out the cycle is no solution

The reinsurance landscape will look different when the dust of the present cycle settles. And reinsurers, rather than just manage the downside and react to short-term opportunistic trends, will have to reinvent their business models to remain relevant

Johannes Bender and Ralf Bender
Standard & Poor's

The traditional reinsurance business model is under threat from external sources, such as capital markets, corporations and technology companies that could become substitute providers of risk protection. If reinsurers fail to leverage their key strengths and expertise to new and existing clients, they could find themselves marginalised.

As reinsurance capacity outstrips demand, competition in the global reinsurance market is intensifying. This is reflected in premium rates declining materially at the major renewal dates (January, April, June and July) in 2014. As reinsurers look to deploy excess capacity, we are seeing competition spilling over from the catastrophe lines of business, which is now weakening pricing in most lines around the globe. Standard & Poor's (S&P) estimates pricing across the sector will decline between 5% and 10% for 2014, particularly on excess-of-loss reinsurance.

Moreover, reinsurers in the present environment selectively provide coverage enhancements. One increasingly used enhancement is a multi-year reinsurance contract, particularly for property catastrophe coverage. Because multi-year deals often proliferate in soft markets as underwriters scramble to maintain market share, we are wary the trend may indicate a weakening of underwriting standards. Although judicious use of multi-year contracts could help reinsurers defend their market share in difficult conditions, overuse of these offerings is generally a warning sign that could indicate a deteriorating competitive position.

Alternative capital

Reinsurers' recent track record of strong earnings has attracted new forms of capital to the market as investors are keen to diversify their risks and find ways to achieve better yields while interest rates remain low. This has seen an influx of alternative capital from pension funds and hedge funds, which are supporting insurance-linked securities or start-up reinsurers, the so-called "hedge fund reinsurer" business model. These companies aim to produce above-average investment returns on the premiums received from writing lines such as liability insurance, where insurers and reinsurers typically hold larger reserves because policyholder payments come in well before claims typically occur.

Hedge fund reinsurers' asset-management strategies are numerous and wide-ranging. They include speculative-grade leveraged loans, private equity, long-short equity, fund of hedge funds and speculative-grade bonds. The one common thread is hedge fund reinsurers' investment strategies tend to be significantly riskier than those typical of traditional reinsurers. As a result, they are more capital-intensive, which may reduce their capital adequacy in our risk-adjusted capitalisation analysis. In addition, as hedge funds form reinsurance companies, the contrast in business practices between asset managers and reinsurers is evident. Most notably, traditional reinsurers typically set forth comprehensive risk controls to manage the volatility in their businesses. Although asset managers employed by hedge fund reinsurers also set limits, they tend not to be as restrictive, comprehensive or risk-based as traditional reinsurers.

Table: Global property/casualty reinsurance earnings forecasts (%)

	2009	2010	2011	2012	2013	2014f	2015f	Five-year average (2009 to 2013)
Loss ratio	56.8	62.1	75.1	57.0	53.0	60-65	62 to 67	60.8
Combined ratio	86.8	92.6	105.6	88.1	86.4	95-100	98 to 104	91.9
Return on equity	22.2	14.1	5.2	14.4	14.1	7-9	7 to 9	14.0

Source: Standard & Poor's

Investment: hedge fund reinsurers' investment strategies tend to be significantly riskier than those typical of traditional reinsurers

The strength of reinsurers' balance sheets has enabled most of them to withstand the pricing pressure and competition to date. Without this, we are likely already to have taken rating actions on some of the reinsurers most exposed to these pressures. S&P estimates more than half the global reinsurers we rate are more susceptible to the present competitive and earnings pressures – and even those well positioned to navigate softening prices now are likely to find it harder to handle the pressure over the longer term.

Nonetheless, we firmly believe reinsurers have a continuing role to play in the global economy – and they need to emphasise this to existing and future clients. For example, they can facilitate the use of big data to help clients identify fraud, protect themselves against cyber attacks or manage their risk exposures. They can also help governments and corporations improve their resilience to natural disasters and protect themselves against extreme events. In providing solutions for long-term issues, reinsurers can also establish a foothold in and help unlock insurance markets, thus solidifying future competitive positions.

The reinsurance market remains difficult for all players. We expect pricing and profitability will continue to deteriorate for the next 12 to 18 months and we do not anticipate any increase in investment returns that could provide a respite. We expect this to weigh on reinsurers' ability to sustain existing profitability over the next 12 to 24 months. This could weaken creditworthiness in the sector as increased exposures eat away at capital adequacy and heighten potential for volatility and as pricing and competition erode business risk profiles. Roughly half the global reinsurers S&P rates are more vulnerable to the present competitive pressures because of their scale and business mix. Some of these companies will find it difficult to defend their competitive positions in the market and may struggle to generate earnings that can meet their cost of capital without taking excessive risks.

We believe successful players in the market are those that have the capital strength to withstand increasing risk exposures, can exercise disciplined underwriting to maintain profitability and can retain or expand their presence with key clients by offering capacity, expertise and a range of products that can support cedants' changed buying patterns.

That said, the industry will look different when the dust of the present cycle settles. We anticipate seeing fewer, larger global reinsurers that will use capacity from the capital markets to provide the level of syndication and diversification the insurance market requires. Over the long term, reinsurers will have to reinvent their business models to remain relevant as the economy changes, rather than just manage the downside and react to short-term opportunistic trends. The entire sector cannot be a following market and those that choose to follow are likely to lose out to those that lead. ■

Johannes Bender and Ralf Bender are credit analysts at Standard & Poor's Rating Services

SPECIAL REPORT/ BADEN-BADEN

ILS: avoiding legal pitfalls

Litigation risk for insurance-linked securities is greater than for cat reinsurance

Clive O'Connell
Goldberg Segalla

While insurance-linked securities (ILS) are seen as a more secure product than reinsurance (particularly catastrophe reinsurance) because of its lack of solvency risk, it is very important to be aware reduced solvency risk does not mean reduced litigation risk.

To begin with there is the relatively rigid structure of the ILS product. For example, with a reinsurance product if you, as the cedant, need to change mid-term, you speak to your broker and the broker runs around the market obtaining signatures to an endorsement. As reinsurers are keen to continue their business relationships, they are likely to be amenable to a change. To object would put them at a serious disadvantage at the renewal.

ILS products, on the other hand, are structured very differently. However amenable the fund manager might be to an amendment, its hands are tied. Renegotiating the terms of cover within the ILS context is simply not possible. Indeed, the fund manager would have to go out to investors with a new prospectus to change the terms of cover. Thus the inflexible nature of the ILS structure can leave cedants in the position of having cover they do not need (at great expense) or of having constraints on their ability to implement strategic change in the short term. Needless to say, their ability to respond rapidly to opportunities in the market are similarly constrained. In turn, this situation can lead to disputes as parties seek to wriggle out of arrangements.

Multiple perils

In addition, catastrophe reinsurance typically covers multiple perils, which means if the cedant's underlying underwriting philosophy changes, amendments can be made swiftly by endorsement. Catastrophe reinsurance is a commoditised product. The perils it covers are known and understood. Everyone in the market faces the same issues. Solutions are found swiftly to them. For all these reasons catastrophe reinsurance carries with it very little litigation risk; far less than other classes of reinsurance.

The litigation risk for ILS is, however, greater. Unlike catastrophe reinsurance, ILS is not necessarily a long-term relationship. Whereas catastrophe reinsurance is priced on the basis of recouping losses over years, ILS is a short-term investment. Profit is made by spreading risk across specified perils. Indeed, in many cases, ILS investments may be traded.

While a catastrophe reinsurer will look to a renewal to recoup losses, an ILS investor is not so bound. Instead of another ILS product, it might look to investing in a roofing company or flood-prevention project to recoup losses paid.

The fact payment within the ILS context should be automatic does not limit the possibility of legal dispute. Possession might be nine-10ths of the law but in the real world, if a sizeable sum is paid out and a claim to recover it can be made, it will be. Indeed, there is even the suggestion some investors might be prepared to buy the shell special-purpose vehicle or somehow the right to sue on its behalf. In these cases an ambiguous wording, which may result in a lawyer giving a 50/50 chance of success, could translate in to a significant profit for an investor who bought the claim for, say, 20¢ in the dollar and then settled at 40¢.

The litigation risk of ILS is therefore greater than the litigation risk of catastrophe reinsurance. That said, let us not exaggerate the risk. It is greater primarily because the litigation risk of catastrophe reinsurance is zero or close to zero. There are many ways to reduce if not eradicate the risk of litigation, such as the choice of legal jurisdiction governing the ILS contract. Needless to say, here the objective is certainty – a system of law with experience in complex issues and, ideally, legal precedent, as well as a framework which allows for mediation and arbitration. However, the most important consideration is contract wordings.

Wordings

ILS products, despite the fact they can be fitted into a small number of categories at present, are all individual, unique contracts, each with their own bespoke wordings. And, not surprisingly, new wordings will face challenges, particularly within the context of the ILS environment, where a lack of market standards means one party could very easily find itself in new territory, without the support of legal or any other kind of precedent.

Looking at issues arising from the alternative risk transfer market in the past, some of the worst disputes have come from clashes between capital markets and insurance markets. Each party has a very different appreciation of what the product is there for and a very different appreciation of the risk being covered.

One way in which this manifests itself is in the area of the duty of disclosure. Insurers are used to full disclosure and capital markets to due diligence. This difference of approach (reflected generally in price as well) is of key importance. It is important to consider whether or not you want to give (or receive) full disclosure. In many instances it is unnecessary. If the trigger is an industry or parametric trigger, is there any need for disclosure? Even if there is a dual trigger, generally the pricing will be calculated on the objective trigger rather than the indemnity trigger. It is important to consider this at the outset.

Wordings in ILS, as noted, are unique and tailored for the specific deal. There is always a risk of ambiguity in the drafting. Sometimes, the draftsman may not fully understand the deal. Sometimes the understanding of the parties to the deal may vary making drafting impossible or rather certain to end in confusion and possibly dispute.

One is always looking at words to cover an uncertain future event. Clarity is difficult (as it is in reinsurance) but in reinsurance there are the market formulae to fall back on. In ILS, one cannot even look for a market understanding. The counterparty is generally not of the market but comes from a different cultural background. ■

Clive O'Connell is a partner at Goldberg Segalla

Do not wait until

Potential benefits of adverse development year loss reserves appear to be at a point


Ed Hochberg and David Flandro
JLT Re

There is only one thing we ever know about a loss reserve pick – it is wrong. In fact, loss reserve selections will always be subject to more volatility than the selection of ultimate losses because of the leverage of the unpaid portion.

Since the mid-2000s, the industry has benefitted from favourable accident-year loss reserve trends, in large part owing to remarkably low loss inflation and reduced loss frequency. Many industry observers question the sustainability of these factors, and indeed, it does appear that the industry's accident year loss reserves are at a point of inflection. Coupled with the harvesting of earlier loss reserve redundancies on a calendar-year basis, we may be on the precipice of negative loss reserve trends.

With respect to the notion of the loss-reserving cycle, we have observed a definitive set of trends in terms of accident-year reserving. The graph demonstrates these trends for the US property/casualty (p/c) industry.

There are some interesting observations from the graph. One notable trend is good years tend to get better and bad years tend to get worse; the late 1990s developed much worse than originally anticipated, whereas the early 2000s turned out much better. It is likely the main reason was the loss trends factored into original pricing assumptions were significantly different (worse or better as the case may be) from originally anticipated. Another key observation is the more recent years do not appear to be developing nearly as favourably. Fuelled by (arguably) unsustainably benign inflation and loss frequency, the years from 2002 to 2006 developed well; however, with the harvesting of much of these years' redundancies in recent calendar years and the potential slowdown in the favourable loss trends, it does suggest the relative loss reserve position of the industry is not nearly as strong as a few years ago. With more recent ultimate picks appearing less conservative, adverse changes in loss trends could result in net adverse calendar-year loss reserve trends.

US reinsurance

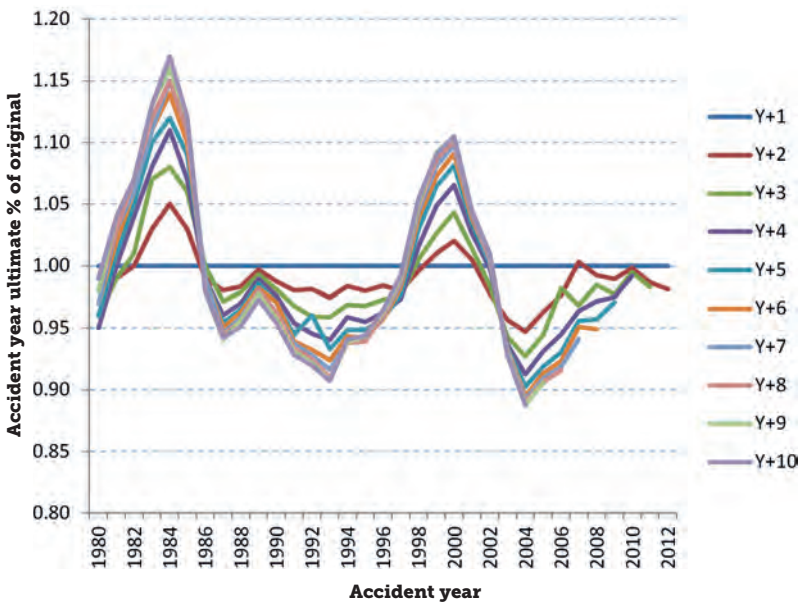

Andrew Holland and Charlene C McHugh
Sidley Austin

It has been almost three years since the National Association of Insurance Commissioners (NAIC) modernised collateral requirements for reinsurance placed with unauthorised insurers when it amended its Credit for Reinsurance Model Law and Regulation in November 2011 (CFR model laws). The amended CFR model laws enable unauthorised insurers to post a reduced percentage of collateral (ie, less than 100%) if they are approved by the ceding company's domiciliary state as "certified reinsurers". The extent of collateral now required (ranging from 0% to 100%) depends on the rating assigned to the reinsurer by state insurance regulators. Since 2011, a number of states have adopted (or are in the process of adopting) the CFR model laws[1]. New York and Florida (the

the loss-reserving trend is negative

coverage for a company's capital management strategy at a time when the industry's accident-of inflection

Graph: Property/casualty accident-year reserving trends



Source: JLT Re, NAIC, SNL data

With the backdrop of the reserving cycle, it points to value of adverse development coverage solutions. Particularly for insurers with long-tail exposure, loss-reserving risk represents a significant (or even dominant) consumer of economic capital. Rating agency capital models, in particular, can allocate 35% to 50% of required capital to loss reserves, depending on a carrier's reserving track record. Moreover, we would suggest there is a stigma associated with adverse loss reserve development, such that the relative value is somewhat worse than other losses. We would attribute this to the fact the overall exposure to adverse development is very difficult to quantify; in contrast to even shock losses like catastrophes, it is very hard to know how inadequate reserves can be. Accordingly, when the loss reserve cycle goes negative, the environment changes; counterparties no longer believe reported balance sheets and results.

What this suggests is even though the industry is perceived to be overcapitalised, important constituencies (rating agencies and investors) place increased value on the capital that supports loss reserves. Evidence of this hypothesis can be observed from rating agency and equity market trends seen during the last unfavourable reserving cycle. From 2000 to 2004, 26% of the top 50 rated US commercial lines writers were downgraded by AM Best and 61% by Standard & Poor's[1].

From the standpoint of investors, one sees the absolute and relative underperformance of p/c stocks during the last negative reserving cycle.

Another disadvantage to the capital tied up in reserves is the historically low interest rate environment. While this certainly correlates with the (helpful) benign inflation trends, it adds to the perception/reality that holding such capital can be a drag on valuations.

Given this backdrop, for many companies, adverse development coverage may add value. Reducing capital tied up in loss reserves can enable companies to enhance capital-management strategies, as well as improve the perception of capital efficiency. Furthermore, rating agencies typically look favourably on such protection, which can help preserve ratings profiles. Having such protection in place can also help prevent the impact on valuation in negative reserving cycles.

If one believes we are at a point of inflection in reserves, the time to implement this strategy would be now. Once the reserving cycle becomes unfavourable it becomes relatively difficult to execute adverse development coverage. With pervasive doubt about loss reserve adequacy, counterparties will find it very hard to come to mutual agreement about the best estimate of loss reserves; with diverging views of the "starting point", transaction execution becomes nearly impossible except in extreme situations. In addition, the market today is relatively conducive to purchasing adverse development types of protections. Many types of markets, including traditional players, hedge fund-backed reinsurers and run-off markets are very active. As such, the market today enables execution of transactions that provide capital at a cost lower than other capital sources. Because of that, several carriers have recently entered into these arrangements on both holistic and specific bases.

Of course, these are not simple transactions to undertake. Besides a reasonably lengthy marketing and due diligence process, a company should plan for extensive "socialising" of a proposed transaction with both internal and external constituencies. Additionally, these transactions can take many forms, including adverse development coverage, loss portfolio transfers/sales and reinsurance-to-close deals (for Lloyd's syndicates), requiring considerable up front work on structure. While beyond the scope of this article, the accounting can also be complex, requiring consultation with internal accountants and external auditors. Still, these transactions can add significant value in terms of protection and capital efficiency and therefore are often worth the investment of time and money. ■

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1) This includes public information ratings. Note: each of the top 50 US commercial lines writers at the time was not necessarily rated by both Standard & Poor's and AM Best, thus the percentage of the top 50 downgraded under each rating agency's coverage has been used.

collateral reform still in a state of flux

latter applying only to property/casualty reinsurance) had already amended their reinsurance collateral requirements before the NAIC amended its CFR model laws.

States that have begun approving certified reinsurers include Connecticut, Florida, Delaware, New Jersey, New York and Iowa. In deciding whether to certify a reinsurer, state insurance regulators evaluate a number of factors, including whether the reinsurer is domiciled in a "qualified jurisdiction" (a country state insurance regulators believe "effectively" regulates reinsurers) and the ratings and financial status of the reinsurer.

Qualified jurisdictions

Through its reinsurance task force the NAIC created a written process to help state insurance regulators determine what constitutes a qualified jurisdiction (the qualified jurisdiction process). In drafting the process, the NAIC recognised the importance of consistency among states and took into account some states (such as Florida and New York) had already, in effect, vetted certain countries when they certified reinsurers domiciled in Bermuda, the UK, Switzerland and Germany. It therefore provided for an "expedited review" for such jurisdictions and, using this expedited process, the NAIC granted conditional qualified jurisdiction status to such jurisdictions. Ireland and Japan have accepted the NAIC's invitation to begin the qualified jurisdiction process.

Through its reinsurance financial analysis working group (RFAWG), the NAIC provides a forum for multi-state evaluations of a certified reinsurer to determine whether a certified reinsurer should be permitted to "passport" into states beyond its initial state of certification. Passporting enables a certified reinsurer to use its certified status obtained in a lead state to become listed in other states' certified reinsurer lists, without having to apply separately for certified reinsurer status in each state.

To passport into another state, a reinsurer first applies for and becomes a certified reinsurer in a lead state. Next, at the certified reinsurer's request, the lead state refers the certified reinsurer to the RFAWG, which confers privately (ie, in meetings not open to the public) on whether to recommend the certified reinsurer for passporting into other states. If the RFAWG makes such a recommendation, states agreeing with the recommendation add the certified reinsurer to their certified reinsurer lists. If the RFAWG recommends against passporting, a certified reinsurer must apply separately for certified reinsurer status in all states where it seeks such status (ie, where its cedants seek credit for reinsurance). As of September 2014, no state has declined to accept the RFAWG's recommendation for passporting (in a handful of instances, the RFAWG has declined to recommend a reinsurer for passporting).

Overall, the RFAWG forum helps expedite the certified reinsurer process by allowing multi-state

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review of certified reinsurer applications (and access to diligence conducted by the lead state) and for "peer review" of decisions made by states on specific applications.

Collateral requirements

The NAIC will be re-examining the collateral requirements set forth in the CFR model laws to determine whether changes are needed (raising or lowering collateral levels; creating new categories of collateral levels and so on). At present the CFR model laws have six categories of reinsurer ratings, which correspond to the amount of collateral required (0%, 10%, 20%, 50%, 75% and 100%). These initial collateral amounts were set with the intent they be reviewed within two years of their use by certified reinsurers.

Finally, notwithstanding the considerable work done by the NAIC and state insurance regulators in changing collateral requirements, it is still possible the US federal government could pre-empt state authority over certain aspects of collateral arrangements related to international reinsurance agreements. For example, the US Federal Insurance Office (FIO) believes the US federal government should negotiate agreements with foreign jurisdictions related to reinsurance collateral requirements. In its December 2013 report to Congress, the FIO recommended specific changes to insurance regulation. While the FIO generally supported state (versus federal) regulation of insurance, it maintained reinsurance collateral is one area of insurance regulation that warrants direct US federal involvement. Specifically, the FIO recommended it assist the US Department of the Treasury and the US trade representative in negotiating covered agreements with foreign jurisdictions.

More recently, the FIO reiterated this suggestion in its 2014 annual report, published in September, in which the FIO also highlighted state inconsistencies in implementing reinsurance collateral reform and questioned the wisdom of relying on credit rating agency assessments of insurers as opposed to "risk-based empirical factors". The report says: "These observations support Treasury's view that in the context of international prudential matters regarding the business of insurance, questions concerning reinsurance collateral should be uniformly addressed on the national level." These views were echoed in remarks made by the FIO's director, Michael McRaith, at an annual meeting of the National Association of Mutual Insurance Companies. ■

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1) While states are not required to allow reductions in collateral, ceding insurers in such states could be disadvantaged. Further, states can no longer impose their credit for reinsurance requirements extraterritorially upon ceding insurers licensed (as opposed to domiciled) in the state. The federal Non-admitted and Reinsurance Reform Act, enacted in July 2010, prohibits a state from denying credit for reinsurance if the ceding insurer's domiciliary state recognises credit for reinsurance and is an NAIC-accredited state (or has similar financial solvency requirements).

Eastern European reins of new licence

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The granting of a special licence to the Ukrainian insurance company Brok-business by the National Bank of Ukraine (NBoU) to post collateral abroad represents the culmination of developments in both the global catastrophe reinsurance markets and the local insurance markets in the central and eastern Europe (CEE) and Commonwealth of Independent States (CIS) regions. It is envisaged this will enable regional companies to provide around $100m retrocession capacity to the global insurance market by insurers in the CEE region over the course of the next three to five years.

One the one hand, there is the collateralised reinsurance and insurance-linked securities (ILS) markets, which are growing very rapidly because of the involvement of non-insurance capital. These markets provide a number of different instruments to enable those who are not professional insurers or reinsurers to participate in the international catastrophe reinsurance market. On the other, there are the local markets within the CEE, the CIS and the Middle East where there is the capacity and understanding to participate in the international cat markets, but where the local markets are not quite developed enough. But these markets have no exposure whatsoever to global cat events; they are not able to participate because almost no company in these markets has an

urers poised to provide $100m retro capacity in wake

adequate financial strength rating as the sovereign rating in these countries, which limits the scope of individual corporate ratings, is well below the minimum requirements of the security committees of international brokers.

Collateral trust

At present the possibility of CEE insurers making use of letters of credit confirmed by A-rated western banks is very limited. This issue is further complicated by the negative attitude on the part of Western banks towards the region. This makes the whole process of obtaining a letter of credit very expensive and very complicated for CEE insurers.

However, one of the broader benefits of the licence issued by the NBoU is it also opens up the possibility of the use of escrow accounts in insurance transactions between companies in Ukraine and companies based elsewhere.

It is also now possible to use collateral trust agreements (CTAs) within the CEE insurance context. CTAs are widely accepted internationally as a simple, clear and efficient way of collateral provision and are frequently used in transactions between local and international banks. So if local financial systems use collateral as a way to attract credit for the economy, why can insurers not use it as a way of guaranteeing their financial performance and reap the added benefit of generating inward premium income for the region as well as increasing the diversification of their portfolios?

However, the CTA concept does not widely exist or is not implemented in the existing legislation in CEE. Indeed, some countries in the region have legislation in place but it is not implemented.

In terms of this diversification, the CEE region represents a primary insurance market with $45bn to $50bn of gross written premium annually, with a good combined ratio and minimal exposure to global catastrophe events. Indeed, many countries in the CEE region usually have one national reinsurer to which the local insurers cede their reinsurance. These national reinsurance carriers are therefore ideally positioned within their local markets to write ILS business to diversify their portfolios. In this regard, they can act as a hub for the amalgamated capacity in their country.

Again, this complements the risk/liability profile of the local markets: many of the domestic insurance companies in the region are part of larger financial groups, usually with banks or asset managers as the shareholders who understand the role of ILS as an alternative asset class for investors.

Emerging ILS

This trend also coincides with the World Bank's policy to encourage emerging states to resort to the ILS market to provide another level of protection for their economies in the event of the country being struck by a major catastrophe. For example, the recent success of the issuance of a cat bond by Turkey should encourage other emerging-country governments or insurance groups to follow that example.

There is, however, one major challenge which needs to be overcome. And this is the lack of understanding and almost complete absence of communication between the state and regulatory authorities in the CEE and the global financial centres. One prime example would be how Bermuda is perceived by central banks and regulatory authorities in CEE. In a number of CEE countries, there are significant regulatory restrictions on transactions with entities based in Bermuda. This is despite the fact 15 out of the 40 global reinsurance groups are based there and Bermuda is a well-established and highly regarded part of the international ILS environment.

To transform this state of affairs will require a sustained process of engagement between the global financial centres and the state and regulatory authorities in the CEE. ■

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