Strength in numbers

Tim Evershed advises that insurers must flex their financial muscles and prove their ability to adapt to testing economic times if they want to retain their customer base

BARELY A DAY PASSES without further disturbing economic news. Record losses are being reported by banks around the world, several of which are now owned by taxpayers. Although the banking sector is at the heart of the current downturn, there are real fears that the contagion will spread further into the financial services.

There have already been casualties in the insurance sector, most notably American International Group (AIG), and so corporate insurance buyers are more interested than ever in the financial strength of their insurance provider.

More than ever buyers want to know if their insurer is financially secure - that it has adequate capital to meet claims and will be around for the long term. Many buyers no longer feel they can rely on reports from the rating agencies, putting an increased onus on insurers to reassure their customers by other means.

The travails of the banking sector have been well documented from the nationalisation of Northern Rock in the UK to the collapse of Lehman Bros in the US, with governments around the world still struggling to turn the crisis around and restart the flow of credit.

Those (re)insurers that have been worst affected by the crisis, such as AIG and Swiss Re, have been those that were involved with banking instruments such as credit default swaps. However, last year insured catastrophe losses totalled $45bn putting a strain on capital at a time when raising additional funds is not straightforward. Added to that, (re)insurers traditionally invest in the stock markets, but share prices have been falling lower with each bout of bad news. In early March, the Dow Jones share index fell below 7,000 points for this first time since 1997, while London's FTSE 100 was at a six-year low and Japan's Nikkei at a 26-year low.

However, it appears that some insurers have learnt their lessons after a combination of 9/11 and the end of the dot.com bubble previously hit their equity portfolios. "The British insurance industry entered the current period of market turbulence in a far stronger position than in 2003. Firms have, for example, changed their business models and now rely far less on equity holdings. Above all, working with the Financial Services Authority (FSA), firms have introduced a new generation of risk controls, which require them to use realistic numbers for assets and liabilities and stress the actual risks their business will face," says Peter Vipond, Director of Financial Regulation, at the Association of British Insurers (ABI).

Some feel that stronger regulation will be a boon to those who can demonstrate their capital strength by complying with Solvency II, the proposed risk-based capital regulatory regime for insurers and reinsurers in the European Union. The European Parliament has approved the final text of Solvency II, including requirements for pro-cyclicality.

Pro-cyclicality is a counter-cyclical approach to manage periods of boom and bust in capital assets, namely equities and bonds. Yann Le Pallec, managing director and head of insurance ratings for Europe, Middle East and Africa at Standard and Poor's (S&P), says that the issue of pro-cyclicality is a risk that is inherent in any regulation. "Regulators need to avoid a situation where requirements under Solvency II could accelerate a crisis when one occurs," explains Le Pallec. "They must make sure that the measures they put in place and the metrics they use to monitor the solvency of institutions could not lead to a worsening of the situation for the institution. This can be done by allowing (re) insurers to use an average value for equities, instead of taking the spot share price."

Brokers are also aware of their clients' concerns about insurer stability during the credit crunch and are developing new products to respond to the recent economic volatility and reduce reliability on the ratings. According to brokers, insurers can reassure corporate buyers by structuring policies in such a way that the policy will help companies mitigate and deal with the risks they face from rapidly changing markets. John Turner, Aon's head of broking excellence, UK, notes: "The business world finds itself negotiating an alarming stretch of financial rapids, as we head towards a new economic reality at breakneck speed. Aon has recognised and responded to the anxieties of businesses in a time of such turmoil."

Flexible policies will protect corporate buyers against the possible insolvency or financial impairment of insurance carriers by ensuring cover will continue regardless. In the property & casualty market Aon has recognised that volatility in financial markets is putting strain on the asset side of some insurers' balance sheets. Many businesses are therefore seeking assurance over the efficacy of their insurance programme. In response, the broker now provides an option to deliver certainty of cost, capacity and conditions.

Similarly, in buyers of terrorism and extortion covers are being given access to capacity at pre-arranged agreed terms and conditions. Turner explains: "Given that the terrorism insurance market is restricted to a small number of carriers, there is a real risk that a major downgrade or insolvency crisis with a major terrorism market would drive terrorism insurance rates up." He adds: "It is absolutely vital that businesses constantly monitor and assess whether they are comfortable with the risk mitigation programme they currently have in place is still suitable and comprehensive. It may very well be that businesses need to take no action at all, but the worst course of action would be to operate in the dark."

Corporate buyers sometimes have requirements that general insurers cannot meet and the Lloyd's market specialises in covering those requirements. Although Lloyd's syndicates are rated by the agencies, policyholders can gain further confidence from the "Chain of Security". Luke Savage, Lloyd's Finance Director says: "Lloyd's unique capital structure provides excellent financial security to policyholders through a combination of premium trust funds, members' capital and the Corporation of Lloyd's central assets."

At the syndicate level all premiums are received in trust funds, which are the first resource for paying claims. Funds are held in liquid assets to enable prompt claims payments and profits are not released until full provision is made for future liabilities. The second link in the chain is Members' funds at Lloyd's whereby corporate and individual members must provide capital to support underwriting. Finally, the Lloyd's central fund is funded by members' annual contributions and subordinated debt and is the last resort for claims that members cannot pay by other means.

Vipond explains: "None of this means the industry is complacent - there have been major falls in key markets- and there is no guarantee that the current market conditions will come to an end soon. These conditions, coupled with the specific challenges of bank recapitalisation, pose real issues."

Banks are not the only institutions that need to recapitalise. At the end of February life insurer Prudential eased fears over its financial health as it used future income from its with-profits fund and the release of capital from an asset sale in Taiwan to boost its reserves by £1.1bn. Prudential's Finance Director, Tidjane Thiam, says that the improved capital buffer meant that the insurer could now manage the kind of shocks to financial markets last seen in the wake of the Wall Street crash in 1929. "We could withstand a Great Depression every year for the next ten years," he explains. Prudential says that its capital cushion, most recently reported as £1.2bn, would now total £2.5bn. It has agreed with the FSA to transfer £300mn of future income from its inherited estate, or the surplus in its with-profits fund, to its capital reserves.

The fact that large parts of the UK life sector are under pressure was highlighted by a recent ratings review by S&P that led to four downgrades and 38% of the long-term ratings in that sector being assigned a negative outlook. S&P says: "In our view, this environment will present growth and earnings challenges for the sector, alongside increased risks in both assets and liabilities. We believe that these near-term challenges have added to our existing concerns around industry risk factors, creating incremental downward pressure on ratings."

The ratings agency adds: "Despite these negative factors, we continue to view favourably the strength of prudential regulation in the UK, improvements in risk management across the sector, the long-term fundamental strengths of the UK economy, and the size and diversity of the UK life market."

In the case of Prudential boosting its capital has reassured investors – the company's share price rose by 11% in the wake of the announcement – but it remains to be seen whether buyers of life policies and pensions feel similarly. Vipond explains: "This should not be confused with the underlying strengths of this industry. General insurers will go on providing insurance to people's homes, cars and businesses that they need; and life insurers will go on providing savings and pensions as before. Insurers are long-term businesses and will protect customers in the difficult times as well as the good ones." J