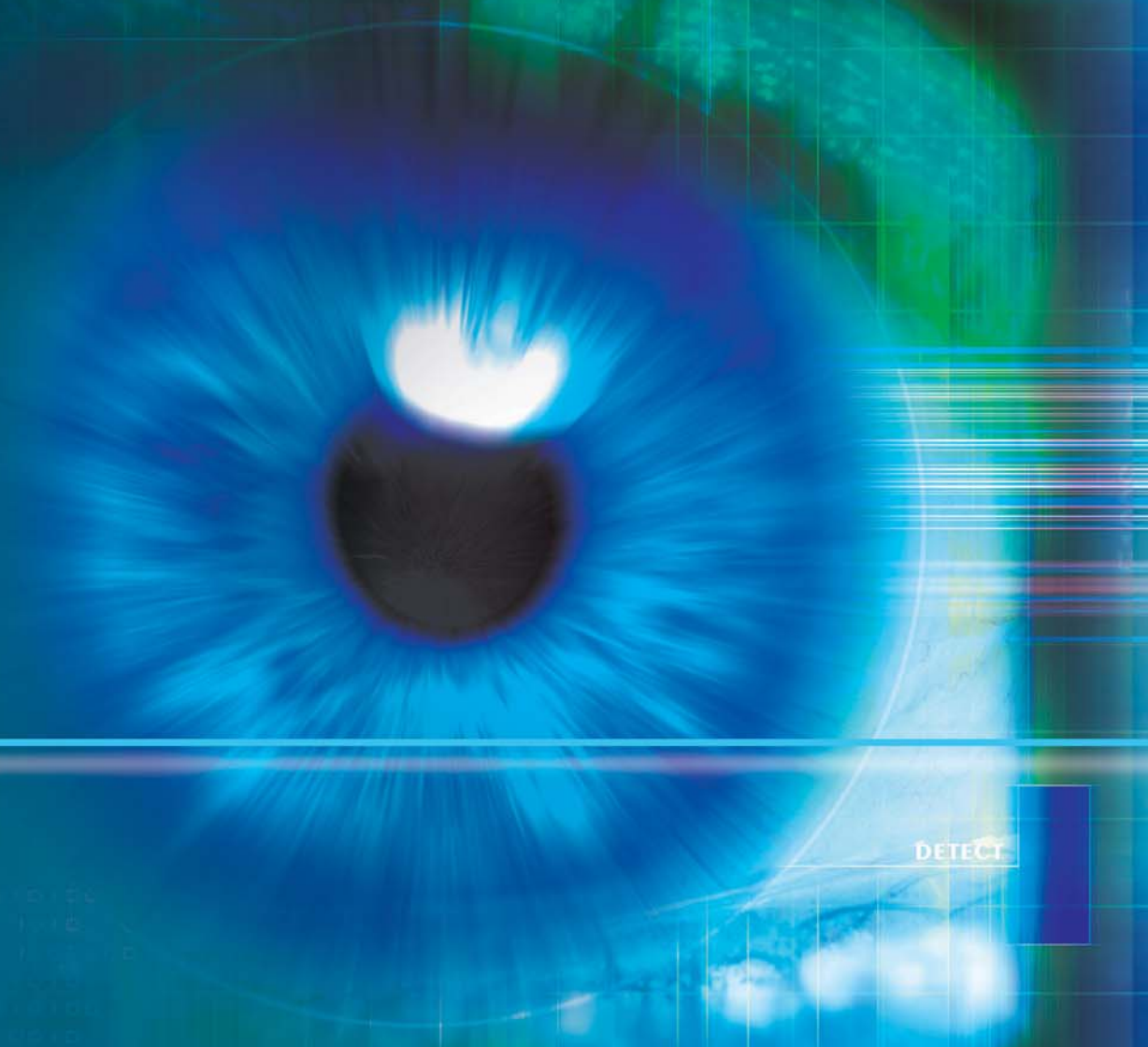


DETECT

A Vision of the Future?
June 2006



Willis

Contents



	Page No.
– A Vision of the Future?	3
– What Do Insurers Want As Policyholders?	4
– Let's look at the structure of the Reinsurer	
– Where is the unease leading?	
– And where are those issues leading?	
– So what do we need to do?	
– What Do The Reinsurers' Shareholders Want?	12
– Where Are The Rating Agencies Headed?	21
– A retrospective look – how good were the views from ten years ago?	
– Are there gaps between the Rating Agencies' Agenda and their Clients' Agenda?	
– Regulatory – What Will Happen With The Upheaval Following Solvency II?	26
– The likely wider impact	

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A Vision Of The Future?

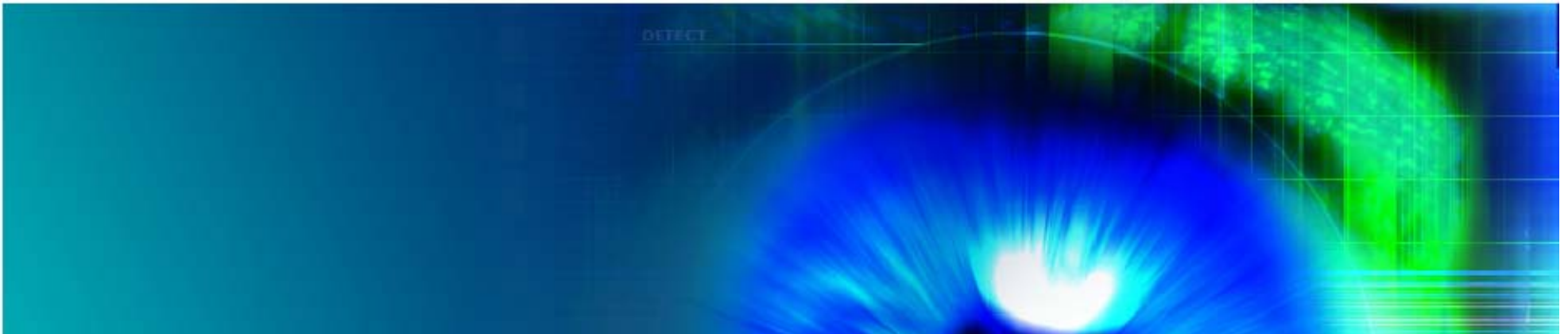


This Autumn sees the fifth anniversary of the World Trade Center atrocity, an event that perhaps even literally shook the world. Within the insurance sector as elsewhere, its economic reverberations are still being felt.

With the passing of five years, we felt this was a good moment to pause and review the evolving shape of the international reinsurance market. Perceptions as to what Reinsurers can and should be have shifted radically; these changes have arisen across the market, in the minds of buyers, sellers, regulators and rating agencies. The face of the market has been transformed; change and the pace of change are fluctuating more significantly than ever before.

The following few short debating notes aim to dissect the key issues and to promote discussion among all Willis' many friends around the world. The "debating notes" are grouped into four general sections. Three of these assess the pressures upon market evolution from the perspective of Policyholders (where the Insurers are buyers of reinsurance), Shareholders (being capital providers to Reinsurers as sellers of reinsurance), and Rating Agencies, while the fourth draws together some important broader themes emanating from the Regulators as the implications of Solvency II become more transparent.

We have many ideas but we cannot know all the answers; your input remains as welcome as ever.



What Do Insurers Want As Policyholders?



We are in continuous dialogue with reinsurance policyholders about what they want. The pressures upon them come from a range of sources. These principally are the issues that drive their shareholder returns but there are also issues of a regulatory nature. All of these in turn vary with the evolution of the market: the key needs of two decades ago focussed upon price, capacity and coverage, while today questions relating to counterparty security and the true meaning of the Rating Agencies' work rise higher and higher up the agenda.

Accordingly we start our discussion by looking at counterparty security questions.

Let's look at the structure of the Reinsurer

Once upon a time ... older style Reinsurers offered a single corporate entity with a single balance sheet to contemplate. Today matters have become more complicated.

Three-wheeled transport?

One obvious and topical issue is the current vogue to create "side-car" vehicles. A side-car is "a small car for a passenger or passengers attached to the side of a motor cycle". One direct insurance client of ours was questioning what this truly meant. "Does this mean that the side-car's business plan is too volatile for the sponsor's management to risk including it in the main entity? If it is not good enough for them, why should it be good enough for me?". Of course there is a more complex story to be told than this allows, but there is nonetheless some basic common sense to the question posed. We develop some "side-car" issues below.

Holding company or local subsidiary?

We have had similar dialogues about the fashion for designing corporate structures for Reinsurers with a principal holding company, whilst certain classes of policyholder are only offered the security of various subsidiary enterprises. Of course there are some important tax issues here, but we are getting increasing concern from clients as to whether the tax questions have gained undue prominence in the order of things.

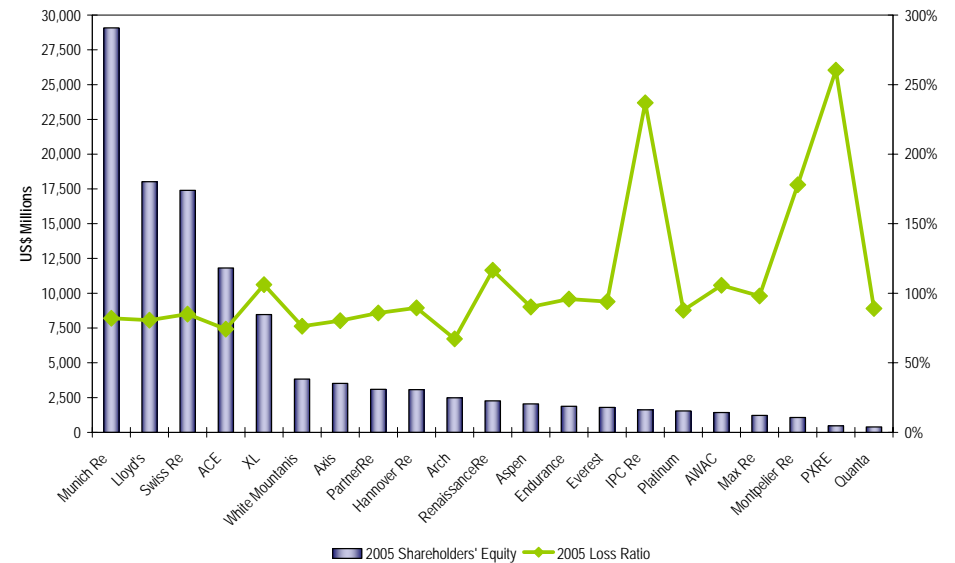
One client commented recently at the extended delays and obstructions they were encountering with collecting claims from a UK subsidiary of a European Reinsurer. This entity is no longer trading today, and unfortunately our client perceived that the intricacy of the entity's past retrocessional quota share arrangements was proving a severe blockage in cash flow. Our client used an image which we thought might be helpful here :- "We never liked this 'local subsidiary' structure from the beginning. At the time we agreed to buy cover from them, it felt a bit like being told, 'Well, our main residence is Windsor Castle but guests like you are only welcome at our country estate in Sandringham'. Now we knew Sandringham was a beautiful place set in many beautiful acres, so we went along with it ... but actually what we truly wanted was to be on terms that gave us an open invite to all our host's estates. And now look where we have ended up." Perhaps it is better that we don't quote here too literally the type of accommodation that was used to conclude the analogy.

What Do Insurers Want As Policyholders?



Structure of the corporate or structure of the portfolio?

Naturally there is structure in the corporate sense, and structure in the portfolio sense. A comparable group of issues to the above surrounds the proliferation of new Reinsurers wanting to specialise in writing property catastrophe business. This is scarcely news, of course, but the implications of the problem are much more transparent to the customer today. Our clients have been asking what kind of balanced business plans could underpin such initiatives. Of course *Katrina* has lit up those questions with bright flashing lights: some Reinsurers with less perfectly balanced portfolios were hit very seriously, and clients have undoubtedly been taken aback by the thought that some of these entities were not so far from being squeezed very much more seriously still. Those same clients were aware beforehand at a theoretic level that property catastrophe as a whole is an inherently imbalanced class, but nothing brings home the truth of the theory so much as a loss like *Katrina*.



What Do Insurers Want As Policyholders?



Reinsurers volunteer information

A consequence of this thinking is the recent development which has seen Reinsurers starting to volunteer information about their retained major loss scenario exposures. Any client who had had the chutzpah fifteen years ago to ask the leading major European Reinsurers to disclose the scale of their commitments to a Californian earthquake or a North European windstorm might well have expected a fairly sharp rebuff for impertinence. Today we see such information being volunteered: the Reinsurers with deep roots and good portfolio balance have seen significant marketing potential in drawing to their clients' attention just how strong and well-balanced their business models are. They make serious mileage out of the "reality check" of how resilient their portfolio was even to this heaviest of American catastrophe losses. One newer entrant to the market even made a voluntary statement as to their business plan's absolute aggregate exposure targets.

And why not? We see these types of disclosure as an evidently desirable phase in the market's evolution. The generic Rating Agency business model has served a number of purposes very handsomely, but as time passes, some of its weaknesses are becoming more transparent. Insurers have liked the simple appeal of using an independent third party opinion, but we hear increasing concerns about the real value of some of these views. If Reinsurers themselves are not comfortable with the levels of influence that Rating Agencies' views have reached (and we hear many concerns at many levels on this score) then the Reinsurers can only help their own cause by fronting up with as much information as they can afford, to enable insurers to form their own opinions on as sophisticated a basis as possible.

We discuss the evolving status of the Rating Agencies in more detail below. For the moment the point is clear enough. Policyholders are beginning to crystallise their views with increasing firmness as to the type of counterparty structure that they want to work with. Single, simple corporate structures are strongly positive; multiple and complex ones are meeting with increasing resistance. Well-balanced, resilient business portfolios encourage strong policyholder levels of comfort; unproven track records are meeting with scepticism.

What Do Insurers Want As Policyholders?



Where is this unease leading?

Two obvious questions raise themselves as the immediate consequence of the escalation in policyholders' security concerns. First, will there be a post-*Katrina* "raising of the bar" to require a higher threshold level of Reinsurer credit rating acceptability for Property reinsurance? Second, is there any sign that some clients are beginning to lose faith in the basic validity of the casualty treaty reinsurance product?

A property question

Our reading of the property question is that clients are already sceptical, in a mature way, as to the counterparty security risk. They clearly do not like what is perceived as the diluted level of security that is generally on offer today in contrast to that perceived to be available fifteen years ago and more. But the issue is broadening out beyond a simplistic matter of thinking about raising the bar in terms (for example) of asking for one higher "notch" of Rating Agency assessments. Insurers appear to be thinking very much more deeply about what has been motivating Rating Agency assessments. This of course is a profound and complex subject. The out-turn from this deeper analysis has been that Insurers' analysis, of who they want to do business with and to what extent they want to accept large commitments, is moving to a level well beyond making a memo-footnote reference to a then-current rating assessment.

In any event, we notice that reinsurance buyers are looking at the gradual slide in Rating Agency assessments with a shrewd weather eye on the broader commercial reality – they want a certain level of catastrophe and other systemic and remote-risk coverage, and need to have a certain diversity of Reinsurer panel to achieve a balanced economic result.

Many buyers feel some form of a pragmatic certainty that there is sufficient commonality of direct-insurer self-interest in there being some form of viable reinsurance market, that at some pragmatic level there is a dependability for a core group of Reinsurers beyond the normal parameters by which these things are reckoned. So the debate about Reinsurer creditworthiness is at least to some degree evolving from an absolute one into a relative one. We have had several clients commenting to us sentiments such as "Well, if XYZ Reinsurer folds up then we might as well all go home".

One might doubt whether Cuthbert Heath would have approved such a perspective, but it would not be the first time that a financial institution has taken a credit decision based upon this type of premise.

So we do not see it as being likely that buyers will be pressing for any general "raising of the bar" as to their property security requirements. Much more evident has been an evolution in client thinking towards specific analysis of specific reinsurance relationships and partnerships that goes well beyond ticking internal analysis boxes. We see this as being healthy for all concerned.

A casualty question

The second question posed above relates to customer faith in casualty as an attractive long-term product for the reinsurance buyer. This of course is a matter with huge implications for Reinsurers: casualty loss reserves and IBNR form the great majority of many Reinsurers' overall general insurance provisions, and the accuracy of the estimations involved is at the heart of the strength (or otherwise) of many of their businesses. A serious long-term shift in buyers' perceptions of the viability of this product would potentially have enormous ramifications for the Reinsurers' balance sheets.

What Do Insurers Want As Policyholders?



The three main concerns turn on the scope for Reinsurers to question the recoverability of claims, the scope for time to erode goodwill and with it behavioural standards, and the absolute challenge of the harsh fact that security risk with a long-term horizon is a quite different quality of risk than one of short-term horizon. The third of these is the biggest threat. But before discussing it in greater detail, it is worth reviewing the first two briefly.

You doubt me and I'll doubt you

We watch closely the evolving nature of claims relationships between clients and Reinsurers. There can be little doubt that the willingness of Reinsurers to question the recoverability of individual claims has risen very materially over the past decade. We have recently had the occasional bad example where even some of the best established market participants have been declining liabilities in contexts where we would absolutely not have expected such responses. There's an old saying that if you live by the sword, you die by the sword: this type of practice is not a good advertisement for the product. Less obviously serious but nonetheless a real issue for many UK buyers is the reality that Reinsurers are being very shy about answering a basic question in relation to the Courts Act: how will they evaluate a court award for a steady monthly index-linked award for the claimant's lifetime as a single nett present value loss amount? One client asked us recently, "How can I decide whether I want this [excess of loss] product if the Reinsurers won't tell me today what they expect to pay for a naturally foreseeable loss scenario?" Of course it is our business as brokers to see things from our clients' perspectives, but we find it hard to understand why Reinsurers do not seem to want to promote their product with greater transparency as to what it is that they are selling.

Where's my product warranty when I need it?

The second issue is an inherent element in long-tail reinsurance. You pay your premium today and you have to take an intelligent view as to the quality of the service that you can expect over the potentially decade-plus lifetime of the contract. So what is new? Well, what is new is that the quality patterns have deteriorated to the point where buyers are beginning to question the basic appeal of the product. We are reminded of a recent conference on Directors' and Officers' insurance, when one of the speakers drew attention to the website of a leading D&O carrier where at the time there were no fewer than 29 references to the word "rescind" or "rescission". His comment was that "this is a bit like trying to sell cars by advertising 'Look how often our cars get smashed up'".

How far is the horizon?

As noted, the third issue is the real concern. In an earlier era when there seemed to be almost a super-abundance of top-rated security competing for business, the difference between making a decision about security in a short-tail context and security in a long-tail context was not something that seemed quintessential to the process. Today however buyers are thinking very much more deeply about this issue. A twelve-month credit risk that might have been evaluated once as being a 99.75% probability of meeting its liabilities will compound, if viewed over a ten year horizon, into a 97.53% probability of meeting its liabilities. Clearly not as appealing as the short-tail alternative, the compounding of the time horizon nonetheless delivered an outcome that many buyers found acceptable. But look what happens if the first assessment is newly analysed as being positioned at 98.75%. The ten-year compound works out at 88.18%. This of course puts the Reinsurer creditworthiness assessment process into an entirely different perspective.

What Do Insurers Want As Policyholders?



And where are those issues leading?

The fear here must be that there is an element of a “vicious circle” in operation. The buyers are becoming suspicious of structural aspects of Reinsurers’ businesses, both in corporate framework and in portfolio balance. They are also looking at the pragmatic reality of what is happening with the product that they have been buying, and inevitably asking the question as to whether this should be seen as being at all as attractive as it used to be.

Could it be lose-lose – a vicious circle?

The “vicious circle” is this. The more the buyers grow in wariness as to the virtues of the product, the more they retain for own account. The more this happens, the less well balanced is the overall offering to Reinsurers. The more that happens, the less can be the ability of the Reinsurers to build structurally sound portfolios. The harder that becomes, the higher is the requirement for the margins and for the return on the capital employed on the part of the Reinsurer. The worse this becomes, of course the less attractive the offer from the Reinsurer can be.

So what do we need to do?

Naturally the Reinsurers would like to see clients recognising the inherent difficulties that they are facing. “Don’t just cede to us your most difficult exposures” is a plea that we hear from Reinsurers more than just occasionally. But clients are not charities – they are businesses who have often very sophisticated internal disciplines; there are some risks where they have a serious need for coverage, and others where it is marginal.

If Reinsurers want more than just the “serious need” zone, they need to look at the “marginal” zone and see what they can do to smarten up the product.

It’s not just better lipstick that’s needed ...

The phrase “smarten up the product” sounds glib and superficial. We chose the phrase deliberately for effect, because of course what is needed is a profound and far-reaching review – indeed, something that is absolutely far from being glib or superficial.

The following sections consider just how far-reaching a review may be needed.

What’s “serious need” buying, what’s “marginal”?

The “serious need” zone has been present in insurers’ buying practices for many years, albeit that not all of them have always bought all that they perhaps might have bought. But very little attention has ever been given to the question “what proportion of total buying has been ‘serious need’ buying?”. The “marginal” zone has been heavily present, partly thanks to post-war capital shortages, partly thanks to some sophisticated marketing by Reinsurers, and partly thanks to some elements of less than wholly sophisticated underwriting by Reinsurers over periods in the 1970’s and 1980’s. Indeed one might well suspect that for many decades the “marginal” zone has exceeded the “serious need” zone in size, perhaps at times to the point of dominating purchasing habits.

Hence if the entire element of the Reinsurers’ business that constitutes “marginal” buying is being put under close scrutiny, we are debating a huge proportion of the total arena of transacted reinsurance.

What Do Insurers Want As Policyholders?



And it's the "marginal" piece that's the tasty piece?

Naturally the "serious need" zone contains the catastrophe accumulation risk and other difficult-to-assess exposures. The converse of this is that the "marginal" zone contains the greater part of the business that helps the Reinsurer balance its business.

The working excess of loss layers are an obvious case in point: most buyers are under pressures not just to contain external reinsurance spend but (particularly in the light of Solvency II, as we discuss in some detail below) also to contain the scale of their balance sheet external reinsurance recoverable asset. Similar issues surround a substantial element of the proportional reinsurance market.

Money-back guarantees – has the time come for at least a 90% option?

It must seem a long time ago now, but it was in 2000 that Willis published a document that detailed the leading options of the time for Downgrade Clauses. These were not in widespread use at the time of writing then, but the concept caught on very quickly. Insurers aim to pay a premium to a Reinsurer of a certain level of credit standing as at the date of purchase.

If during the course of the currency of the transaction the Reinsurer's credit standing is reduced, the usual Downgrade Clause provides for the insurer to cancel at suitably proportionate terms. There are of course a range of variations upon this theme.

To us it was self-evident, then as now, that this was a reasonable proposition. The quality of counterparty security on offer from the Reinsurer has always been an absolutely fundamental element in the reinsurance transaction. We have not been surprised over the past six years to see that market forces have found in favour of this principle, although there remain one or two Reinsurers who still find it hard to accept, albeit that even they appear to be recognising that this is not a sustainable stance.

The problem for many clients lies not in the Property arena, where the Downgrade Clause is in good use and provides a broadly fair outcome. Rather it lies with the Casualty and other longer tail reinsurance products, where a downgrading can arise one or more years after expiry and this still acts as a very material prejudice to the quality of the product that the customer understood was being bought at inception.

What Do Insurers Want As Policyholders?



"Reinsurers have been listening to rating agencies who have been promoting the idea that "downgrade clauses" are a serious threat to Reinsurers' stability. The banking sector have been trading for centuries on the basis of offering an open promise to repay depositors with funds that in reality would be hard for them to find at short notice. Indeed, the banks would scarcely exist but for that promise. Yet the reinsurance world is facing a crisis of confidence in the more general creditworthiness of the Reinsurers, and the response appears to be not to engage with the customer ("how can we make our product more appealing to you from a credit risk perspective?") but rather to retreat into the shareholder shell ("how can we make our business plan seem more robust to our shareholders?"). To me the bank that seeks to control the pattern of payback to the customer is almost advertising its own insecurity. How enormously attractive to the customer is the guarantee that if at any point in time you are worried, you can have your deposit back? Even a promise to return a deposit shorn of a 10% haircut would be a real gain. "

("Inside View" Article in Reinsurance Magazine, April 2006)

We were glad to see market debate on this issue being stimulated by comments such as the quotation shown above, which prompted a number of positive pieces of feedback from various of our clients. What is it that is blocking progress here? We used a car manufacturing analogy earlier; another will help us here. Those car manufacturers who promoted their products as being supremely well-built and therefore extra safe have nevertheless succumbed to market forces and incorporated airbags, literally to cushion the impact to their customers of anything going wrong. Of course an airbag is an extra expense. But these days it is common sense – you have to have them.

Happily we are beginning to see concessions in this direction. Reinsurers with less than ideal credit standing are increasingly offering casualty coverage with (for example) Letter of Credit collateral against 100% of known outstandings, subject to a minimum of 80% of premiums for the first three years. In a similar vein, we at Willis have pioneered and promoted a carefully crafted Commutation Option clause which gives the client the right to recover something broadly approximating to the casualty excess of loss "loss portfolio", duly discounted for the time value of money. But Reinsurers have dragged their feet and have been slow to see the need to offer this type of product. If they want to promote themselves in the "Marginal Need" arena rather than just offering "Serious Need" products, this surely is the sensible direction.

And are there marginal needs in the other direction?

This is an interesting question, where it is good to see that the arena of risk transfer is rich enough that there are classes of business where the issues are complex enough that only a minority of insurers feel the need to offer the coverage. These are mostly specialist and niche lines such as Warranty and Indemnity, Residual Value Insurance and the like. But even a class such as Directors' and Officers' has developed, at least in the context where evident USA exposures arise, to a quality of uncertainty that many insurers themselves see no compulsion to offer it at all. By a parallel process, the willingness of Reinsurers to offer facultative or treaty reinsurance for these classes has become very much a "free vote" issue. Insurers accordingly can find themselves in a situation where they are looking to Reinsurers for help and not the other way around.

What Do The Reinsurers' Shareholders Want?



We see at least three distinct styles of shareholder in the modern reinsurance environment. This emanates from the way in which we have evidenced the capital markets moving beyond their traditional role as providers of equity and debt capital to the reinsurance industry, to an increasingly visible and direct involvement in the sector. This new role is quite unlike that of a conventional equity investor. The three types are :-

- the "old values" holders of older Reinsurers' equity (and/or the supporters of their rights issues)
- the pioneers of new-equity Reinsurers (with short-and/or medium-term horizons); and
- the investors in Catastrophe Bonds and those Hedge Funds that accept risk in direct form

Doubtless some interests might participate on all three bases. Modern financial markets offer all options so it is as well to be realistic and recognise that to do one is to compete with those who do the others.

We discuss the implications of this complex and fast-evolving world under broad headings :-

- the new game-plan post-*Katrina*
- factors drawing Capital Markets to the Reinsurance Sector
- factors drawing older Reinsurers to Capital Market practices
- the Catastrophe Bond Market
- Basis Risk issues
- Side-Cars
- Looking Ahead into 2007

Lastly we will close this section with a look at Bermuda, London and the changing role of the Reinsurer as regards some elements of direct policy practice.

[Post-Katrina - the new-style Reinsurer's gameplan? Is property cat a stand-alone business?](#)

Following the unparalleled devastation caused by the 2005 hurricane season, there was much debate about how the reinsurance market might react. Would those companies that were principally associated with writing only Property Cat exposures diversify into other areas such as Casualty, or would they aim to maintain their status quo?

The principal advantage of multi-class diversification is obviously the use of more than one "basket" in which to keep one's "eggs". This not only provides crucial portfolio balance, but also has the pleasing side-effect of requiring less capital. A possible tactical disadvantage might be a concomitant fall in the perceived return on capital, but one might have imagined that prudent shareholders would take a longer-term view and thus prefer to see volatility reduced, possibly at the expense of potential short-term returns.

Yet this is only part of the motivational story. Capital markets have looked with some reservations at the historic business models of the more traditional European Reinsurers, and undoubtedly there have been reservations about the depth of tail exposure that is generically part of writing a mainstream casualty account. As a direct consequence of those reservations, capital markets were willing to finance new Reinsurer ventures that were expressly focussed upon writing short tail property exposures. The concept was that if the pricing was right, Property Cat could make a viable stand-alone business model.

What Do The Reinsurers' Shareholders Want?



The theory might have seemed good at the time ... but of course with the passage of time and the pressures of market forces towards pricing in competition with other Reinsurers who enjoyed diversification benefits both as to capital and as to portfolio, the difficulties facing this concept have proved to be significant. The jury must remain out for some time as to the true future for this type of business model – Property Catastrophe is far from a simple risk class and its exposures are clearly not standing still with time. Cyclical market pressures will take their toll over time too. Customer attitudes likewise are far from reaching a fully rounded consensus. The likely scenario must be that market forces will make it difficult for pure stand-alone property catastrophe vehicles, who may be squeezed by contrast with diversified multiline Reinsurers whose capital models (and whose multi-class cross-selling flexibility) will encourage them to offer a more appealing product. But the sheer demand for vertical limits, which as we note below in the Solvency II discussion is likely to rise, may prove key in maintaining the stand-alone model framework.

Factors drawing capital markets to the reinsurance sector

The broad investment environment of recent years has been characterised by :-

- a surplus of capital seeking asset classes in which to invest, coinciding with
- a time of unspectacular returns in traditional investments
- a low interest rate environment (although this is now arguably changing)
- perceived high equity prices
- again a perceived over-supply of private equity capital and
- in an increasingly global marketplace, a dearth of uncorrelated investment opportunities

These circumstances have led to the emergence of new breeds of investor personified by the hedge funds and private equity funds. Some of these have identified reinsurance sector opportunities that address many of the above factors. This of course stands out in some contrast to the actual performance of the reinsurance sector. In particular, investors have noted the broad lack of correlation between event risk and the performance of the broad financial markets. Driven by a desire to enhance returns by investing in instruments that are generally decoupled from financial market risk, and perceiving that high potential returns may be available in a capacity-constrained reinsurance market, investors have been led to consider and assume more direct and targeted involvements in reinsurance risk. This is taking two main formats, through the issuance of Cat Bonds and the creation of "Side-Cars".

Conversely, factors driving Reinsurers to capital markets practices

There is considerable pressure on reinsurance industry capital, following reinsurance losses arising from two unprecedented US hurricane seasons. Key issues include revised risk perceptions, the recalibration of risk models and rating agency expectations. These pressures have manifested themselves in a lack of traditional reinsurance capacity for peak zone exposures, particularly on a retrocessional basis. There are also concerns regarding the credit quality of Reinsurers, the appeal of current pricing levels, and the coverage expectations of remaining retrocession providers.

What Do The Reinsurers' Shareholders Want?



The traditional Reinsurers' business models in turn are struggling with forward planning. This is due to :-

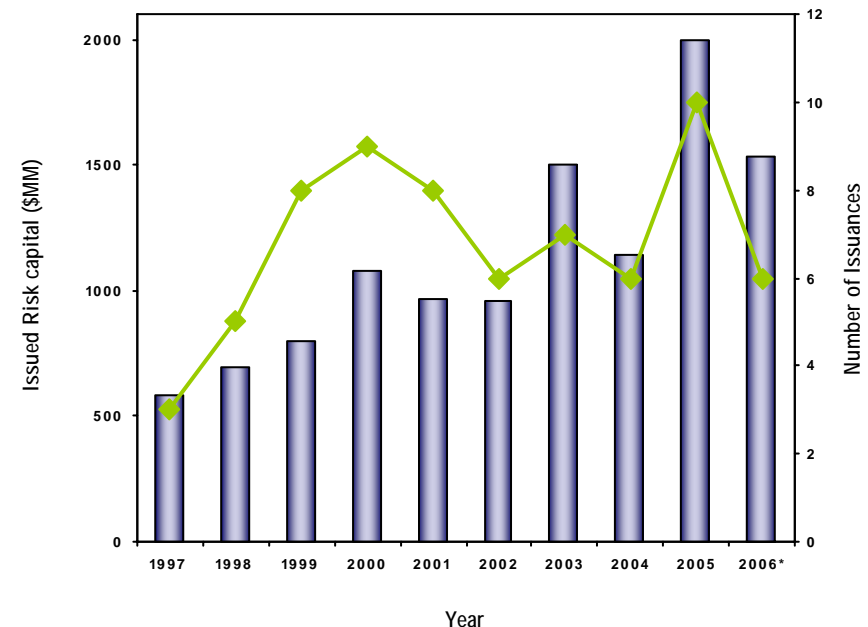
- lack of certainty that retrocession cover may be available on a long-term, stable basis
- the recognition that tail risk exposures, such as peak zone catastrophe risk, may not be capable of financing on a sustained basis by equity capital
- the consequent need to de-risk the balance sheet by means of the use of off-balance sheet risk absorbing instruments

The Catastrophe Bond market

Catastrophe Bond technology has existed for some ten years now. A sophisticated and relatively extensive non-insurance industry investor base has existed for some five years, with investor demand consistently outstripping supply. Until 2005, prices crept downwards, as did associated costs and expenses. But the Catastrophe Bond market was slow to develop. With the exception of a few committed sponsors, most transactions effected were "one-offs" and were largely experimental in nature. One deduces that Reinsurers continued to provide peak catastrophe cover supported by equity capital at less than the cost of the alternative capital. Not only was this cover relatively cheap, but it was simple to arrange and was based on the conventions of the traditional reinsurance sector: ultimate net loss and utmost good faith.

The hurricane seasons of 2004 and 2005 forced new thinking, particularly for US peak catastrophe exposures. The jury appears to be reserving judgement in other territories (the market seems to be pricing a 1/100 risk in Australia, for example, as a considerably better risk than a 1/100 risk in the US) while one should never forget that large earthquakes can occur in many unexpected places. As traditional reinsurance capacity for peak US perils has first escalated in price and then melted away in scale (and pretty much disappeared altogether when the risk is on a retrocessional basis), Reinsurers have found themselves looking much more closely at the Catastrophe Bond arena.

P & C Cat Bonds: Issuance Volumes
*as at 8th June 2006



What Do The Reinsurers' Shareholders Want?



The year 2005 saw a record level of catastrophe bond issuance, much of it taking place in the last quarter of the year. The trend has continued into 2006. In May 2006 alone, more than \$1bn of catastrophe bonds were issued, of which about a third were exposed to US hurricane. The investor base, which always felt it was pricing cat risk correctly, has clearly remained robust. Some Hedge Funds have even positioned themselves to accept some catastrophe risk on a direct basis. The investor market is finite in size and, in parts at least, has succumbed to the temptations of other event-risk related investment opportunities (side cars and new start-up Reinsurers), but it is still there. Sceptics might say "Of course it is", given that probably only one Catastrophe Bond will experience losses as a consequence of hurricane Katrina. But the moral appears to be growing that the "first take" of the Capital Markets – to be uncompromisingly precise as to what event they were covering, and to ask what at the time felt like a lot of money for it – has proved to be resilient.

Basis Risk issues

The same sceptics will point to the basis risk that exists between most catastrophe bonds and the underlying risks assumed by the sponsors of such transactions. But who if anyone is making an error here? Is it the reinsured that has accepted risk onto its balance sheet on a blanket basis covering all perils, including risks it has not even contemplated, or the capital market investor that likes to define and parameterise the risk it is assuming?

"Basis Risk" is the risk that loss payment under the bond does not exactly match the actual loss experience of the Reinsured. It can be positive or negative. Basis Risk comprises something of a gulf that continues to exist between the capital markets and the re/insurance industry.

Should we expect traditional Reinsurers to move to the new model, or the new model to drift in the other direction? In a capital-driven world, one would have thought it might be a fair bet as to which view would be likely to prevail. The capital markets may well yet redefine the way in which the reinsurance industry assumes and manages peak catastrophe risk. And those pioneers of insurance risk securitisation that have absorbed a fair volume of criticism over the last ten years may yet be claiming the credit for a major evolutionary step forwards in this field. Clearly there is much dust to settle, but it must surely be safe to say that the Catastrophe Bond will play a significantly greater role going forward.

Side-cars

Side-cars are very much a phenomenon of 2006 and the current market conditions. Although rating agencies appear to view the existence of a side-car as neutral as far as the sponsoring firm is concerned (a surprising conclusion from our perspective, particularly where gross risk assumption is involved), the question has to be asked: who is deriving the greater benefit, the sponsor or the investor?

Side-cars come in different guises. Some are structured on a one-for-one basis whereby the investors collateralise every dollar of limit written to the reinsured, but most are geared, the first two or so large losses being collateralised whilst residual exposures fall back to the sponsor. From an investor's perspective, an investment in a typical side-car looks like a geared investment in a portfolio of catastrophe bonds. The investor becomes more "first loss" but is rewarded with a much greater return, receiving the substance of premium from the entire portfolio of risks ceded to the side-car vehicle despite not being in a position to pay all the losses that could theoretically arise.

What Do The Reinsurers' Shareholders Want?



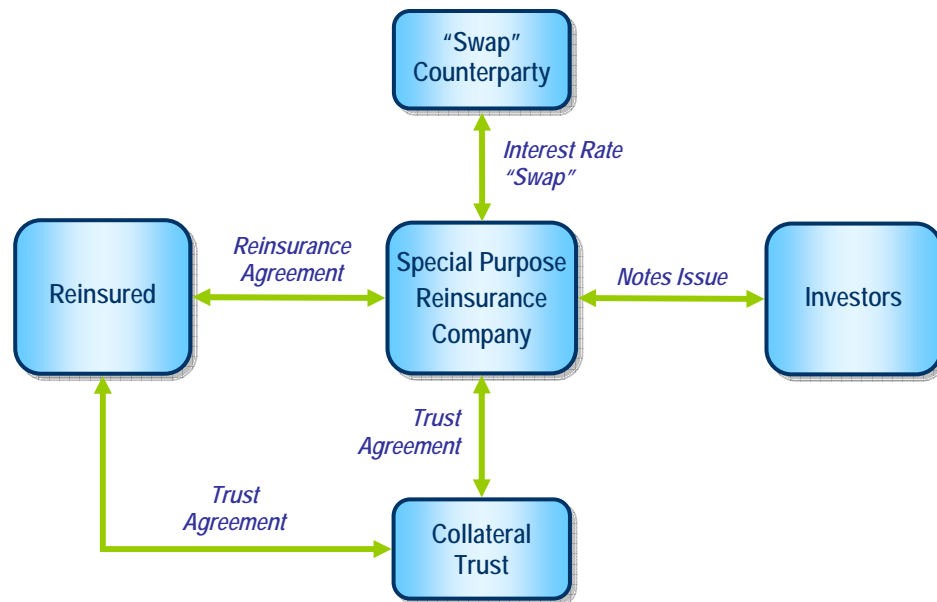
Clearly this is a very attractive proposition to a certain type of investor who is prepared to accept the lower transparency of a side-car investment (Ultimate Net Loss cover, written within guidelines), in return for an opportunity to earn high returns over a short term. So why do rating agencies seem unconcerned and, similarly, the shareholders of the sponsor? The benefits of the side-car are that it offers the sponsor the ability to maintain or increase its lines in certain areas of business and to earn an over-rider and profit commission from that business. The rating agencies seem happy provided that the side-car appears able to meet a worst case scenario assessed at say two 1 in 250 year losses. The fact that in return for an over-rider the sponsor must surely have increased its risk of ruin (it has written business that it otherwise might not have been able to and has ceded away the premium, whilst retaining residual exposures) may be being overlooked. Then there is the non-renewal risk. Most side-cars are contemplating two year life-spans, at the end of which outstanding risks return to the sponsor on a pre-defined basis. If it has been a good couple of years, both parties will be satisfied. The sponsor will have built up capital and may no longer need the side-car. If it has not gone well, the investors will most likely walk away and the sponsor will be left with a problem, although by then this may well have evolved into an opportunity.

So the contention that a side-car is “sticking plaster” merits consideration. But we also see wisdom in understanding side-cars as a natural “half-way-house” between the parameterised Catastrophe Bond on the one hand and the full-blown new carrier on the other. Investors have become a little cautious of new carriers, originally set up with sharply defined rules of engagement, but developing into entities with a momentum of their own that is drawing them back towards traditional Reinsurer cultures.

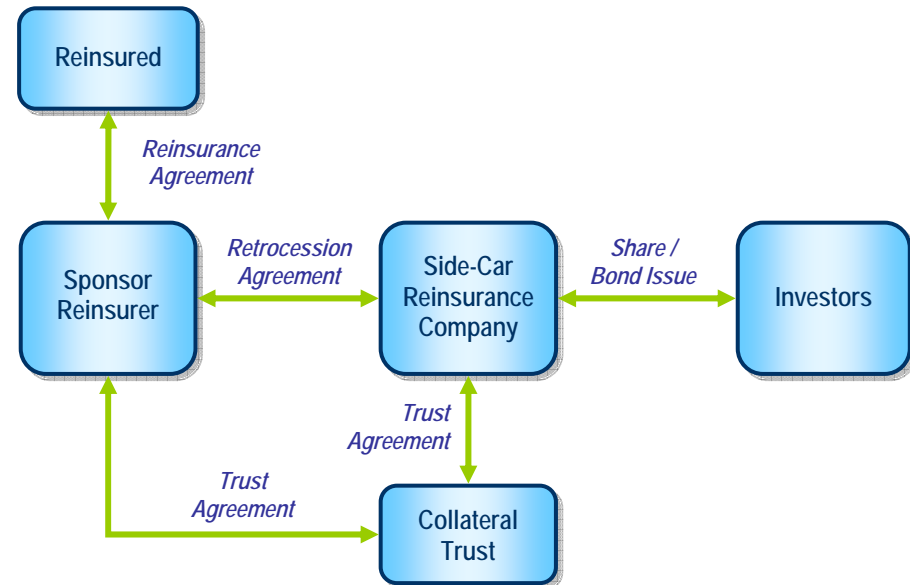
What Do The Reinsurers' Shareholders Want?



Cat Bonds



Side-Car (Typical Structure)



What Do The Reinsurers' Shareholders Want?



Are these factors expected to be prevalent in 2007? If you don't need me, please don't use me!

The short answer as to 2007 is "Yes". But there is much more to be read into the current situation.

The confluence of interests of Reinsurers and capital providers, now operating increasingly openly in competition with one another, has been evidenced by market activity in the final quarter of 2005 and in 2006 to date. This embraces capitalisation of new Reinsurers, establishment of side-cars, increased catastrophe bond activity, and even some private placements with hedge funds. It can be expected that this activity will continue into 2007, but much will depend on the experience of the 2006 US hurricane season, and the occurrence, or non-occurrence, of other large catastrophic events during the course of this year.

This expectation of a severe hurricane season in 2006 has already been taken into account in the capital markets, as evidenced by the limited supply of first event US Wind cover at an attractive price. Should the 2006 season turn out to be more benign than expected, investor and Reinsurer confidence can be expected to increase. A worse than anticipated season will have an adverse affect on Reinsurers' balance sheets and investor perceptions and would likely signal an even greater upheaval in the reinsurance markets.

Separately, a major financial and/or political event could have consequences on the availability and expectations of capital.

So, assuming a "normal" hurricane season (one wonders what this might be) and no other major catastrophe or financial markets event, what role can the capital markets be expected to play in the reinsurance sector? We included the clip-quote above, *"If you don't need me, please don't use me"*, to illustrate what we see as potentially a key issue ahead. Mainstream Reinsurers are bound to be in a key position to see as much catastrophe business for the key target zones as they want to – indeed, for some time they have been working to optimise their use of such aggregate capacity as they have in those zones. Capital Markets are offering, whether through Catastrophe Bonds or through Side-Cars, to top up the capacity that is available from the more traditional Reinsurers. But for the key zones there is no need for competition – there is a substantial surfeit of demand over supply. For all three types of vehicle, the negotiation is ultimately with the primary carrier's self-insurance option.

How far will Reinsurers succeed in dictating direct policy coverage conditions?

As we have discussed above, we are likely to see a continuation of the trend that sees insurance companies retaining more risk. This must surely mean at the personal and small commercial risk level that any pressure that might be brought to bear by reinsurance companies, to tighten up the original policy terms and conditions, should almost certainly be diminishing.

On the other hand, at the larger industrial risk level there is every sign (and most noticeably so in the casualty arena) that the larger leading Reinsurers are very deliberately setting out to reposition themselves to enable them to exercise real direct influence on direct policy coverage conditions.

What Do The Reinsurers' Shareholders Want?



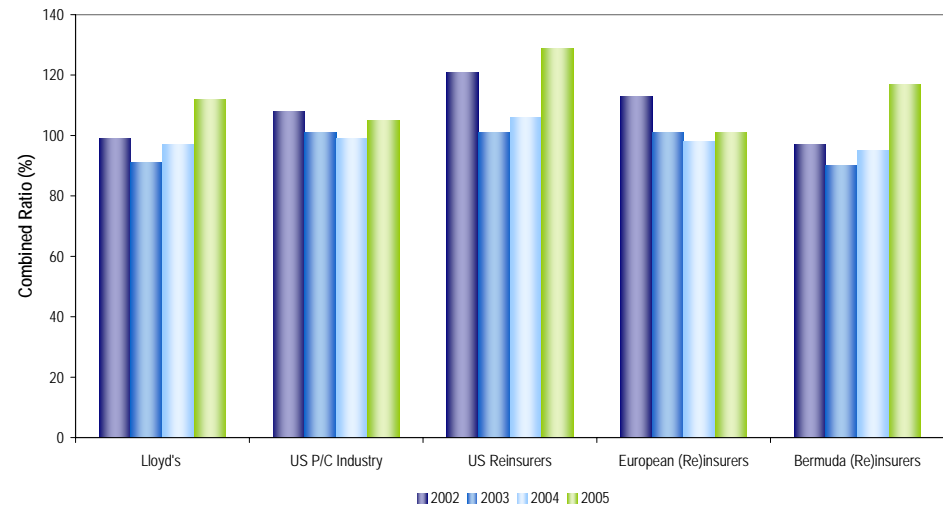
One large Reinsurer commented to us that they estimated they held in excess of a fifth of the total market coverage for some of the largest liability risks in one particularly exposed field. "If we carry that much of the risk, why should we not be properly engaged in the setting of the parameters, both as to price and as to coverage?". We wonder a little of course how far this approach is sustainable: if this type of argument is taken to its logical conclusion, one could begin to see a case for such an approach being newly situated as a direct excess insurer, for what truly is the role of the insurer at such a point? One insurer commented, "Where the Reinsurer is asking to determine the direct conditions to this degree, we wonder why they don't roll up their sleeves and negotiate the terms for themselves?".

The role for Bermuda

Since the 1960s, Bermuda has developed and grown, not always steadily, into what is now one of the world's leading offshore centres for risk finance. Bermuda plays host to thousands of international companies, and particularly since the WTC tragedy, hundreds of insurance companies have been incorporated on the island. More than 30% of the world's top 40 global Reinsurers now call Bermuda home, and as the US and European Reinsurers continue to feel the painful legacy of the last soft market, so Bermuda's financial capacity has soared. Several Lloyd's entities have been particularly active in creating Bermudian subsidiaries, with Amlin and Hiscox leading the way and setting up reinsurance companies capitalised to tune of \$1.5bn. Indeed some former critics of Bermuda companies have decided that if they can't beat them, it may be advisable to join them. Other new companies funded from the US include Validus, Arrow Re and New Castle Re.

This much of course is familiar territory. The real issue ahead lies in whether the lighter regulatory touch that characterises the insurance and reinsurance sector there is possibly going to prove to be some form of Achilles Heel for the market there, or whether the tax advantages which entities based there enjoy will prove sufficiently strong to win through. This isn't something that it makes sense to make pronouncements upon, for the range of professional activity in Bermuda is simply huge, and there is little in the way of generalisation that is likely to be helpful in such a context.

Combined Ratio Comparisons



Source: Lloyd's

What Do The Reinsurers' Shareholders Want?



Reinsurer strategies

The events of the last ten years have caused a seismic shift in the underwriting appetites of Reinsurers. The five years from 1997 saw the Casualty markets produce some eye-watering results (mainly US driven). More recently the Property and Marine markets have been similarly devastated by the 2005 hurricane season. The resultant increase in risk aversion combined with a more disciplined approach, with "corporate underwriting guidelines" and "decision-making by committee" putting on a fine double-act, has meant that the market is in danger of losing the "balance of risk" and with it the long-term viability of the traditional reinsurance product itself. In the international casualty arena, there are clearly fewer mainstream markets than there were, prompting Reinsurers to be more aggressive on both price and terms / conditions, which in turn encourages clients to retain more and manage it in-house. Going forward we are likely see cedants ceding even less risk, with retentions rising further, an increase in the use of aggregate deductibles and a continued tightening of terms and conditions. As we know, cedant / Reinsurer relationships are not what they were, loyalty is a protected commodity and "credit risk" is now an all too familiar phrase in the vocabulary of reinsurance buyers.

One perspective is perhaps worth consideration. The proliferation of management incentive schemes that are rooted in the possibilities created by the Stock Option principle has become so extensive that one should pause and contemplate the potential real-world implications of them. When management is succeeding, of course the stock options all seem well merited and problems are not so evident. But when management is failing and the stock price is fading, the very existence of stock options can be a dynamic hazard for shareholders. Management's own situation will have become precarious with the fading of the stock price.

The dynamic may work as follows. Management may quite possibly be contemplating the prospect of early dismissal if they cannot do something fairly radical to address the stock price pressures. This perversely creates an environment where management may find themselves looking hard at corporate decisions which otherwise they might never have contemplated – they are at risk of concluding that the only rational decision to take is to accept disproportionate risk, since this is the only realistic game plan that promises to deliver the quick profits that will stabilise and re-orient the stock price. In this situation of course if the gamble comes off then all seems well and good. But the prudent shareholder should surely want to have some dynamic constraints in place to avoid this type of situation arising.

What Do The Reinsurers' Shareholders Want?



To be fair, regulators have been increasingly active in pursuing the need to monitor the exposures being carried by insurers and Reinsurers. The regulatory team at Lloyd's in particular have shown good leadership in this context. We hear many complaints about the burden of regulation, but it is not so often that people acknowledge when it is serving a valuable purpose. Of course it was at Lloyd's that some of the "excesses" of the Spiral Market ended by causing some particularly acute problems, so perhaps it is fitting that regulation has been vigorous there. Nonetheless it is good for once to be able to applaud this type of work.

[Where is the strategic thinking of leading London market operations heading? Is London's role increasingly distribution as well as placement?](#)

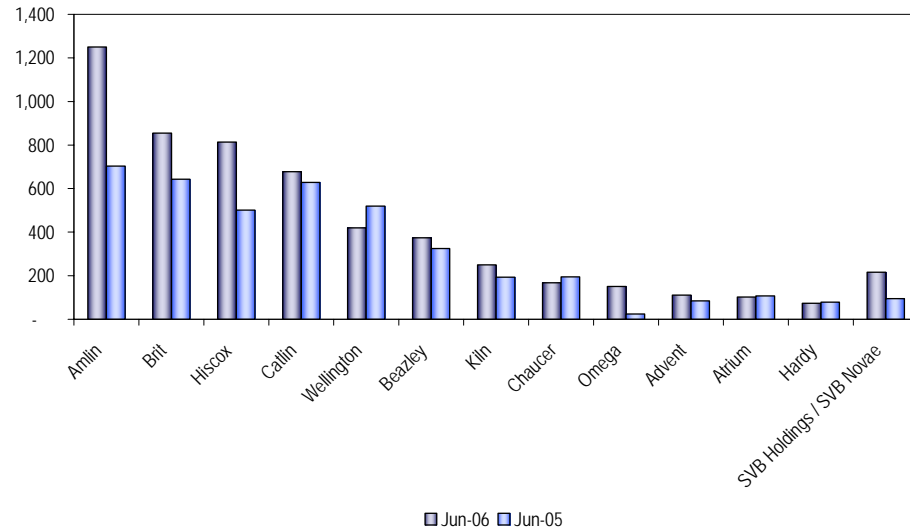
The future for London is undoubtedly a matter of key interest for many strategic thinkers. The remarkable resilience of the City of London across many decades and in many forms of financial services has long been the source of admiration if not envy. It has equally been the source of strong impressions if not continuing surprise. London is not infallible – there was a time when it held significant hegemony for many leading USA treaty programmes, but this was long since transferred to the USA and Bermuda. Much the same has happened more broadly with the world's stock exchanges, where America undoubtedly plays the pivotal role. But London remains a key centre, perhaps the key centre, outside of the USA.

We track the chart (overleaf) the evolution over the past twelve months of the London Stock Market's view of LSE/AIM-listed Lloyd's operations. As one might expect, there are winners and losers, although the volatility across the different cases is considerable, and some care needs to be taken with rights issues and the like. Some practitioners were anticipating more in the way of merger and acquisition activity; we have generally been wary of making predictions of this nature given the significantly personal nature of the critical skills deployed in this field. We have remarked in past publications how many Lloyd's practitioners have sought to establish for themselves a range of options as to platform; this trend has continued during the past year.

What Do The Reinsurers' Shareholders Want?



Market Capitalization of Listed Lloyd's Vehicles, £ millions



But what is undisputable is that primary direct insurance clients continue to seek out London as much as ever. Both European markets and Bermuda have been vigorous in asserting their case to be considered as a key option for risk acceptance, and in some cases the key decision-making certainly rests outside London. If there is a hint of a tendency, it might be that the emphasis may have moved slightly towards London being the focus of the orchestration of the process, rather than London being exclusively the end-outcome as the destination of risk placement.

Market Capitalisation data is not adjusted for rights issues, dividends and similar.



Where Are The Rating Agencies Headed?



We hear many conflicting views expressed about the role of rating agencies in the insurance/reinsurance sector, and the way that this has grown over the past two decades. Many market practitioners comment that their influence is undue – “an excess of power, with a shortage of responsibility” is a typical theme.

Of course it is a tidy option for a reinsurance department to have an external assessment to look to for guidance. But we see matters as having moved beyond that, as the following discussion notes will illustrate.

A retrospective look – how good were the views from ten years ago?

We often feel that the debate and scepticism in the market is less than fully informed about the broader impact of rating agencies upon the community. One obvious context where we could all take steps to improve matters would be in the absolute analysis of historic performance as regards the ratings of Reinsurers. How good were the views of three, five and ten years ago? We believe it would be absolutely healthy to be able to consider the data and provide analysis on the past performance of the Rating Agencies. Indeed, we wondered about asking the Rating Agencies if they would like to provide input and to engage them in debate to illustrate the quality of their Reinsurer rating assessments over a period of time. Unfortunately, we did not have sufficient time to do this properly prior to publication of this review.

However, we were able to develop some material to assist in progressing our thinking here. There are some cogent, market-wide issues that make the two tables below difficult to interpret; we discuss these in detail below. We should also like to stress that we make no claim to any authoritative conclusion on the matter; we are offering only a quick and simple analysis of the most basic facts over the past decade. But the results are nonetheless fascinating to consider.

The following two exhibits show how the credit ratings of the 40 largest companies by Net Reinsurance Premiums Written have been transformed since 1996.

Where Are The Rating Agencies Headed?



Standard & Poor's

Current rating	AAA						2*				2
	AA+						1*				
	AA						1	1	3	1	1
	AA-	1	1*				1	1			6
	A+									1	1
	A						1*	1			2
	A-							1			1
	BBB+	1*									
	BBB										
	NR	2*		2*				1			
	<BB		1				1	1	1		
		<BBB	NR	BBB	BBB+	A-	A	A+	AA-	AA	AA+

Rating as at Aug 1 1996

AM Best

Current rating	A++							1	1	2
	A+		4					5	4	2
	A		1					2	5	1
	A-		1						1	
	B++								1	
	B+									
	NR			4						1
	<B+							2	1	
		<B+	NR	B+	B++	A-	A	A+	A++	

Rating as at Oct 1 1996

Where possible we considered the position from the policyholder perspective – in other words, if the policy obligations of a rated entity have been novated, the position we try to reflect is that of the current security.

This of course is only a simplistic analysis. There are several important notes that should be made; in the course of discussing them, we will look at one or two tentative comments of interpretation.

- There is a comprehensive movement towards downgrading over the period. This is widely appreciated through the market. However whilst this by itself is a disappointment, it is far from the only lesson that we can draw from the tables – there is scope, for example, to test out the correlation of movements independently of the general downwards migration. We leave the reader to do this but we were surprised at the results
- Both the absolute downwards migration and the “migration-adjusted” levels of variation are well outside the expectations of S&P’s own matrices. The Best’s tables are in a slightly different position in that they did not rate some of the largest Reinsurers at the beginning of our exercise. But this is not to say that matters are bad today – it is a statement only about how they were a decade ago
- Matters are clouded by past use of unsolicited “public information” rating assessments. S&P has now ceased to issue this type of assessment on predominantly reinsurance entities

Where Are The Rating Agencies Headed?



- Four of the forty Reinsurers considered are now within the “vulnerable” range of ratings or have visited this part of the rating agency ranges before being withdrawn. They are Constitution Re, Gerling-Konzern Globale Rueck, Zurich Re North America and Centre Re. Neither S&P nor Best’s appeared to spot the potential long before it happened, at least insofar as it was reflected in the assigned rating. Each of these companies carried ratings comfortably in the “A” range; indeed, as recently as 2002, all of these companies had ratings in the S&P “AA” range. In this context it is worth remembering that S&P’s average cumulative default rate over a 10 year period for a AA rated company is 1.05%
- All four of the above companies were assigned ratings that were identical to those of members deemed “core” to their respective groups. In each case, other core members from those groups have since continued to trade with ratings deemed at least secure. This prompts one to ask the question – How core is core?

Our expectation would be that a more detailed analysis on the performance of the rating agencies in the reinsurance sector over the latter half of the past ten years would likely show an even more marked pattern. We believe that the rating agencies on the whole continued to upgrade Reinsurers during the soft casualty market right up until September 2001. The reaction of the rating agencies to the impact of 9/11, the falls in global investment markets and of reserve deterioration announced through 2003 caused perhaps the first wide-ranging realignment of the sector’s ratings for many years.

Naturally the whole rating process has been engaged in an evolutionary development. It would not be appropriate to judge today’s skills by state of the art standards of ten years ago. But we can see quite clearly that reinsurance customers are becoming restive as to the meaning and impact of ratings, and an undeniably sensible step forward in this debate would be a greater level of transparency as to the quality of their output.

The rating agencies do publish cumulative transition matrices over various time periods and do publish default probabilities associated with their assigned ratings. Although there may be debate over their statistical significance given its modest size, we feel it is vital to see detailed, transparent data for the reinsurance sector. Every investment fund uses its twelve month, three year, five year and ten year track record (where available) as a key means of self-promotion. Now how long can it be before customers of the rating agency product insist upon the same type of transparency?

Where Are The Rating Agencies Headed?



Are there gaps between the Rating Agencies' Agenda and their Clients' Agenda?

"Start-up" ratings

Rating agencies have been generally unwilling to assign an 'unsolicited' public information rating to a company without a meaningful track record demonstrated in at least a few sets of annual statements. However, for many years it has been the case that a rating can be assigned to a start-up that subscribes to the interactive rating process. In this context it must be remembered that ultimately the subscriber has the ability not to announce the rating. Presumably, with most reinsurance clients demanding a rating starting with an "A", this is one reason why we see few 'B' range ratings of start-ups. All of the "Classes of 2001 and 2005" started life with at least an A- rating, with no sign of a B anywhere. One infers that those that could not pass this exam were unable to get investor support, which gives some testimony to the power of the rating agencies.

Clearly there are variations in the attitudes of the rating agencies and their willingness to base a significant part of the rating on a business plan and a management track record. This issue is perceived to be a significant one by many clients – they face a problem in that they don't want an unrated Reinsurer and they are wary of trusting a "start-up" rating from a single source. The rating agencies will continue to refine their methodologies for start-ups. Problems in this arena appear unlikely to be resolved by the tweaking of a model. Is there a case for a clear distinction to be made to designate a "start-up" rating? There is currently little history to prove or disprove the validity of the ratings issued to start-ups in the past five years.

Nonetheless, one thinks of examples such as one of a company with a relatively short history, springing from nowhere to reach the very highest credit standings, only to fall away into non-trading oblivion – does it really serve the longer term objectives of either the rating agencies or their clients for this to happen?

Property analysis vs Casualty analysis

Another question we hear raised is that of whether the rating perspective takes the term of exposure into account, and if so how? Some companies with a certain type of portfolio structure might have a certain quality of appeal for short-tail buyers, but equally might be very much less satisfactory from the perspective of long-tail buyers. The world has got so refined and complicated in so many ways that it seems natural if not inescapable that rating agencies develop in this direction.

There is a link-up here with Solvency II which is worth thinking about. The lower levels of security normally accepted for shorter tail reinsurance exposures carry actuarially targeted failure expectations of the order of 0.6% when viewed on a five-year horizon. Some property catastrophe upper layers can take as long as five years to reach payment, most obviously for earthquake losses when loss adjustment may require considerable technical input and debate. In a Solvency II context where 0.5% is likely to become a standard yardstick, consideration may need to be given to factoring some of this risk into capital adequacy calculations. Rationally it should only be at the fringe that any of this would impact most short tail purchasing, but the equivalent calculation for longer tail buyers illustrates quickly why most casualty purchasers operate to a materially higher set of security criteria.

Where Are The Rating Agencies Headed?



Longevity of claims paying capability vs longevity of willingness to pay claims satisfactorily vs longevity of underwriting consistency

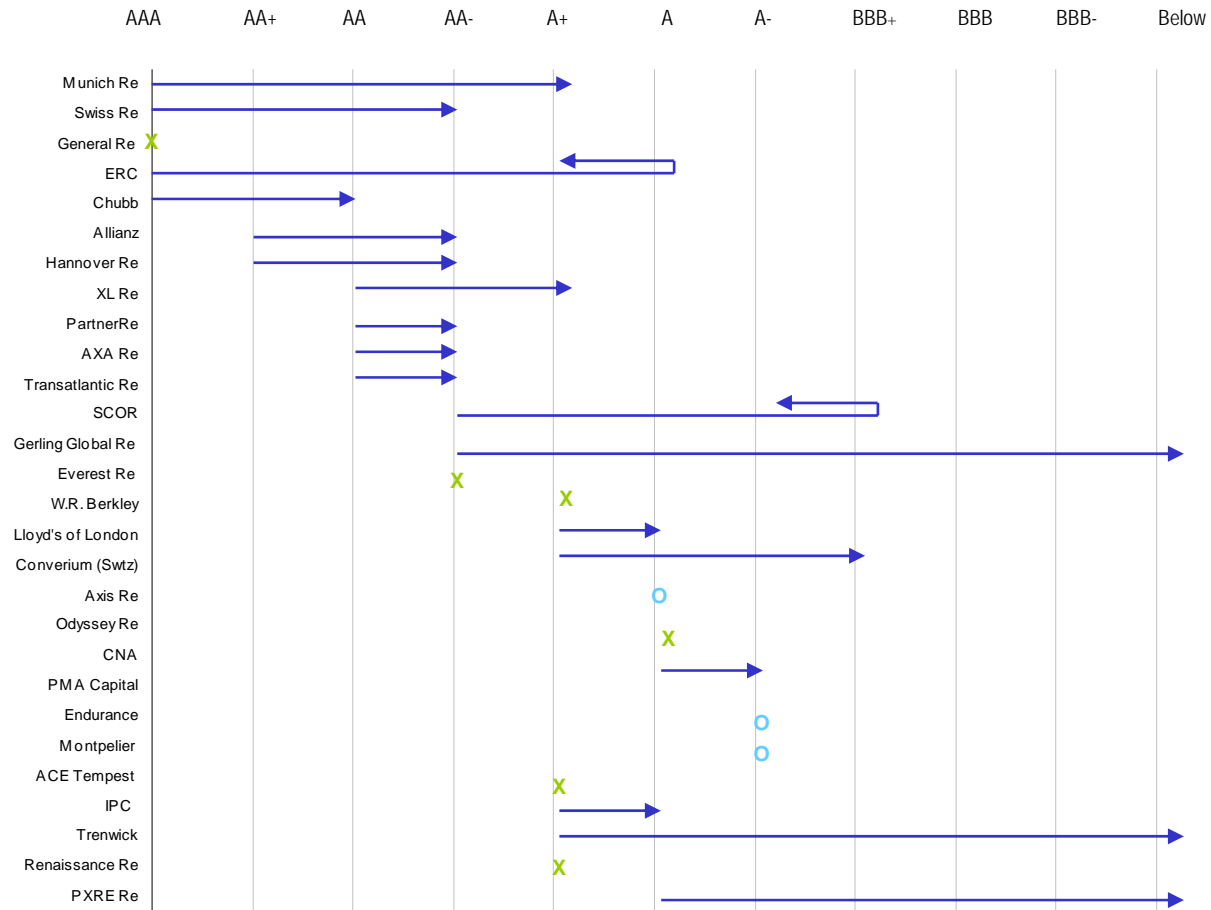
Some Reinsurers are explicitly established with a short-term life span intention. Clients are bound to wonder how rating agencies include this within their assessment. Most of our clients are immensely aware what a long-term process it is to be buying reinsurance. While there is clearly a case to be made for exploring options with all types of counterparty, it must be bizarre these days to think that a single rating scale could possibly bracket together on level terms, first a business with a clearly stated 36- or 48-month horizon, with second a business supported by decades of steady trading track records.

A more subtle distinction must exist as regards issues like underwriting consistency and willingness to pay claims, but the common theme of the above is that the existing palette of colouring available to rating agencies is becoming increasingly constricted as to its ability to differentiate Reinsurers helpfully for twenty-first century insurer clients.

Where Are The Rating Agencies Headed?



Standard & Poor's Rating Movement Major Reinsurance Markets, Sept 2001 – Jun 2006

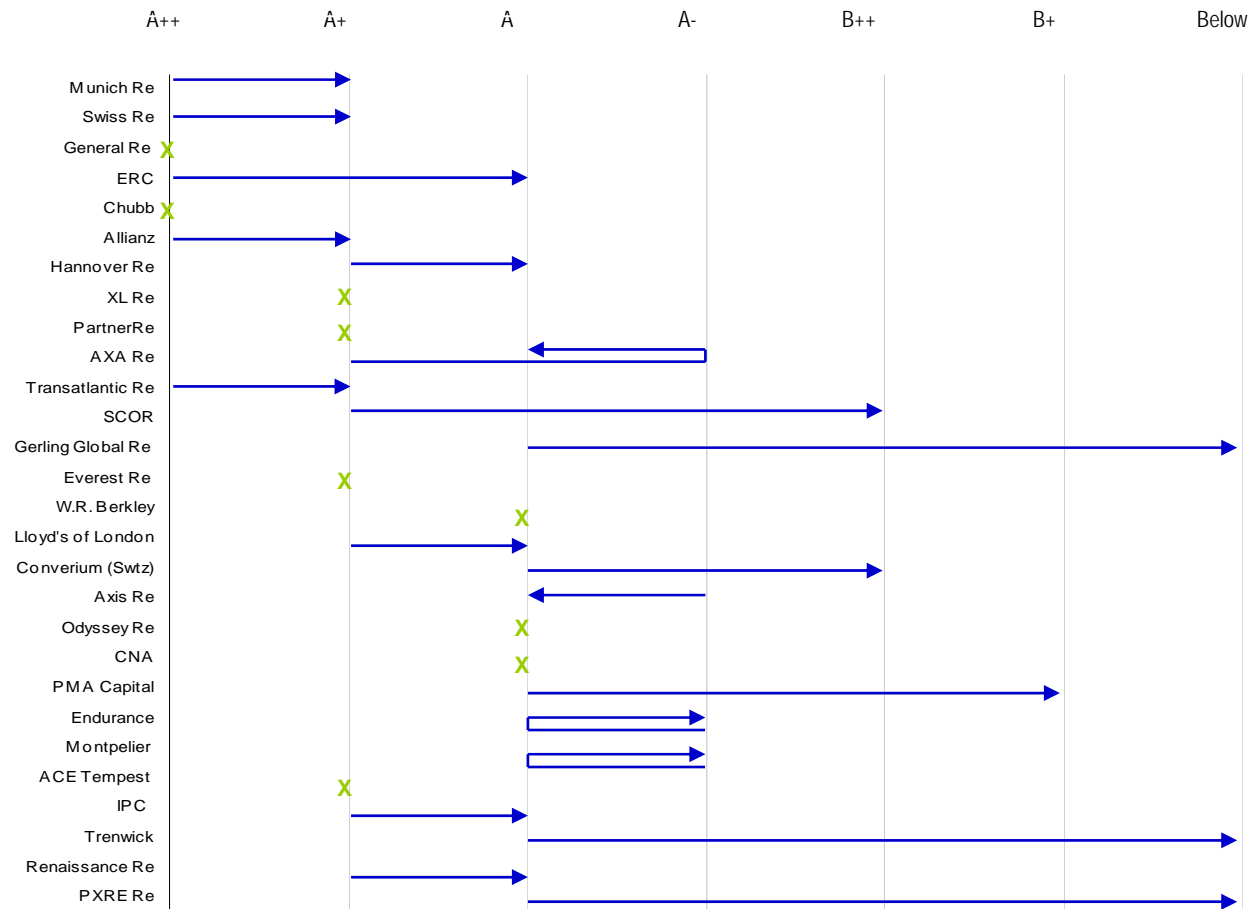


Blue lines denote movement between Sept 11 2001 and Jun 14 2006

Where Are The Rating Agencies Headed?



A.M. Best Rating Movement Major Reinsurance Markets, Sept 2001 – Jun 2006



Blue lines denote movement between Sept 11 2001 and Jun 14 2006

Regulatory - What Will Happen With The Upheaval Following Solvency II?



Our clients are rapidly moving towards a fundamentally different way of thinking about risk as compared with the regime that held sway say five years ago. The world-wide influence of the International Association of Insurance Supervisors (IAIS) has given rise to a substantially simultaneous repositioning of perspective in a significant number of International markets. The message as to the immediate context of the upheaval involved is beginning to be appreciated. However what is less clear is where it will lead. The notes below give some suggestions as to what we see as being some probable implications.

The six core categories of risk are far from being stochastically independent silos. We discuss all six individually below, but it is not a complex insight to perceive for example that a sufficiently large market loss could coincide with (if not actively trigger) any or all three of a Reinsurer credit risk, a liquidity problem and an asset value disturbance. Following this six-part analysis, we look more broadly at the likely impact of these issues.

Underwriting risk

The Lloyd's market has provided some very helpful examples here with its Realistic Disaster Scenario "RDS" disciplines. Much of this type of analysis has been around for quite some years, so this element of Solvency II is unlikely to herald new patterns of insurer or Reinsurer behaviour.

However the sharp improvement in regulatory disciplines across the insurance and reinsurance sector has been part of a wider process that has generally lifted the regulators into "pole position" in many International markets. Recently we were shown some comparable questions raised by one of the better-known rating agencies, and we were struck at the relative lightness of their impact when set along side the relevant regulatory demands. More broadly, this theme has provoked a shift even in the last two years as to the scale of cover required. We could instance the UK market, where in 2003 it was not uncommon for an insurer to look at buying catastrophe cover to a 1 in 100 year risk, perhaps with a 10% modelling risk uplift. Today the contrast is that a 1 in 200 year analysis has become predominant.

Of course this has not meant a doubling of coverage requirements; but what we have undoubtedly seen has been a more conservative market stance on the main RDS risk. In some markets this has happened already; in others it is surely likely to follow.

Regulatory - What Will Happen With The Upheaval Following Solvency II?



The graph below illustrates the enormous variations in modelled loss exposures that different companies can have in different territories and with different mixes of business profiles. For each company, we show the one in 100 year (and 200 year and so on) loss picks, firstly on a gross basis and secondly on a net basis. Obviously the proportions of gross to net vary with the extent of reinsurance purchasing, but the varying impact of different types of exposure peril and different reinsurance structures is very striking.

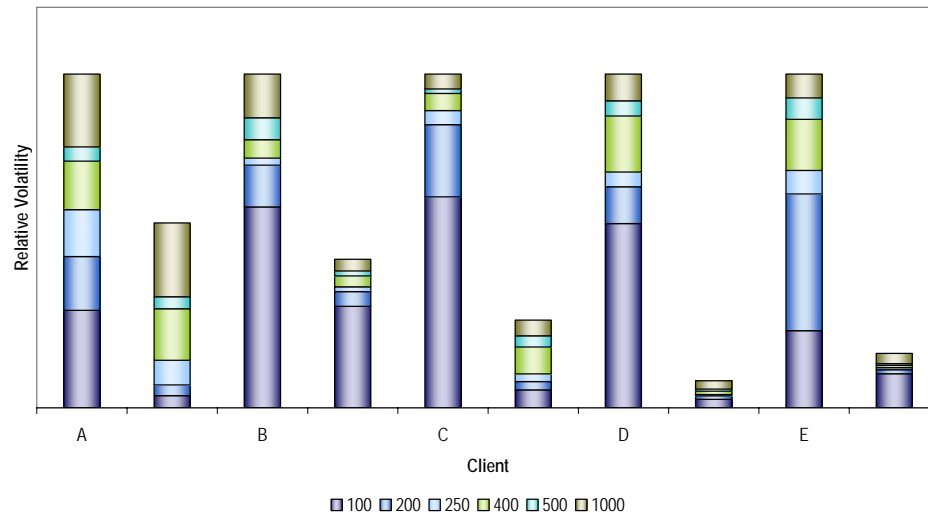
Reserving risk

At the risk of stating the obvious here, we need to differentiate between liabilities on the one hand and the capital necessary to support those liabilities on the other.

The EU has made a policy decision that pending the introduction of Phase 2 of International Accounting Standards, it expects outstanding loss provisions to be valued for solvency purposes at the net present value ("NPV") of the expected ultimate cost of the claims, including a prudential margin. It has now sent away its experts to tell it what it means by NPV and prudential margin. As a working hypothesis, a figure of the 75% confidence level of the probability distribution has been suggested.

It will come as no surprise to those who do not already know this, but this concept is not being well received by the respective governments' taxation experts. The tax authorities, at least in the UK, are for obvious reasons very much against the idea of prudential margins. Their standard position is that they expect estimates to be at the 50% level, and they then try to discount this for net present value. Whilst one can readily see their self-interest in taking this standpoint, it must equally be obvious that in the long term the community needs insurers to operate with civilised levels of reserving risk management. The proposed Solvency Margin, defined as the excess of assets as valued, over the liabilities as valued, has to be sufficient for the company to trade forward one year with a probability of greater than 99.5%. There will be a public hearing in Brussels on June 21 2006, where a progress report will be given.

Exhibit D - Relative Volatility



Regulatory - What Will Happen With The Upheaval Following Solvency II?



The IAIS has promoted an obviously sensible pathway here, whose broad wisdom it would be hard to dispute.

Credit risk

The Credit Risk section of Solvency II embraces all forms of credit exposure, from supplier and agent through investments to reinsurance broker and Reinsurer. Obvious shifts here will be to shorten terms of trade for many agents and to look for sharper performance from reinsurance brokers and Reinsurers. Smaller agents and brokers are going to find rising pressures on their businesses; the greater operational certainties associated with working with larger brokers (doubtless with their generally larger Errors and Omissions programmes) are going to see a shift away from using "boutique" arrangements.

More complex here is the question as to whether insurers are going to look more critically at the total scale within their balance sheet of their external reinsurance recoverables. We have just seen that the demand for vertical coverage generally is likely to rise; but here we see a real reason to expect that insurers are going to want to contain their external Reinsurer credit risk. The obvious implication is that the use of proportional reinsurance (other than with one or another form of collateralisation) is likely to feel the squeeze; and similarly the buyers are going to look rather more carefully at the virtues of buying working level excess of loss protection, particularly on the casualty side. Here again the Reinsurers need to look long and hard at their offering: simply stacking up "security loadings" and other price surcharges will only serve to drive away the business that they most need for balance.

Operational risk

Around the world the flight to quality operational risk management is at quite widely varying stages of its natural evolution. However the trend to sharper contract certainty around the world is unmistakeable. This too will enhance the position of the major intermediaries.

More frustratingly for leading management executives is the opportunity cost of key management time being allocated towards creating corporate disciplines strong enough to "raise the game" in the context of operational risk. Some of this can be accomplished by the use of external advisers (we at Willis have assisted a number of our clients in this arena) but in the last analysis there is bound to be a shift towards better practices which has its cost. Clearly this will not change the life of the average sales telephonist very noticeably, but it will be felt more at middle and senior management levels. Once again this issue is likely to be managed very slightly more easily by larger corporate entities than smaller ones.

A parallel theme here is that emanating from a range of new corporate governance initiatives, whether those in the US (Sarbanes Oxley), the UK (Cadbury, Greenbury, Higgs) or more broadly around the world. The increasing call for greater presence and impact of external directors is causing significant difficulties. The pool of talent in this field was never enormous. We do not anticipate a major shortage of people who might be willing to step forward (albeit that the availability and price of Directors and Officers coverage is an increasingly uncertain matter) to help in this context, but it must be doubted whether it will be feasible to find a sufficient number of people who are able to make the overall quantum-leap of improvement in corporate disciplines that is the central objective.

Regulatory - What Will Happen With The Upheaval Following Solvency II?



Market risk and liquidity risk

These are the last two of the six risk categories addressed under Solvency II. Here the main shift in market positioning appears to have taken place in the past five years rather than being something that needs to be allowed for as a major adjustment issue for the coming five years. It has been said, perhaps with more truth than is easily calculable, that non-life insurers suffered greater equity portfolio losses after the World Trade Centre loss than they did from the immediate insurance consequences of the catastrophe itself. The repositioning that ensued over the years from 2001 to 2006 has probably absorbed the majority of the likely impact of Market Risk to the non-life sector.

The likely wider impact

Capital allocation

It must be inevitable that capital allocation will become materially more focussed. Shorter tail lines with lower catastrophe risk will find that they can be written to slightly thinner margins as the return-on-equity implications of their lighter capital requirements become felt. Conversely and more noticeably, the longer tail lines will more transparently be seen to need more capital, and management attitudes will adapt accordingly. The cost of maintaining longer tail reserves will also be higher; casualty pricing must feel the impact of all these.

A corollary will be that per-class diversification will become increasingly attractive. Monoline insurers will find the pinch of the absence of diversification benefits at the capital level. Even multiline insurers will operate with improved disciplines in this context.

Reserving and the tax implications

This is a matter of potentially enormous implications for the tax structure of insurers' balance sheets. If the need to establish substantial prudential margins gives rise to greater effective capital needs, then there is a competitive implication as compared with other environments where such prudential margins may not be required. There would be a more specific competitive issue for new prudential margin requirements as between environments where tax relief is and is not obtainable. The tax "take" in environments where the tax relief is obtainable might be expected to be heavily cut, which of course might stimulate some undesirable debates about alternatives such as Insurance Premium Tax. The alternative, where the tax is collected regardless, of course makes the generation of adequate shareholder returns an even harder proposition.

Naturally these issues all affect casualty lines very much more seriously than property lines. It might arise that working layer reinsurance acquires a new appeal since its costs would attract immediate tax relief, unlike the equivalent balance sheet reserve predicated by the above debate.

Analytic intensity will rise

The past decade has seen a simply enormous and pronounced development in the non-life sector's use of actuarial and other analytic capabilities. It's not clear whether we will truly be saying to one another "You ain't seen nothing yet" as the impact of Solvency II is more broadly felt, but it does seem inevitable that the focus upon an escalating use of analytic skills is sure to intensify.

Regulatory - What Will Happen With The Upheaval Following Solvency II?



We at Willis have seen a dramatic increase in all our analytic capabilities, both centrally and more widely across the full range of our more local offices, and the trend is showing no signs of abating.

Pressures on correlating catastrophe risks will mount

This must militate towards greater demand for a less well-balanced reinsurance product. This is a theme that we have dwelt on above, which will gradually move towards greater pressures upon Reinsurers to deliver a cost-effective solution in an environment that is not likely to become any simpler.

The “flight to security quality” will continue

This last point is finally something to warm the better-placed Reinsurers’ hearts. Of course the debate about who stands where in this context will rage long and hard, but there is an undeniable appeal to the thought of responding to any Solvency II pressure upon Reinsurer receivables and the like with a riposte such as “but look how we have improved the quality of our Reinsurer panel”.

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