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Broader foundations

Is mortgage re the key to building a diversified portfolio?

The intelligent quarterly from the publishers of

Feeding the hungry

When I started doing this in 2010, global specialty (re)insurers had a slightly imbalanced business model.

It involved a measure of diversification by line of business and geography, but its cornerstone was the assumption of catastrophe reinsurance risk.

Property cat was a relatively small part of the overall premium base of Bermuda, London and the global reinsurers, but it made a disproportionate contribution to the bottom line.

The cat cross-subsidy was relatively little spoken about in interviews and from conference platforms, but everyone in the industry knew where the real money was coming from. And it wasn't aviation insurance or marine treaty.

Industry returns were driven out of the cat book in an era of zero interest rates. That needed to be balanced by some longer-tail exposures and some specialty lines, but these were very much secondary.

Structural trends, overlaid by cyclical pressures, have destroyed that business model. Alternative capital has sucked the excess returns out of the cat space and juicy bottom layers have been retained by data-savvy cedants more comfortable running a bigger net cat bet.

And now we are in a period of difficult adaptation in which beleaguered industry participants flail around for a new, more defensive model.

There are a number of different possible answers to the question that (re)insurers are grappling with. Transformative M&A. Third-party funds management. Brutal efficiency drives. Technology.

Insofar as there is an industry orthodoxy at present it centres on the virtues of diversification.

If there is no golden class of business, then (re)insurers must find ways to lever their balance sheets as much as possible to squeeze out a point or two of underwriting margin here or there on a well-worked capital base.

> "The burgeoning mortgage reinsurance space potentially offers reinsurers a life line in the form of new and diversifying demand. This slightly exotic food is sustenance for a starving market"

So, leaven reinsurance exposures with insurance, property with casualty, casualty with speciality. Offset US exposures with Japanese risks, and stretch the capital supporting European wind to support Australasian wildfire.

Or, even, step outside of the P&C space altogether and look to mortgage reinsurance.

The burgeoning mortgage reinsurance space potentially offers reinsurers – fearful of ebbing returns and pressured top lines – a life line in the form of new and diversifying demand.

Aon Benfield has said that $3.5bn of limit was purchased last year by US government-sponsored entities Freddie Mac and Fannie Mae. It has also projected that each could buy $3bn-$4bn of limit by 2017 or 2018. Additional purchases are also expected from the private mortgage insurers.

The numbers are relatively small at this stage in the context of P&C exposures, but there is scope for further growth and this admittedly slightly exotic food is sustenance for a starving market.

The adventurer in me says that they should grasp it with both hands, working at the inception of a new (or at least re-awakened) market to fashion something that is profitable and sustainable for both cedant and reinsurer.

And the early signs are that that is exactly what they are doing. The diversification that is carrying reinsurers into insurance and cat writers into casualty, is drawing P&C players into the mortgage space in droves, with 25 carriers already wielding lines and another 10 gearing up to do so.

Perhaps in five years' time it will have become just another staple part of a specialty (re)insurer's business, alongside a Florida cat account, a global surety book and a London market energy portfolio.

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AROUND THE WORLD

IQ's roundup of regional market developments

01 CANADA
Spreading like wildfire

Loss notifications from Canadian cedants for the Alberta wildfires in May are approaching C$2.8bn ($2.1bn), according to sister publication *The Insurance Insider*.

Sources said that TD Insurance had warned its reinsurers to expect gross claims of between C$250mn and C$550mn from the Fort McMurray wildfire.

Meanwhile, in a preliminary communication, Economical Insurance guided its reinsurers to expect a C$75mn loss from the ground up.

The Alberta Motor Association Insurance Company has disclosed expected losses of C$348mn, with a retention of C$5mn and C$180mn of vertical limit. Sources said that the carrier will try to claim two limits based upon a 168-hour clause in its cat treaty.

02 JAPAN
Pandemic payment

Japan has committed the first $50mn for a $500mn pandemic insurance fund launched by the World Bank.

The World Bank will issue cat bonds as well as sourcing reinsurance capital to fund the initiative, known as the Pandemic Emergency Financing Facility.

The three-year insurance cover will use public data on the size and severity of an epidemic outbreak to set parametric triggers to determine when the money is released.

In the event of an outbreak, funds will be disbursed quickly to countries and responding international agencies.

03 CHINA
Shanghai exchange

Some 91 Chinese companies have agreed to contribute the 2.24bn yuan ($343mn) of registered capital required to found an insurance exchange in Shanghai, according to local reports. The founding members, most of which are insurance companies and their subsidiaries, met on 18 May for the first time to discuss developing the marketplace.

The group also includes around 20 companies from other sectors, including state-owned bank Shanghai International Group and the investment arm of acquisitive conglomerate Fosun Group.

The proposal was originally floated in 2010 as part of the China Insurance Regulatory Commission's aim of expanding Shanghai's presence in the global insurance market by 2020.

04 AUSTRALIA
Aussie rules

Enstar subsidiary StarStone (formerly Torus) has announced that it has applied to Australia's regulators to begin underwriting in the region.

StarStone Australia will be led by Robin Barham and will target specialty business emanating from Australia and New Zealand on behalf of its Lloyd's Syndicate 1301.

Syndicate 1301 offers marine, property, casualty and specialty products for small and middle market and multinational accounts. The new operation will provide direct access to those classes for brokers in the Australasian region.

Barham has 28 years of insurance experience, both at Lloyd's in London and with Catlin in Sydney, and has underwriting and management experience across a broad range of classes.

A touch of class

Business class updates for the global market

Cyber

The Association of British Insurers (ABI) has called for a UK central database of cyber-attack information to help insurers to better price cyber risk.

In a statement on 23 May, the ABI said information sharing was "crucial" in order to put the UK's insurance industry at the head of a potential $20bn global cyber market.

The body proposed leveraging the European Network Information Security Directive – which requires firms to notify of data breaches as of 2018 – to build the not-for-profit database.

"This data could be anonymised and made accessible to insurers who could then use it to improve pricing and potentially put the UK at the forefront of the global market," the ABI said.

Aviation

The beleaguered aviation war market could soon be hit with another total loss after the downing of EgyptAir flight MS804 on 19 May.

Talbot Underwriting is understood to lead the hull war policy for the airline, with the rest believed to be on one of Marsh's lineslips in the Lloyd's market.

The loss could lead to claims totalling $18mn for the aviation war market if the crash is confirmed to have been the result of a terrorist attack.

XL Catlin is the lead on the all-risk programme exposed to the loss.

According to broker JLT, the aviation war market suffered $615mn of hull losses in 2014 following major claims related to fighting at Tripoli airport, the disappearance of Malaysia Airlines flight MH370 and attacks at Karachi airport.

The year produced a massive loss when compared to the niche market's premium income of around $60mn.

US flood

Lloyd's chairman John Nelson has called on the US government to stop providing residential flood cover.

The Corporation said that Washington should be largely "out of the risk-taking business" and that the private sector should pick up the policies, barring some essentially uninsurable risks.

The National Flood Insurance Program (NFIP) was first established in 1968, at a time when insurers were unwilling to cover flood risks.

However, Lloyd's has argued that the industry is now better placed to provide the cover due to improved mapping and satellite imaging – as well as a surplus of capital.

In April, the Flood Insurance Market Parity and Modernization Act was unanimously passed by the US House of Representatives.

If made law the bill would give consumers the choice between coverage provided by the NFIP and that bought in the private market.

Reinsurance

Reinsurers continued to concede rate reductions at 1 April, with "the reinsurance value proposition for insurance companies" improving in line with 1 January, according to Aon Benfield's renewal report.

The broker's outlook for the June and July 2016 renewals period remained positive, with insurers expected to achieve improvements in pricing, terms and conditions similar to those recorded for Q1 2016 renewals.

The demand for reinsurance has increased slightly in major markets, Aon Benfield added, while there was more significant demand growth in India.

There was also evidence of demand increases stemming from tactical reinsurance transactions.

In addition, the report found that almost $6bn of additional alternative market reinsurance capacity was secured in 2015, pushing total alternative capital to $72bn.

Energy

The Brazilian Public Prosecutor's Office has filed a 155bn reais ($43.bn) lawsuit against mining firm Samarco and parent companies Vale and BHP Billiton over the tailings dam collapse last November that resulted in 19 deaths and widespread environmental pollution.

The suit is separate from the previously settled case between Samarco and the Brazilian government, which resulted in the company agreeing to pay the government 20bn reais over 15 years, with 4.4bn reais of the total to be paid in the next three years.

Elsewhere, the (re)insurers on troubled Mexican state-owned energy company Pemex's programme are likely to avoid a payout as a result of the explosion at the Pajaritos petrochemical complex on 20 April, according to sister publication *Inside FAC*.

It is understood that in this instance the loss will be absorbed via Mexichem's (re)insurance programme rather than Pemex's.

Market intelligence on the QT

Mine's a pint

Disturbing news reaches *IQ* PI's ears from EC3, after it was informed that one of the London market's stalwart underwriting houses has issued a clampdown on reimbursing expenses for boozing with clients.

Apparently the higher-ups have decided that some of its staff were proving to be too generous at the local watering holes, and have implemented restrictions on claiming back alcoholic drinks.

At least the carrier is now practising what it preaches. Last year, some bright, enthusiastic young thing posted a blog on the firm's website decrying the effect of booze on your liver. Watch out for underwriters propping up a juice bar near you soon...

Your call is very important to us...

American International Group (AIG) is on something of an efficiency drive at the moment, as it battles criticism from activist investors.

As well as divesting some non-core operations and sacking a plethora of staff, gossips on both sides of the Atlantic suggested to *IQ* PI that all but the upper echelons of AIG had seen their voicemail boxes removed as part of a money-saving exercise.

But the reality is somewhat less dramatic – an insider tells us that the rationale is that no-one used their inboxes very much, and calls are now forwarded to the individual's mobile phone.

Spice up your life

Inga Beale's Desert Island Discs made for fascinating listening on Radio 4 in May. As well as gamely dealing with Kirsty Young's probing into her being both a high profile female insurance executive and an openly bisexual woman in a still-conservative market, Beale divulged stories about her experiences in the male-dominated world.

One of the more light-hearted anecdotes saw her discuss her own unconscious bias, and how she had unknowingly surrounded herself with female team members, prompting one broker to label the group "The Spice Girls". *IQ* PI can't help wondering which Spice Girl Beale would most liked to have been: Sporty, given her rugby playing history? Posh Spice to get access to a good wardrobe? Or Scary Spice, to keep the boys in check?

Broader foundations

The fallout from the financial crisis has created new growth opportunities for reinsurers to take on mortgage credit risk. **David Bull** investigates...

"If you build it, they will come," goes the popular misquote from 1989 movie Field of Dreams, in which Iowa farmer Ray Kinsella builds a baseball diamond on his maize fields, ultimately attracting spectators from miles around.

And in a P&C market short on profitable growth opportunities, it seems the allure of bricks and mortar – at least in the form of newly created mortgage credit risk transfer products – has reinsurers coming in droves.

From a standing start, US government-sponsored enterprises (GSEs) Freddie Mac and Fannie Mae placed over $3.5bn of limit with reinsurers last year through broker Aon Benfield.

Since the first syndicated deal was placed in April 2014, they have transferred over $6bn to reinsurers, including over $1.4bn to date this year.

According to projections from Aon Benfield, the deals are likely to grow to $3bn-$4bn of annual limit for each GSE towards 2017-2018.

At the same time there has been a build-up in risk transfer to reinsurers from private mortgage insurers (PMIs) in the US and overseas.

For growth-hungry reinsurers, the appeal of a capacity-hungry class of business that appears to be uncorrelated to their P&C portfolios is clear.

"It has an underwriting or credit cycle that is largely uncorrelated with our other lines of business, so it gives us this built-in diversification," explains Andrew Rippert, CEO of Arch's global mortgage group.

"It also offers good returns and requires specialised knowledge with some barriers to entry – that fits well with us because we can exercise our demonstrated underwriting discipline and cycle management," he tells *Insider Quarterly*.

Arch has been in the mortgage space since the start of the decade, operating as a reinsurer and insurer – including through its 2014 acquisition of CMG.

Others have also entered the arena in the last couple of years as they look for growth opportunities away from their core business.

RenaissanceRe's chief underwriting officer for casualty and specialty David Marra says that the expansive Bermudian sees mortgage reinsurance as an opportunity to diversify its product base.

"It's a growth opportunity where we can help clients and brokers by providing more than capacity. As in other classes we look to build a leadership position, select the best portfolio and solve clients' problems," he adds.

And RenaissanceRe is not alone in seeking opportunities as it continues to broaden beyond its roots in the under-siege property cat reinsurance market.

"Sitting around and waiting for a correction in property cat is

Continued on page 10

Broader foundations
continued from page 9

not a strategy. And intelligent reinsurers are absolutely not counting on that. They are looking for diversification with reasonable returns, and mortgage reinsurance really tops the list," observes Aon's global head of strategic growth and development Bryon Ehrhart.

From lead reinsurers such as Arch, RenaissanceRe, PartnerRe, TransRe and Everest Re, the number of markets participating in the space has grown dramatically. Indeed, Aon Benfield's US credit and guaranty practice leader Joe Monaghan tells *Insider Quarterly* that from the three reinsurers that wrote the first syndicated transaction the broker placed for Freddie Mac in 2014, the number of active participants has jumped to about 25 and is expected to rise to 35 by the end of 2016.

"When you look at that group some are doing all the things a lead would do: they're quoting the risk, they're actively underwriting the risk, they're engaging with the GSEs and presenting ideas around structure and coverage terms and conditions.

"The others are just as thoughtful in their internal analytics, but they tend to want to wait for terms and have a following role," he explains.

On the GSE side of the business, Aon Benfield says it is placing 12-18 transactions a year, while rival Willis Re is also starting to become active in the mortgage reinsurance space.

The GSE deals are typically structured as aggregate excess-of-loss (XoL) covers and tend to be more remote from the risk (see box-out left), because the loans have more equity or they include mortgage insurance that kicks in first in the event of default.

Private mortgage insurer (PMI) transactions can be either XoL or quota share, with reinsurers providing coverage further down the expected loss curve.

XoL transactions for both tend to limit the term of reinsurance coverage to 10 years.

So what has opened up the market as a genuine growth opportunity for reinsurers?

Foundations laid

The foundations of the burgeoning reinsurance market for GSE mortgage credit risk transfer were laid as recently as 2013.

But the origins of demand for reinsurance lie in the rubble of the US mortgage market, the collapse of which triggered the credit and wider financial crisis in 2007-2008.

As well as the much-publicised damage caused by mortgage-backed securities and their derivatives in the capital markets, traditional PMIs were left exposed to credit risk on mortgages sold by banks to the GSEs.

When the crisis hit, a tidal wave of defaults on residential mortgages put three of the

How GSE deals are structured

Risk transfer to reinsurers by the government-sponsored enterprises (GSEs) is currently based on the excess-of-loss (XoL) structure.

Freddie Mac takes a pool of loans with face value of say $20bn and transfers portions of risk on layers at various attachments to capital markets via its structured agency credit risk transactions, and to reinsurers through an agency credit insurance structure reinsurance programme.

The first loss layer sees risk shared between the three, with reinsurers then taking a portion of the risk up through the next three layers.

Freddie Mac retains an interest all the way up through the structure, with a 50 percent portion of the first loss layer, a minimum 5 percent share on the XoL layers and a 100 percent retention above the XoL structure at the catastrophic loss level (see diagram).

A Fannie Mae credit insurance rating transaction (CIRT) would take that $20bn pool of loans and typically retain the first 0.5 percent and then transfer the next 2.5 percent to reinsurers in one book.

The GSE would then step back in above the XoL layer to retain all the risk above.

Fannie Mae's reinsurance deals are also usually written with a 10-year term, with an option to call in five years.

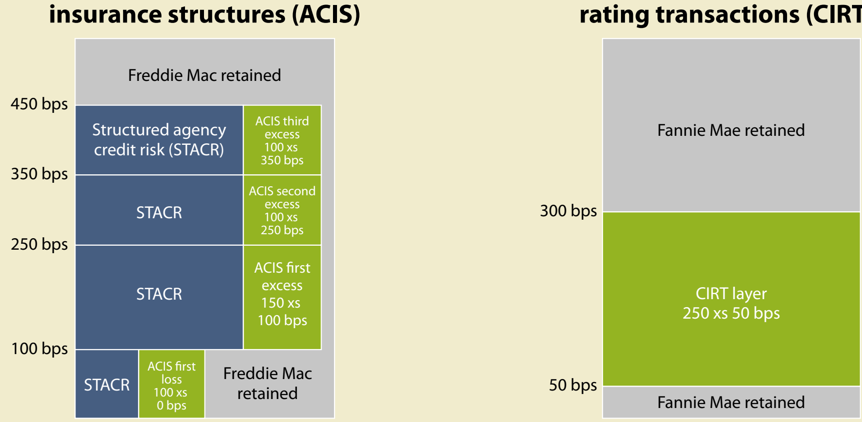
Loans in the pool that have a loan-to-value ratio of 80 percent or above will already have had mortgage insurance purchased from private mortgage insurers (PMIs).

In that instance the PMI is in a first loss position on a defaulting line, with any residual loss flowing into the CIRT structure.

Government-sponsored enterprise credit risk transfer

Freddie Mac agency credit insurance structures (ACIS)

Fannie Mae credit insurance rating transactions (CIRTs)



Source: Arch

seven active PMIs operating in the space out of business, and led to both GSEs being taken under conservatorship by the US government as part of an $185bn bail-out.

In the inevitable capacity crunch for risk transfer that followed, the response was for the GSEs to hoover up the exposure and retain it, effectively dumping it back on the US taxpayer.

Fast forward a few years, and with a more stable macroeconomic environment, Freddie and Fannie overseer the Federal Housing Finance Agency (FHFA) began to push for a new approach.

"The GSEs were incentivised to find more creative, innovative and novel ways to transfer this credit risk to private capital that didn't exist previously," Rippert explains.

In 2013, the GSEs were told by the FHFA that they had to come up with a way to transfer an unspecified amount of credit risk on a pool of $30bn of mortgage loans.

That year, Freddie Mac did its first deal under the new mandate with the launch of a structured agency credit risk (STACR) programme to transfer a portion of credit risk on its single-family loan portfolio to the private sector.

Arch, which had entered the mortgage space a couple of years earlier, become the first (re)insurer to participate on the STACR programme as the sole underwriter on the deal, alongside capital markets participants.

And Rippert explains that as part of the discussions surrounding the carrier's purchase of CMG, Arch proposed that an insurance solution could provide the GSEs with access to another pool of capital to transfer credit risk.

With Arch pioneering as reinsurer and Aon Benfield as broker to the GSEs, the reinsurance product quickly evolved.

Freddie Mac now transfers risk to reinsurers through agency credit insurance structures and Fannie Mae uses credit insurance rating transactions (see box-out opposite).

Meanwhile, the mandate from the FHFA has expanded, with the GSEs directed to each transfer risk on a $90bn pool of loans in 2014, raised to $120bn for Freddie and $150bn for Fannie in 2015.

This year the FHFA said that these credit risk transfer deals are now a core part of the GSE business model.

The FHFA added that the GSEs must transfer credit risk on at least 90 percent of loans that fall into a target bucket, which covers fixed rate mortgage loans with a term of 20 years or more.

"It's a significant portion of Fannie and Freddie's business," explains Rippert.

The target class is thought to amount to around $450bn of mortgages across the GSEs.

With Fannie and Freddie typically transferring around 3 percent of targeted exposures, that would equate to around $12bn of limit transferred each year, around half of which is expected to end up with reinsurers.

"Fannie and Freddie could choose to go to the mortgage insurers to do the credit transfer deals. But their whole mantra is to attract more diverse and deep pools of private capital," says Rippert.

He adds that if the GSEs just went to the mortgage insurance companies they'd essentially be doubling down with monoline entities they are already taking a bet on.

The GSEs also expect to see more stable and consistent pricing and participation from the reinsurance industry than from capital markets investors currently drawn by yield in a low interest rate environment, the executive suggests.

"So we keep saying to the FHFA: offer this business to P&C reinsurers and they will establish a market and invest in assets and infrastructure to do it. They'll be there for the long term much like they are in many other lines of business," he continues.

According to Jay Cahill, a senior vice president at RenaissanceRe who specialises in mortgage reinsurance, PMIs are viewing reinsurance risk transfer as attractive from a risk and regulatory capital perspective.

He notes that regulatory capital for PMIs was redefined by private mortgage insurer eligibility requirements, which were finalised last year. This allowed the companies to finalise their capital structures.

Monaghan says that his firm is now seeing growth of reinsurance demand in the PMI sector.

"It's a very similar story. It's capital-driven and more specifically it's regulatory capital-driven. It goes hand-in-hand with the same motivations for Fannie and Freddie, which is the inadequacy of capital the industry had going into the crisis," he observes.

Like GSEs, PMIs are also now incentivised to use reinsurance as a source of capital and as a capital management tool.

"Historically, mortgage insurers used no real reinsurance and had the mentality of writing it and keeping it long, whereas they would have been better served by using reinsurance," says Rippert.

Cahill also highlights the characteristics of the PMI market that shape the sector's different relationship with reinsurers than in the GSE space.

"The PMI market is a smaller market with a less remote risk. The management of those companies prefer to deal with expert underwriters.

Continued on page 12

Broader foundations
continued from page 11

"That's not to say that GSEs don't also want to deal with expert underwriters in the first instance, but they have a larger capacity need, so there's a larger following market to be built behind the expert leaders in that segment," the executive explains.

PMIs also use quota share reinsurance to support growth in situations where they have leverage constraints that limit their abilities to write business as it comes into the private market.

Not like the '90s

For some, the very mention of mortgage risk might evoke images of the toxic exposures created out of the most irresponsible excesses of the housing bubble of the first half of the last decade.

Players in the mortgage reinsurance space are confident that the risk being assumed post-financial crisis is of an altogether different nature, however.

"The underwriting standards since the financial crisis have improved dramatically both at banks and mortgage insurers and the GSEs. They're taking into consideration risk aspects that were unfortunately ignored prior to the crisis," says Cahill.

Sub-prime is no longer supported and there is now full documentation of income and asset value at the original risk level, with full transparency up the chain, he adds.

And Ehrhart emphasises that the picture today is nothing like the mid-1990s, when investment banks were approaching (re)insurers in an attempt to arbitrage their own exposures.

"That was rejected by almost everybody in the industry. Today's product is one where insurers and reinsurers are essentially on the same terms as the capital markets, so they're not being picked off.

"There's also much more transparency than the packaged business that came to light in 2008 and 2009, with weekly and monthly loan-by-loan detail provided to insurers and reinsurers," he says.

The level of detail for underwriters goes down to which loans are current, which are delinquent, and which are in foreclosure.

But as reinsurers get to grips with mortgage risk, they need to take a cyclical view to be successful, warns Rippert.

"The ups and downs of this market and massive exposures mean you really need excess returns in the good times to sustain yourself in the bad times," the executive states.

If that can be achieved, perhaps mortgage reinsurance truly will provide the diversifying growth opportunity that the sector craves…

Back to front?

With government-sponsored enterprise (GSE) mortgage reinsurance deals still at the nascent stage and growing demand from private mortgage insurers (PMIs), there is plenty of scope for evolution and innovation as the market continues to develop.

At the current run-rate with the structure currently being used, Aon's Bryon Ehrhart believes over six or seven years the allocation of capacity from reinsurers to the 10-year GSE deals will mount to a significant volume.

"It won't be quite as large as US hurricane, which is the largest allocation to any single risk in the reinsurance world, but you will have a really nice amount of capacity allocated to US mortgage. It is a diversifying peak, if you will," he comments.

The current deals are effectively back-end transactions, where the GSEs buy the loans, package them up and seek bids for risk transfer on the finite loan pools.

"What would be interesting would be to effect some sort of risk transfer mechanism that brings it from the back end to the front end – to the mortgage origination," suggests Arch's Andrew Rippert.

He adds that a structure that allowed risks to attach at the mortgage at the point of application "would change the whole distribution and origination market for mortgages".

Currently, mortgage lenders are buying mortgage insurance from PMIs on loans that are then sold to the GSEs, which have no control over where those loans are insured or potential concentrations of exposure.

"You can imagine a mechanism where the GSEs are buying high loan-to-value loans but they have this prearranged deal where the risk is transferred as soon as they bind," the executive continues.

With only a small percentage of their overall exposure currently shifted from GSEs to capital markets and reinsurers, there is also scope for solutions that can harness significantly more capital.

"We could see a situation where the demand and opportunity is so great that we wouldn't want to put it all on Arch's balance sheet," says the company's executive vice president for financial services Don Watson.

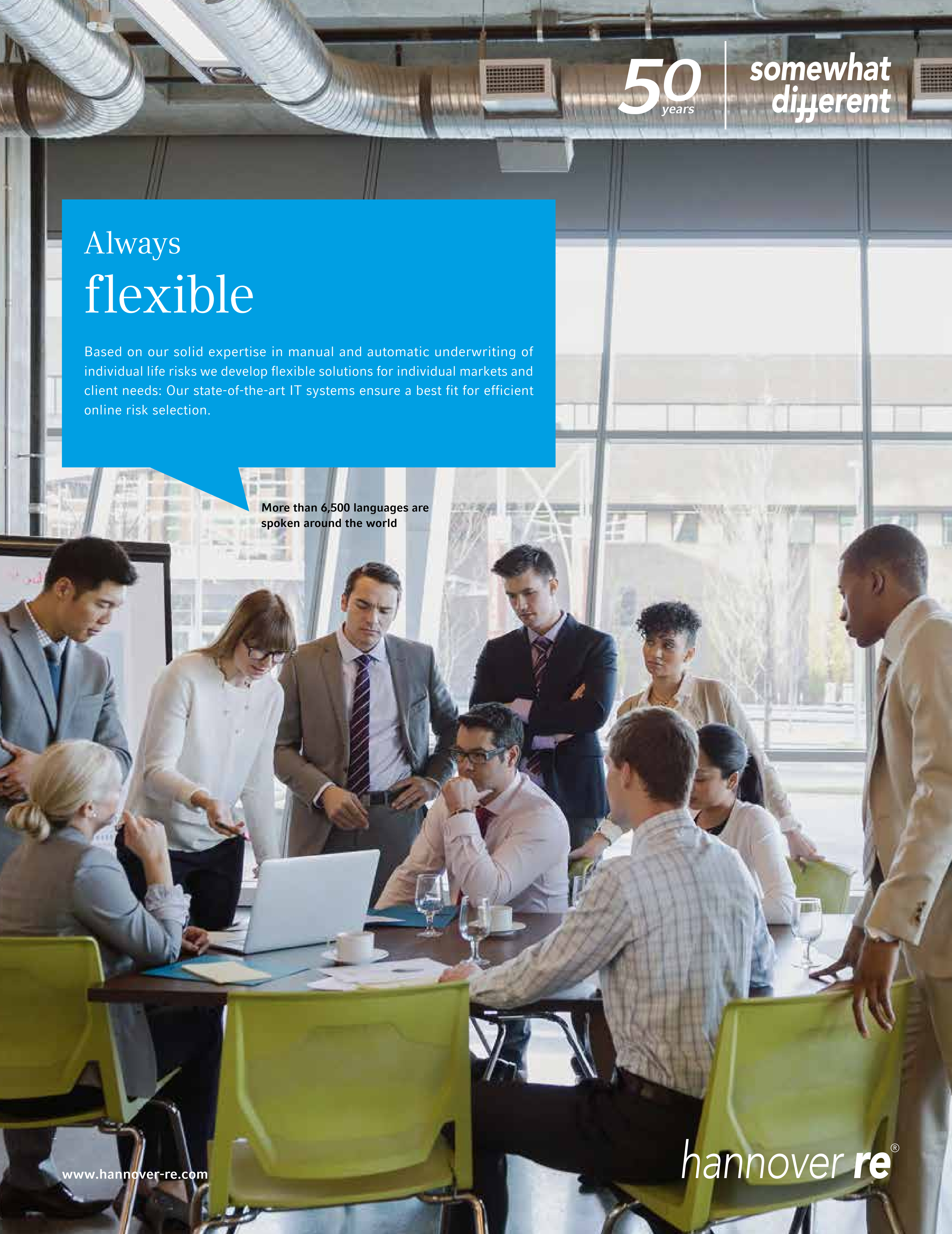
The Bermudian already underwrites some mortgage business through Watford Re, the total return reinsurer it launched in 2014.

But it could explore other sidecar structures that would be purely focused on mortgage risk, according to Watson.

RenaissanceRe's David Marra also hints at the possibility, as he says that the carrier would approach mortgage reinsurance growth opportunities in a similar fashion to other areas of its business: building capacity through third party capital or ceded reinsurance.

There is also potential for growth in securitised reinsurance transactions to transfer mortgage credit risk.

American International Group subsidiary United Guaranty completed its second Bellemeade Re transaction in early May as it transferred pre-2009 exposures for the first time.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Burning issue

The Address Downtown high-rise fire in Dubai last New Year's Eve highlighted a troubling exposure for Middle East property writers, finds **Charlie Thomas**

Dubai has seen more than its fair share of property fires over the last few years.

In fact, at least a dozen fires, four of them large-scale blazes, have taken place in the past four years – and all of them have one thing in common.

The building boom in the Middle East, particularly in Dubai, between 2003 and 2012 saw a huge number of high-rise properties appear on the skyline, many of which used aluminium composite panels on their facades.

The panels, or cladding, have been used around the world, but nowhere are they more prevalent than in Dubai. They have not been used in the UK since the 1980s, and in the US their use is prohibited on buildings of more than three storeys.

But more lax codes in the Gulf and weaker enforcement of them by the local authorities has allowed this cheap and plentiful material to be used.

These sandwich panels, so-called because they have aluminium outer sections and a type of plastic on the inside, are inexpensive, widely available and aesthetically pleasing, providing a mirror-like shine.

There's just one problem – the plastic centre is highly flammable, and the sandwich nature of the panels means that once they are alight, the whole panel and those surrounding it go up in flames extremely quickly.

The aluminium is flame-resistant and will not normally burn initially. However, if the aluminium is breached from an intense fire or a flame ignites exposed low density polythene (or LDPE as the plastic core is known) – for example on a cut edge – the flammable core can ignite, explains Brian Clark, executive director for the Middle East at Crawfords.

LDPE has a relatively low melting point of 120 degrees Celsius and when it is exposed to fire it melts and flows out of the panel – and that molten plastic can be readily ignited.

The fire at the Address Downtown Hotel in Dubai on 31 December 2015; PA Images

The four major tower fires in Dubai were the Torch and the Tamweel Tower in 2012, The Address Downtown Hotel – perhaps the best known as it occurred on New Year's Eve 2015 and was televised live to millions – and the Ajman Towers in March this year.

There was also a large blaze in the Al Hafeet tower in nearby Sharjah in 2013, which was also clad in the composite panels.

Insurance loss estimates are patchy, but the Address Downtown Hotel blaze was reportedly approaching the \$200mn mark as of March, with the figure likely to increase once business interruption was included.

But the relatively high number of fires occurring so close together has got the market concerned about possible aggregation for reinsurers on the property risks, especially given that so many of the high rises in the region are using the same aluminium composite panels.

No skin in the game

Dubai Civil Defence is understood to be in the middle of creating a database of buildings with this sort of cladding. However, estimates from brokers and loss adjusters in the region put the figure at 70 percent of all the towers in Dubai built before 2013, when the building code was changed to prohibit their use. That's approaching 1,000 buildings in Dubai alone.

The material has been used elsewhere in the Middle East, but nowhere more so than Dubai, with its propensity for megatowers and high rise residential blocks.

Perhaps surprisingly, despite the number of high-profile fires and the number of buildings potentially at risk from future blazes, the April renewal season didn't show any signs of rate increases at all.

Under UAE rules, insurance business has to be placed with a domestic carrier. However, virtually the entire risk is ceded out to an international panel of reinsurers, meaning domestic companies have no reason to hike up rates even when there have been losses.

The UAE has around 60 licensed insurers, 29 of which are listed companies. Among the listed carriers, underwriting losses were 120mn dirham ($32.7mn) for 2015, a reversal of the 850mn dirham surplus in 2014, and yet rates continue to spiral downwards.

Property rates had reached as low as 0.1 per mille (0.01 percent) by March, according to sources.

One source told *Insider Quarterly* that local carriers not retaining risk have also caused other problems.

"The local insurers here assume no risk, and the problem with that is it doesn't create a risk management culture," the source explains. "The response to the fires has been pretty non-existent – the attitude is that fires happen and, as local companies have no skin in the game, everything gets laid off to the reinsurance market."

The source adds that Lloyd's had only a minimal impact from the Address Downtown Hotel loss via a couple of London syndicates with a small retention.

Orient, the primary carrier behind the Address Downtown Hotel, did note in its annual report in February that it was concerned that reinsurers might begin to write in exclusions if the issue was not tackled meaningfully.

"The intensity of these fires and the substantial financial loss has now drawn the attention of the international reinsurance market," it said. "Many of the leading reinsurers see this as a serious issue that needs attention and market response. Without such action these buildings can be excluded under the reinsurance treaties.

"There is a clear need for a general market response before the reinsurers are pushed to take drastic decisions."

In March, Orient gathered a number of domestic carriers in an attempt to persuade them to agree to rate increases of a minimum of 0.5 per mille for buildings with combustible cladding, and 0.25 per mille for buildings above 20 floors with no cladding. However, sources told this publication that the call had probably fallen on deaf ears.

Orient also noted in its annual report that "regrettably", the local regulator, the UAE Insurance Authority, had not been active in handling market issues and had failed to take any initiative that could have guided the companies to improve technical results.

A lacklustre regulator was also cited as a problem by a number of sources, who preferred to remain anonymous for fear of falling out of favour with the watchdog. Others also criticised the handling of sites after the event by the local police.

One compared them to a "bull in a china shop", while others vented frustration at restricted access – at least initially – for non-domestic adjusters and forensic experts.

The main reason rates won't move though, is because of the huge levels of capacity. One source noted: "Insurers should do something – they should either charge more premium or not insure the risks at all – but that won't happen as there's always someone else willing to offer coverage."

The region is swamped with both insurance and reinsurance capacity, which has kept rates across the market low.

Better risk management

Ian Peters, Marsh's Risk Consulting practice leader – MENA, says that while rates aren't moving, there is evidence of underwriting requirements becoming more stringent and of more due diligence being carried out at the point of placement to better understand the nature of the buildings' construction.

"More questions are being asked, with carriers wanting to know what materials are being used, whether they are fire resistant or retardant, and which type of panels are used on the façade."

This view is supported by Joe Asmar, group head of the facultative division at Chedid Re. "Most of the reinsurers are now interested to know the percentage of this cladding material used in

Continued on page 16

Burning issue
continued from page 15

the building construction and they are imposing some exclusions to the cover," he says.

"There's still a decent market available to write the risks, but they're amending the terms and the deductibles which are being given."

The good news for those underwriting property risks in the region is that there are changes afoot.

A new fire and life safety code update from Dubai Civil Defence is due imminently. It was first going to be published in April but was later delayed to May and, at time of going to press, had yet to materialise. The code will hold construction companies accountable if fire safety rules are not followed.

Suggestions to introduce fire barriers in older buildings are reportedly being considered, given that retro-fitting and replacing all of the affected cladding would probably be too expensive. Upgrading the sprinklers is unlikely to work though, as the fires typically affect the outside of the building rather than the interior.

Building owners will also be required to renew a no-objection certificate every year from Dubai Civil Defence, following inspections to ensure any modifications are fire-safe. This bolsters rules that previously only required the certificate to be achieved after initial construction.

And clarity over the manufacturers' liability is likely to be outlined, with those companies selling building material not approved by Dubai Civil Defence and municipalities now open to prosecution.

Facades will also have to be tested and consultants will be made responsible for a structure for a year after project delivery.

Major cladding-related fires in Dubai and vicinity

Building	Date
The Torch	Feb-12
Tamweel Tower	Nov-12
Al Hafeet Tower (in Sharjah)	Apr-13
Address Downtown Hotel	Dec-15
Ajman Towers	Mar-16

Source: *Insider Quarterly*

Liability watch

This will mark an interesting development for liability insurance in Dubai, which hitherto has not been a popular product.

"If there are additional liabilities being pushed to the owners and managers of the building there will be additional insurances required to meet those liabilities," said Marsh's Peters. "But this part of the world is very different when it comes to legal liability. It's very early days and the transferring of responsibilities, and what that will entail, will be an interesting one to watch."

Another area worth watching for developments is the effect of private property sales and mixed building ownership on liability.

A large proportion of the buildings in Dubai are subject to mixed ownership and the strata legislation that was imported from Australia hasn't, by all accounts, been implemented fully.

In particular, in the cases of the Tamweel Tower, Torch and Address Downtown Hotel fires, there was no registered owners' association, which presents a real problem in identifying whom insurers are obliged to indemnify and obtain a full discharge of liability from.

As Wayne Jones, a partner in Clyde & Co's Dubai office and head of its (re)insurance team for the region, explains: "Where there is no registered association which has the authority to represent the ownership interests of potentially hundreds of individual owners, the problem is that insurers could be exposed to multiple claims by individual owners, or banks that have lent money on the property, and it is not possible to obtain a full discharge from all the insured interests in the building. The registration of the owners' association after the event does not solve the problem either.

"Up until now the issue has been dealt with by an arrangement being reached between insurers and the developer on behalf of all ownership interests, with assistance from the Land Department where necessary. But there is no certainty that all possible claims will have been discharged, and there is always a residual risk of further complications arising."

He concludes: "All in all, it's not a satisfactory place to be in, and it remains to be seen what becomes of the owners' association experiment in Dubai and Abu Dhabi."

Currently, subrogation and litigation are almost non-existent in the region but, as one source notes: "If there's a clear cause and a clear route to liability, things might change."

For (re)insurers still considering writing risks in the region, there is some advice from the sources we spoke to.

Firstly, consider a pre-policy engineering check – pretty standard elsewhere in the Middle East, but less common in Dubai. Make sure you know the construction inside out, and that fire detection systems are working and maintained.

Building managers are responsible for administering the housekeeping, for instance ensuring the use of hot work permits and that no smoking rules are being followed, so check that these rules are being enforced.

And as always, if the risk looks bad, walk away.

Up, up and away

With reinsurers' profits already under attack from increased ceding commissions and broker compensation, rising acquisition costs are driving up expense ratios, finds **Iulia Ciutina**

The combination of rising pressure on reinsurance rates and intense competition has forced carriers to write business at lower limits of profitability.

Nevertheless, reinsurers have managed to increase their premium bases by finding growth opportunities in new markets and gaining wider geographical exposure.

However, this growth came at a cost, as cheaper reinsurance forced carriers to alter their terms and conditions, with ceding commissions and increased broker compensation informing a new trend over the past couple of years.

Multiple market analyses show that the main driver for the deterioration in underwriting performance was expense ratios – which were in turn pushed up by higher acquisition costs.

Looking at sister publication *The Insurance Insider*'s Bermuda composite, the expense ratio took on 4.3 percentage points in five years to reach 34.5 percent for full-year 2015.

Global P&C reinsurers also reported increasing expense ratios on average, with *The Insurance Insider*'s composite figure rising by 2.3 points since 2013 to 30.3 percent last year.

Keefe, Bruyette & Woods (KBW) analyst Meyer Shields commented on the trend of rising expense ratios in the reinsurance space, arguing that it was a

The Insurance Insider composites

Bermuda	Global
Allied World	Everest Re
Arch	Hannover Re
Aspen	Munich Re
Axis	Scor
Endurance	Swiss Re
Renaissance Re	
Validus	
XL Catlin	

Source: *The Insurance Insider*

normal reaction to the current pricing environment.

"I would divide it into two components. The first is that when you see soft pricing, that's just reinsurers competing for more volume, and another way of doing that is by increasing acquisition costs and ceding commissions, so it seems to make a lot of sense that expense ratios would be increasing," he said in a note.

Shields observed that reinsurers were willing to pay higher ceding commissions in order to get business, as competition in the market continued to increase.

"And secondly, to another extent, you've got fixed costs even in the acquisition expense ratio, and into a generally declining demand, that's going to pressure margins and the ratios as well."

Meanwhile, Janney analyst Ryan Byrnes also believed that reinsurers were willing to increase ceding commissions to the primary side and "give more of the profits", as the primary market continued to show solely adequate returns, he said.

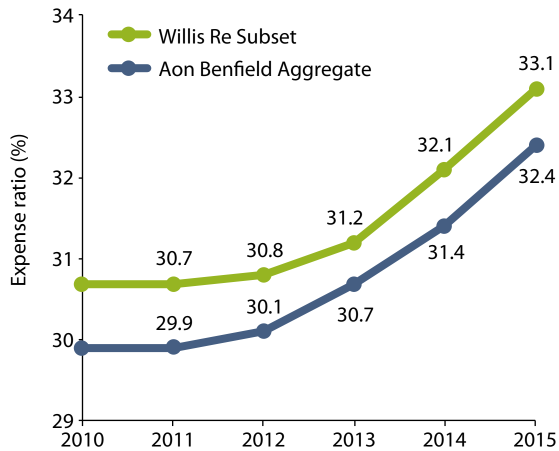
Moreover, in the context of weaker demand for reinsurance, Byrnes noted that expenses were also pressured from top lines, which have been shrinking at a greater speed than general and administrative expenses.

Byrnes also mentioned that rising expense ratios could have been related to growth in the insurance-linked securities and cat bond world, which has "pushed some traditional reinsurance spend into that market so it's shrunk the pie for the traditional reinsurers".

Expense growth

In its Reinsurance Market Report issued in April, Willis Re analysed a subset of carriers representing 82 percent of net premiums and 59 percent of the aggregate capital index.

Reinsurance expense ratios bloat



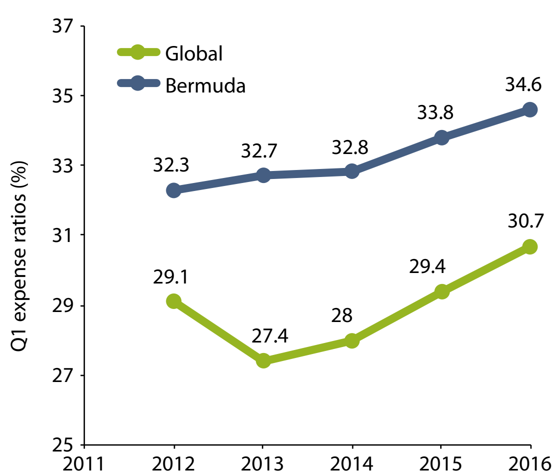
Source: Willis Re, Aon Benfield

The broker calculated the subset's combined ratio at 89.3 percent, 80 basis points more than in 2014.

Expenses were responsible for the entirety of the deterioration, as the expense ratio rose by 1 percentage point year-on-year to 33.1 percent.

Speaking at an Insurance Institute of London lecture at the Lloyd's Library, James Vickers, chairman of Willis Re International, said that the growth in expenses was due to a variety of reasons, such as reinsurers turning to specialty products and expanding into new areas.

Bermuda approaches 35% Q1 expense ratio



Source: *The Insurance Insider*, company disclosures

Increased regulatory costs also played a part, as well as higher ceding commissions, he continued.

The report also showed that the expense ratio impact has been increasing in the past five years.

If reinsurers in the subset had maintained their expense ratios at 2007 levels, the aggregate 2015 return on equity of 10.2 percent would have been approximately 2.4 percentage points higher, Willis Re said.

Similarly, reinsurance broker Aon Benfield reported that the combined ratio for full-year 2015 was 40 basis points higher than the year before for the Aon Benfield Aggregate,

The increase was again entirely due to expense ratios increasing 1 percentage point year-on-year to 32.4 percent, according to the broker's analysis.

Aon Benfield gave similar explanations for the rise in expenses, saying it had been driven by higher ceding commissions and business mix changes, taking the total increase over the past decade to almost 5 points.

Lloyd's pushed by brokers

Lloyd's syndicates suffered from mounting acquisition costs in 2015 as a soft market broker push for increased remuneration continued to ratchet up the price of sourcing business on Lime Street.

KBW's Shields noted that "when you see pricing pressure or declining demand, in many cases it doesn't necessarily change the amount of effort that a reinsurance broker has to do, so for them to ensure that they're being compensated for the work as a broker is going to impact the acquisition expense ratio".

And indeed, Lloyd's aggregate acquisition costs have been one of the main causes of the market's

Continued on page 20

Up, up and away
continued from page 19

deteriorating underwriting performance in the past five years, increasing by 31.6 percent to £6.5bn in 2015.

"That's sort of a function of the fact the amount of work doesn't depend on premium volumes, so you're going to have upward pressure on expense ratios when there's a lower level of volume being transferred," Shields said.

Relative to the Corporation's net earned premiums, acquisition costs were 31.6 percent in 2015, up from 30.7 percent the year before and continuing a five-year rising trend.

The 90 basis point increase represented almost half of the deterioration in Lloyd's combined ratio, which took on 200 basis points year-on-year to reach 91.6 percent – the highest level in the past four years.

However, this was a less dramatic climb than in 2014, when the acquisition costs ratio jumped from 27.7 percent to 30.7 percent, accounting for the entire 270 basis point rise in the Corporation's combined ratio to 89.6 percent.

In 2011 the average acquisition cost ratio for the market was just 27.3 percent.

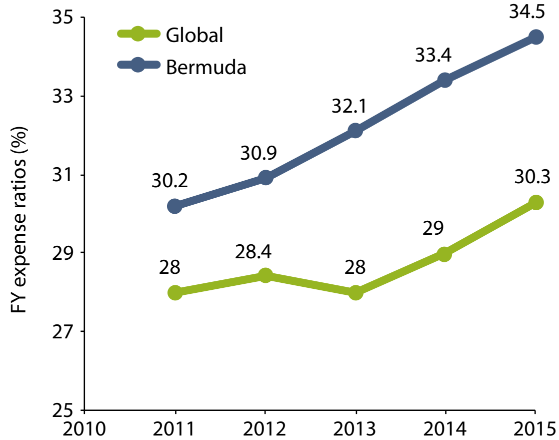
Net operating expenses at Lloyd's reached £8.6bn in 2015, £680mn more than in the prior year, with acquisition costs accounting for £521mn of the increase.

Meanwhile, net earned premiums rose by £1.1bn to £20.6bn, meaning that 45.5 percent of the yearly increase in premiums earned went towards commissions and other costs related to the acquisition of new insurance contracts.

This occurred in the context of syndicates struggling to increase premiums earned, as rates continued to drop, pressurising profits.

In 2014 the impact of acquisition costs was even more marked as earned premiums decreased by 1 percent, or £207mn, to £19.5bn, yet acquisition costs continued to inflate by £544mn, or 10 percent year-on-year.

Reinsurers' expense ratios take on 1 percentage point yearly



Source: *The Insurance Insider*, company disclosures

Q1 follows pattern

Looking at the first quarter results, the trend of rising expense ratios was present throughout most reinsurers' disclosures.

For example, companies in the Bermudian composite saw their expense ratios rise by 1.1 points from 2015 to 34.6 percent in Q1 2016.

However, a few of the companies in the group were involved in M&A activity last year, and the first quarter 2016 results reflected the new additions.

As a result, expenses were naturally higher compared to the first quarter in the year before.

Nevertheless, P&C reinsurers in the global composite also witnessed increased expense ratios, which rose by 1.3 points year-on-year to 30.7 percent in Q1.

Commenting on whether reinsurers will continue to increase ceding commissions in the future, KBW's Shields said that "it will absolutely reach a ceiling".

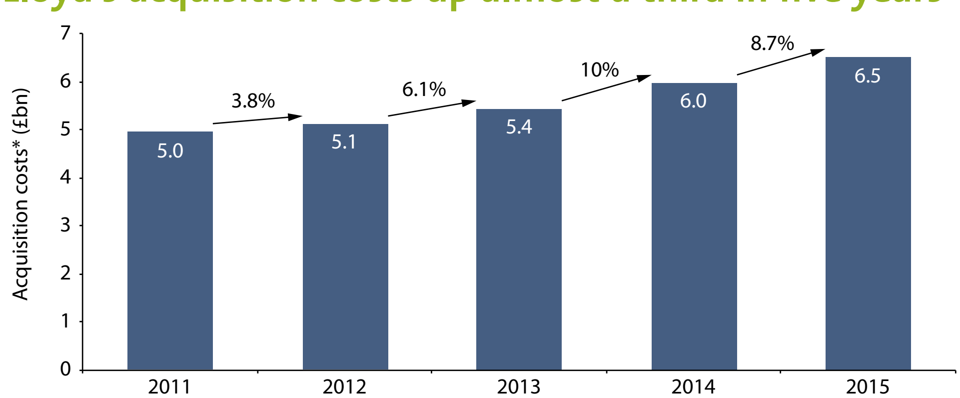
"We've already seen within the retro property and catastrophe reinsurance, I think the pricing decrease is slowing down because they've kind of hit the limits [beyond] which most reinsurers won't pay," he noted.

"Once it becomes obvious and maybe takes too long for it to become profitable, then they're just not going to do it."

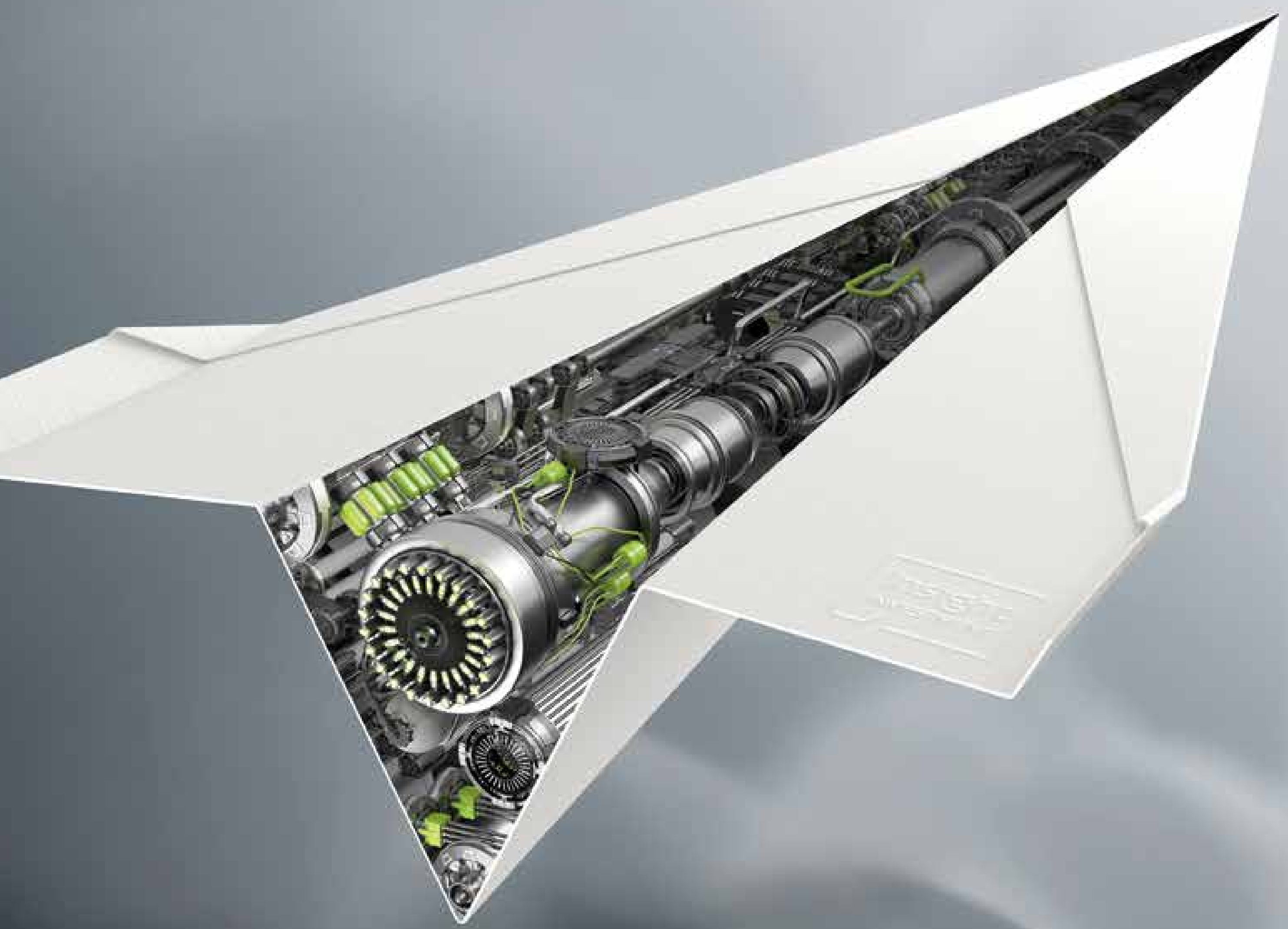
However, Shields predicted that 2017 will be another year of soft market pressures, after which a key player will be inflation.

The KBW analyst said that 2018 is probably the biggest potential candidate for better behaviour. "2018 will be more disciplined and more conservative pricing in underwriting processes," he concluded.

Lloyd's acquisition costs up almost a third in five years



* Net of the change in deferred acquisition costs
Source: Lloyd's annual report, *The Insurance Insider*



Chain reaction

As the potential uses of blockchain technology spread to the insurance sector, could it prove to be the next great disruptor of the industry? **Matthew Neill** investigates

Mutual distributed ledgers (MDLs), more commonly known as blockchains, have been garnering a great deal of hype within the last 12 months.

Google searches for blockchain have skyrocketed, while start-ups using the technology as the core of their enterprise have proliferated, spreading from their roots in California across the Atlantic and beyond.

The insurance industry is not immune to this trend. Blockchains have been lauded by advocates as the next great disruptor for the industry, capable of automating claims handling, providing irrefutable proof of provenance, securing customer and company data, eliminating fraud and more.

Others doubt the need for the systems, and many are sceptical of the technology due to its popular association with the cryptocurrency Bitcoin.

Linked in

So what are blockchains, how do they work, and how could they become a disruptive force in the insurance industry?

Blockchains are ledgers, distributed individually to each party involved, which are unable to be altered on a unilateral basis, and which record a series of transactions. The "blockchain" ledger, which originated as a platform on which to trade Bitcoins, records each transaction in a series of "blocks", which are organised into a "chain" that is recorded on each individual version of the ledger simultaneously.

This allows all parties to review every change made to the ledger, without the need for a third party to review and affirm each transaction.

The technology enables peer-to-peer connection, and allows users to determine the veracity of the information instantly, while still ensuring sensitive information remains confidential.

In order to game the ledger and falsify records, over half of the bystanders would have to lie simultaneously and without prior coordination.

The proof of work demonstrated – a cryptographic process that proves the computer arrived at its destination in the correct manner – allows for a distributed consensus.

Regardless of who has made the transaction, everyone on the network is able to verify its contents, with no intermediary necessary.

Ending fraud

The potential applications of blockchain to the insurance industry are many and varied.

Fraud is one area where blockchain usage is repeatedly highlighted as a game-changer, as proponents say it has the potential to eliminate fraud from the insurance world.

The immutable nature of MDLs, and their ability to store vast quantities of information, could help prevent fraud as insurers would be able to prove the source of a claim and match this with the information they have on an individual, all within the confines of the blockchain.

Mahendra Nambiar, vice president for global insurance solutions and innovation lead at management consultancy Capgemini, says the nascent technology, while not able to eliminate fraud outright, is far more secure than the systems currently in place.

He says losses stemming from fraud could be substantially reduced with the use of blockchains. Given that, according to the Association of British Insurers, fraud currently costs the industry an estimated £1.32bn a year, and forces insurers to invest around £200mn a year in fraud identification, this is no small matter.

Nambiar adds that the distributed nature of the ledger allows any potential security breaches to be patched remotely, without the need for centralised third party oversight, drastically reducing not only the cost of fraudulent claims, but the administrative burden associated with mitigation, processing, erroneous payment and prosecution.

Identity management

However, says Alexander Shelkovnikov, corporate venturing and blockchain lead for Deloitte in the UK: "It's obviously not simple to get fraud to disappear completely, and there are a number of areas you need to solve before you have that happen."

One of the critical areas that could impact fraud is identity management. MDLs do not require a user to reveal their whole identity in order for the counterparty to be certain it is them. This is the system used on Bitcoin blockchains. The user is only required to reveal the part of their identity that is necessary for the opposing party to confirm the identity. Extraneous information is excluded.

> "The distributed nature of the ledger allows any potential security breaches to be patched remotely, without the need for centralised third party oversight"

This system is the equivalent of ordering a drink at a bar, and instead of being required to divulge the full information on your identity card, which includes irrelevant information such as your name, address and gender, having the ability to only show your age.

In a blockchain system, the counterparty, in this case the barman, is able to trust your identity, using only the information relevant to them. The person ordering is able to control which personal information they wish or are required to reveal.

However, for MDLs or blockchains to become usable for business, they will have to meet a raft of regulatory stipulations. Identity management is one of the most pressing issues.

Shelkovnikov says: "Solving identity management on the blockchain is important because you don't necessarily need to align the unique identifier to a specific identity. It can be done, but it is not necessary for the public blockchain to operate.

"However if you want blockchains to succeed in the enterprise world, if you want blockchain services to make a real impact, including in insurance, you need to be able to understand whether the individual or the party you are dealing with is the one you want to be dealing with, and from a regulatory perspective you are able to do so."

In addition, he says: "The other side is you want to take advantage of blockchain technology in order to make identity management secure and enable individuals and consumers to actually own their own identity, control how they share it and how they share documents and assets associated with that identity."

Paolo Cuomo, chief operations officer of Charles Taylor Managing Agency, thinks the adoption of MDL or blockchain technology will also have an impact on speculative claims, which also drain insurers' resources.

"It will immediately be able to reduce claims. You can't lie on a blockchain," says Cuomo. He adds that insurers should view MDL technology not as a radically different approach to the industry, but as the future equivalent of the insurance contract.

He says the technology is more likely to be successfully implemented to determine the origin of goods covered by insurers – for example specie or food products.

Smart contracts

Blockchains could also have a broader application in the insurance industry.

Continued on page 24

Chain reaction
continued from page 23

Smart contracts are consistently touted as one of the best applications of blockchain technology in the business arena.

Smart contracts are protocols stored in the ledger, representing real-world agreements, which are capable of enacting, verifying or facilitating said agreements automatically once certain criteria have been met.

Companies flaunting their smart contract capabilities have increased in number over the last few years. Canadian company Ethereum is leading the charge in this space with a currency known as Ether, which is based on similar principles to Bitcoin.

The technology has also captured the attention of the insurance industry, as companies and individuals have caught on to the notion that it could offer an improvement to the current claims system.

The contracts could enable automated claims payment, cutting the need for claims handling and associated costs including litigation and claims adjustment.

Shelkovnikov says that while the smart contract could indeed prove revolutionary in changing how claims are handled by companies, there are myriad difficulties in translating the logic of an insurance contract into code that can be trusted to act the way it is intended on a consistent basis.

"Smart contracts essentially enable programmability of a blockchain. You can set your logic to automatically execute certain transactions on the blockchain," he explains. "It's all about how easy it is to properly describe the conditions on the contract. How easy it is to write the logic for the executions."

He continues: "In order for the computer to execute the contract there should not be any grey areas. So you need to know whether to process the claim or not. You need to know whether or not to execute a payment, and that will be decided on the back of a specific condition or logic."

One company which is already using blockchain technology and smart contracts as an integral part of its business is SafeShare.

The company describes itself as "the insurance solution for the sharing economy", offering bespoke insurance products for private individuals on a temporary basis.

> "Smart contracts essentially enable programmability of a blockchain. You can set your logic to automatically execute certain transactions on the blockchain"

The products are designed to allow individuals to opt in to temporary cover, with all data for the transaction stored within a blockchain ledger.

While the technology helps to prevent fraud, SafeShare CEO Alex Steinart says it has also aided the company's pay-as-you go model, and provided it with an unambiguous claims service.

He says the three main things blockchain technology can offer to insurance companies are "transparency, clarity and claims processing".

When pressed on whether SafeShare's use of blockchain could be expanded into the commercial and Lloyd's markets, Steinart says that, despite the advantages, he doesn't see the broader market adopting the technology wholesale in the near future.

"There isn't going to be a centralised Lloyd's ledger. I think when it comes they will be more individualised," he concludes.

Future potential

Despite the recent uptake of blockchain technology, it is not an entirely novel phenomenon. Michael Mainelli, chairman of commercial think-tank Z/Yen, which builds blockchains for a variety of purposes including insurance, has been working with distributed ledgers in enterprise for over 21 years.

He says that while ledgers have slowly started to draw the attention of insurance companies in the UK, insurers in Europe, Australia and elsewhere have already begun to adopt the technology for a number of purposes.

Mainelli said the problem in the UK was a fear centralised data centres could cause issues he perceived with Xchanging – that insurers don't want to pay for their own data again.

He says the main problem with the technology is people's perception of it being associated with Bitcoin rather than the ledger itself, adding that major insurers should be "running training courses" on blockchain.

While the potential for blockchain to disrupt the insurance industry is enormous, at present it remains just that – potential. The possible uses highlighted above are just a few notable examples of ways this technology could be applied to help insurers increase transparency and security, while cutting the costs of administration and fraud.

Whenever the blockchain revolution does arrive, Steinart is clear on one thing: "It may take time, but it will be the way forwards."

On the ILS trail

Fiona Robertson and **Lucy Jones** chart the journey of discovery some ILS pioneers have taken towards new frontiers

In the past decade, the insurance-linked securities (ILS) market has conquered large swathes of territory in the traditional reinsurance heartland of natural catastrophe – historically a volatile but richly rewarding peril.

However, following their success, ILS funds are now prospecting for further wins in a more cramped, competitive environment.

Some still believe there are yet more gains to be made in the nat cat market, but others are pushing to journey into entirely new risk territories. *Insider Quarterly* looks at some of the likely trails being blazed by these intrepid underwriters and the hazards ahead.

Early milestones

The ILS fund managers that are already expanding beyond the nat cat sector are often choosing to do so in partnership with existing carriers.

Notably, top two firm Credit Suisse Asset Management made its entry into the Lloyd's market via a special purpose syndicate with Barbican. Even after setting up its own syndicate – Arcus 1856 – Credit Suisse is still taking a quota share of Barbican's portfolio, including marine, aviation, transport and specialty risks.

The asset manager also helped raise capital for a fund investing in legacy insurance risk with Bermudian run-off specialist Armour Group.

In the cat bond market, Credit Suisse has recently completed an operational risk deal that saw it cede risk to Zurich originally before the carrier transferred it to investors.

Conversely, sponsors may also turn to new types of investors to help them source unusual ILS insurance.

American International Group (AIG) recently completed two mortgage insurance deals in ILS format through its Bellemeade Re transactions for subsidiary United Guaranty.

Willis Capital Markets & Advisory's head of ILS Bill Dubinsky says that this transaction shows that progress into new frontiers doesn't need to be accomplished with the same investor pool as the current major ILS funds.

"Different investors will gravitate towards separate risks," he says. "[Expansion] could be either led by new investors who specialise in certain areas or it could be existing investors who add to their underwriting talent and expertise as they see an opportunity.

"In reality, it will probably be a combination of the two, depending on how far the new segments are from what investors are doing right now."

It's no surprise that tabulating a

list of unusual cat bonds produces more variety of transactions before the 2008 credit crisis, when credit wrappers and ratings for bonds were more readily available. But the crisis did also more firmly entrench one guiding principle amongst ILS investors – the pursuit of non-correlating risks.

The crash proved the case for these investors' USP – that their returns did not follow the inexorable slide of other financial markets. This means that certain types of risk, if they ever do return to the ILS market, may be very unlikely to be placed with the specialist ILS funds of the world – just as Bellemeade Re was done in ILS format but placed largely with mortgage investors.

The Crystal Credit transaction performed by Swiss Re, which actually paid out during the crisis as its credit losses spiralled, is a prime example.

One post-crisis example of new risks being taken to the ILS market took the non-correlating principle to its logical end point. Lottery risk deals done by MyLotto24 and Lottoland were able to convince risk-takers of the mathematically random nature of a jackpot payout.

Exotic ILS

Date	Deal	Size (mn)	Sponsor	Risk	Payouts (mn)
2016	Operational Re	CHF200	Credit Suisse	Operational risk	
2015	Bellemeade Re	$299	United Guaranty (AIG)	Mortgage insurance	
2011	Hoplon	EUR33	MyLotto24	Lottery wins	
2010	Vitality	$150	Aetna	Health insurance	
2008	Sparc	EUR61	Axa	Automobile insurance	
2007	Merlin	EUR95	Hannover Re	Reinsurance recoverables (credit risk)	
2007	Dekania	EUR275.5	Merrill Lynch, Friedman Billings Ramsey & Co	Insurer issuers subordinated debt	
2007	Ixis	EUR450.8	Axa	Automobile insurance	
2006	Crystal Credit	EUR252	Swiss Re	Credit reinsurance	EUR102.6*
2005	Sparc	EUR200	Axa	Automobile insurance	
2005	Avalon Re	$405	Oil Casualty Insurance	Industrial casualty	$12.69**
2003	Golden Goal Finance	$260	Fifa	World Cup cancellation (terrorism)	
2001	Georgetown Re	$44.5	St Paul Re	Worldwide all risks	$0.5***
1999	Kelvin	$44.61	Koch Energy	Extreme weather (temperature)	$5.1****
1999	Sectrs	EUR455	Gerling-Konzern	European insolvency	
1998	Gramercy Place	$566.28	TMCC	Auto lease residual value	

*Credit insurance claims 2006-2008; **Oil spill/explosions – asbestos-related losses disputed; ***WTC terrorist attack; ****Warm winter
Source: *Trading Risk*

Setting the compass

So what types of new risk are most likely to be appropriate for capital market investors to take on?

Existing short-tail lines of reinsurance are likely to be the main focus, says Brit Insurance's portfolio director for short-tail treaty, Jon Sullivan.

"I think the shorter the tail, the easier it is to manage investors' expectations on a year to year basis," he says.

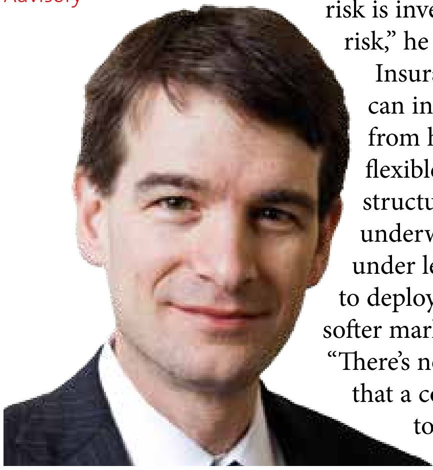
But former AIG head of capital markets and chief reinsurance officer Samir Shah thinks there is scope on a far larger scale.

"I don't think there are any conceptual limitations in terms of insurance risk that can be securitised," he says. "I think the possibilities are endless."

"If you can reliably assess the risk and make it transparent to investors then that really is the path to commoditising capital and that can apply to almost all risk."

The executive suggests that both insurers and investors could benefit from far greater securitisation of insurance risk.

"Investors would benefit from being able to invest in pure insurance risk rather than when they buy insurance company stock, when more than half the risk is investment risk," he explains.



Bill Dubinsky, head of ILS, Willis Capital Markets & Advisory

Insurance carriers can in turn benefit from having more flexible capital structures, putting underwriters under less pressure to deploy capacity in softer markets.

"There's no reason that a company has to rely almost exclusively on permanent capital," he suggests. "It makes sense to have some combination of permanent on-balance sheet capital and temporary off-balance sheet capital that can be flexed in different market environments."

Assessing the risks

The challenges for ILS underwriters in expanding into new regions will likely vary based on the direction they choose to strike out in.

Reinsurance sectors that are already highly developed, even if there is little use of ILS capacity, are likely to be highly competitive, Brit's Sullivan points out.

"I think if people want to get involved, and try to find space in the programme, they can price accordingly," he says.

But competing on price may not work in the context of a collateralised reinsurance shop, whereas rated carriers may have to hold little capital against business that acts as a diversifier in their underwriting portfolio – allowing them to price at the thinnest of margins.

Continued on page 28

On the ILS trail
continued from page 27

In contrast, emerging risks such as cyber present a hotspot of massive, growing demand in an under-supplied sector, but there is a reason that fewer underwriters are venturing into these fields.

"We're talking about an emerging market where the policies and premium are susceptible to change," Dubinsky notes. "Until we have many, many events, it's difficult to really finalise those wordings. Excess of loss structures placed in the capital markets require accuracy and wordings can be challenging to achieve in an emerging risk category."

Investments in modelling are required to address this chicken-and-egg problem – something that is already happening in the cyber market, although progress will take some years.

Using traditional reinsurers as fronting carriers is another model that has been suggested as a template for introducing new risks to the ILS market – just as Credit Suisse did by partnering with Zurich on Operational Re.

In a recent BNY Mellon Report, Willis Capital Markets & Advisory's president of ILS Quentin Perrot suggested that, if done properly, this could create an alignment of interest between investors and the sponsor that could help overcome other hurdles to taking on new risks.

"You may be able to relax the structuring limitations that typically apply to non-proportional ILS a little bit, such as the requirement for an external third-party model," he said in the report.

The explorer's mindset

Setting aside questions of data adequacy, Shah argues that the number one factor holding up increased ILS use is an issue of business culture.

Samir Shah, former head of capital markets and chief reinsurance officer, AIG

While he believes insurers would be more efficient as risk originators and assessors that parcelled out much more risk, he notes that the industry itself doesn't think that way, adding: "It thinks of itself as the warehouser of risk."

Brit's Jon Sullivan says that there are also cultural obstacles to overcome among reinsurance underwriters.

"I think you naturally get that herd mentality that people don't necessarily want to be out on their own doing something brand new, unless you are extremely confident."

One fund admitted to having a heated debate over whether to participate in Credit Suisse's Operational Re bond, which includes operational risk events such as cyber breaches or rogue trader losses, as defined under Basel III regulations.

The arrival of new risk was welcomed and offered diversification, but ultimately it was decided clients had different expectations of what should be in a cat bond and so the fund did not participate.

Trading Risk is the market-leading title covering the convergence of the (re)insurance industry with the capital markets www.trading-risk.com

The road not taken

So what will happen if the industry shies away from innovating?

This was one of the topics of heated debate at the *Trading Risk* Roundtable held during last year's Monte Carlo Rendez-Vous. At the time, Aon Securities CEO Paul Schultz said that remaining concentrated in the cat markets would limit the ILS market's future growth potential, as cedants look for partners that can offer multi-line solutions.

"It's going to be hard to sustain growth in that model versus doing something that's a little bit broader," he said.

The current market environment provides a rich field for development, Shah argues.

"I think [failure to innovate] will be a missed opportunity because the timing is perfect," he says. "Companies are beginning to move away from traditional actuarial [methods] to leveraging big data and gathering very specific information to better understand risk."

This would help companies in turn to provide more transparent information to investors looking to take on new risks, Shah says.

Perhaps the best example of successful adaptation in the ILS market to date has been Aetna's series of Vitality Re bonds.

As the name suggests, the deals cover health insurance risk – a well-modelled line of business that has won support from life ILS investors.

After launching its debut transaction in late 2010, Aetna has gone on to complete a series of regular cat bonds on an annual basis. One year it even succeeded in breaking what had long been perceived as the ILS market's floor on rates, raising cover for just a 1.75 percent insurance premium.

The Vitality deals are now an accepted feature of the ILS markets.

Ultimately, this is the goal for the next line of business to be adapted into the ILS markets – to go from uncatalogued exotic specimen to unremarkable daily fodder.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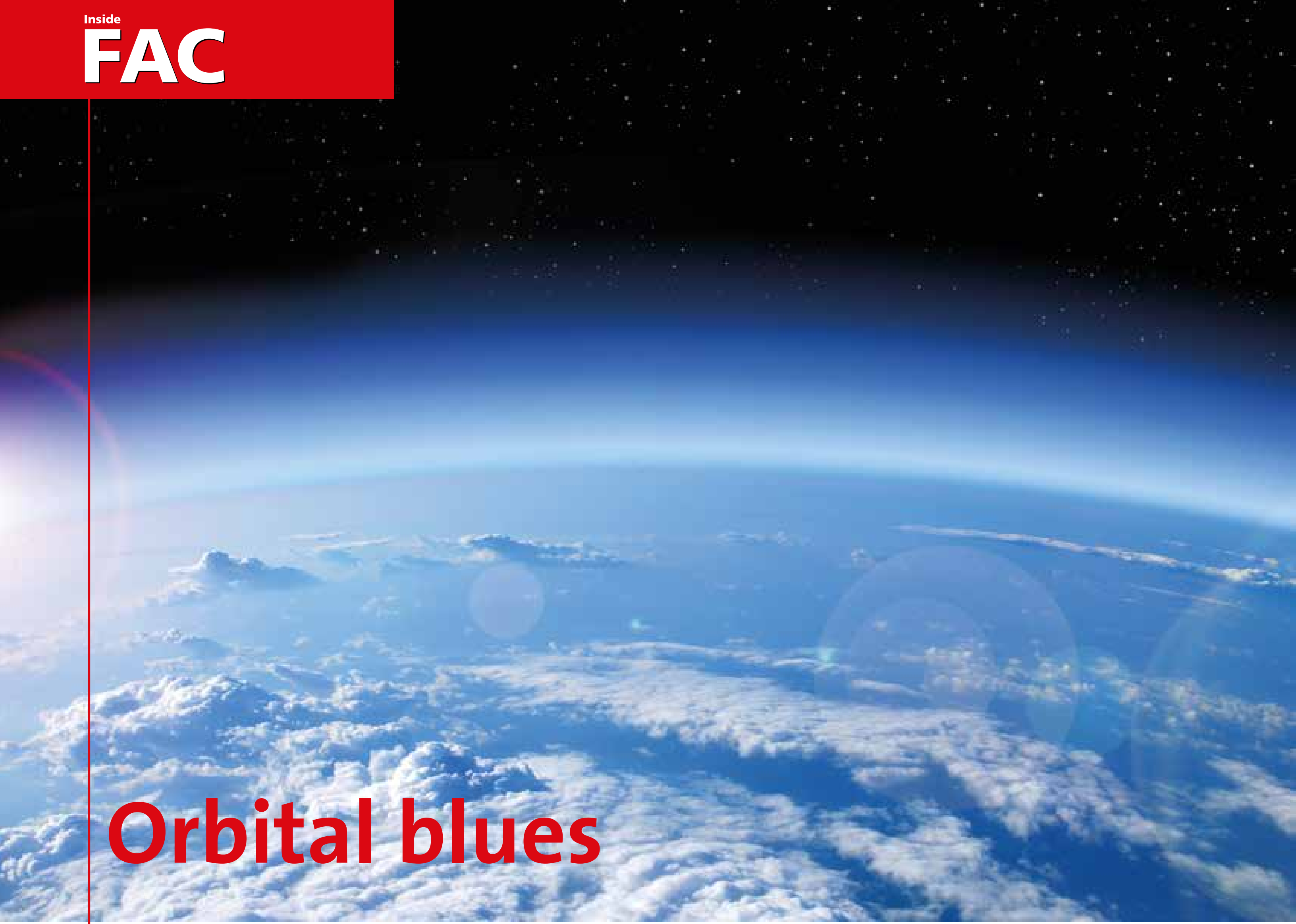

Orbital blues

A severe recent loss record, the continued influx of capacity and a premium base which now seems very stretched indeed spell testing times for the niche space market, says **Marcus Alcock**

So far, so good for the space market in 2016. We shouldn't speak too soon, but there don't appear to have been any really significant losses on the radar for underwriters.

Mind you, it couldn't be any worse than 2015, which with some $761mn in major satellite losses stands out as one of the worst years on record, with claims outstripping a meagre premium base that has been edging downwards for several years.

"This year it's been great in terms of losses, as nothing really seems to have gone wrong so far, so on the face of it it's been a pretty good start to 2016," observes one London space underwriter. "But whether that's such a good thing in terms of rating is another question, given that at the moment premium is so low."

Unsurprisingly, he suggests that much of the current soft rating environment has been caused by the appearance of several new kids on what was an already very crowded block: "It's fair to say it's a very competitive market, with a number of new entrants in recent years, including several MGAs and most recently Richard Brindle's start-up, Fidelis.

Inside FAC is the sister publication to *The Insurance Insider* and is dedicated to the global facultative reinsurance markets. www.insidefac.com

"You can see why people do it, as space is a classic non-correlated line, so in the current market it's a great diversity play for underwriters."

Indeed, it would appear that the space premium conundrum is key to understanding the current state of the sector. Naturally space insurance premium, both for launch and in-orbit, fluctuates in much the same manner as more mainstream insurance lines, but it tends to be less correlated with the core market than one might expect, in some regards sketching its own cycle based on the loss experience.

Going into 2016, the premium

experience had been one of steady erosion, having fallen from a total market peak of some $1bn to a point where at the start of this year it was almost 40 percent off. In part this has been driven by the arrival of extra capacity in recent years from the likes of Starr Insurance, USG Insurance Services and Fidelis – in effect creating a market where, as things stand, supply outstrips demand, both for in-orbit and launch risks.

Despite the influx of new capacity into the space market, some underwriters were hoping that the severe recent loss experience might act as some sort of corrective to the soft state of play, given that 2015 saw two substantive losses – one of them on a par with some of the largest that market has ever experienced.

In-orbit wipe-out

The incident in question occurred in late November last year, with the loss of the Amos-5 communications satellite. In an announcement on 22 November, Israeli satellite operator Spacecom revealed that it had lost contact with the satellite the day before, as a result of an unknown anomaly. A manufacturer's assessment on Amos-5 said the most likely reason for its failure was a "complete breakdown in the electricity supply system resulting from an internal malfunction, external damage to a component in the electricity supply system, or related wiring".

Amos-5 had been in geostationary orbit over Africa, where it had provided communications services to the burgeoning market there. Its sudden loss forced Spacecom to shift transmissions to other satellites it maintains.

The satellite was subsequently declared a total loss in December, with the $158mn in-orbit policy believed to be spread widely across the market. As reported

2015 space market losses

Insured	Date	Details	Estimated market loss ($mn)
Amos-5	21-Nov	The Marsh-placed slip was understood to be led by Munich Re and Swiss Re	158
MexSat-1 Satellite (launch failure of a Russian-made Proton-M rocket)	16-May	Marsh placement; Berkshire Hathaway understood to have largest exposure at circa $50mn. AIG, AGCS and Swiss Re also on the programme	389-489
Progress M-27M spacecraft	8-May	Co-insured in the Russian primary market by Ingosstrakh and Sogaz and reinsured into London	39
EgyptSat-2	23-Apr	Cooper Gay placement	75
			Total: $761mn

Source: *Inside FAC*

at the time, the Marsh-placed slip was understood to be led by Munich Re and Swiss Re, with London market sources indicating that the loss had effectively wiped out around 18 months' worth of in-orbit premium.

> "With some $761mn in major satellite losses, 2015 stands out as one of the worst years on record"

The loss of Amos-5 was not the only significant claim to come from 2015. The explosion of the Space Exploration Technologies (SpaceX) Falcon 9 rocket on 28 June also hit parts of the commercial market.

The launcher, with a Dragon cargo module aboard, exploded two minutes after launch from Cape Canaveral, Florida while on a resupply mission for Nasa to the International Space Station (ISS).

According to a statement from the company, analysis suggested the overpressure event in the upper stage liquid oxygen tank was initiated by a flawed piece of support hardware (a "strut") inside the second stage.

Several hundred struts fly on every Falcon 9 vehicle, with a cumulative flight history of several thousand. The strut believed to have failed was designed and material certified to handle 10,000 lbs of force, but failed at 2,000 lbs.

In the case of the so-called CRS-7 mission, it appears that one of these supporting pieces inside the second stage failed approximately 138 seconds into flight. The pressurisation system itself was performing nominally, but with the failure of this strut, the helium system integrity was breached. This caused a high pressure event inside the second stage within less than one second and the stage was no longer able to maintain its structural integrity.

Although the Nasa cargo was unlikely to have commercial insurance coverage, SpaceX, in similar vein to rival launch firm Orbital Sciences Corp, is understood to receive success fees from Nasa for resupply missions, which were insured in the open market.

The circa $400mn loss of the MexSat-1 craft in May 2015, along with the Russian Proton-M launcher, came hot on the heels of the launch failure last April of the Progress M-27M cargo spacecraft, which took off from the Baikonur Cosmodrome aboard a Soyuz launch vehicle – although the scale of the Progress loss was much smaller.

The failed resupply mission

Continued on page 32

Orbital blues
Continued from page 31

to the ISS was a $39mn loss for the Progress programme, which is co-insured in the Russian primary market by Ingosstrakh and Sogaz and reinsured into the London space market.

Record low?

Given the severity of the 2015 loss experience, one would have hoped that 2016 would present, if not exactly a hardening of rates, at least some sort of correction to the relentless pace of reductions that has been the pattern of the past few years. Yet the signs have not been encouraging here.

According to *SatelliteFinance*, for example, total space insurance premium estimates for the first quarter of 2016 were coming in at less than $150mn, suggesting the market is on target for a record low annual premium tally if the trend continues into the remaining quarters of the year.

So what would it take for the market to turn? Those in the space insurance sector are unsure how to answer this question.

> "I'm not sure we have the premium base to cope with large losses at the moment"

"I'm not sure what would trigger a change at this time," muses one underwriter. "Within the space insurance market you'd expect a couple of major losses within a year which the market should be able to absorb, but I'm not sure we have the premium base to cope with large losses at the moment."

The remainder of the year will be where the real action is for the niche space insurance market, given that the bulk of launch action is scheduled for this period, he suggests.

In particular, he says, the market will be watching and waiting for a series of Falcon 9 launches, which, with a scheduled 18 launches this year, is almost equivalent to the rest of the market put together.

SpaceX's Falcon 9 is significant as it represents the world's first "recyclable" rocket. Last year SpaceX brought the first stage of its Falcon 9 rocket back to Earth for a soft touchdown on 21 December, in the process achieving the first-ever rocket landing in history during an orbital launch. The Falcon 9 mission also delivered 11 commercial satellites into orbit for SpaceX customer Orbcomm.

As SpaceX CEO Elon Musk said at the time: "I do think it's a revolutionary moment…no one has ever brought an orbital class booster back intact…This is a fundamental step change compared to any other rocket that's ever flown."

From the perspective of the space market observer, the prospect of similar launches later this year is thrilling. For seasoned underwriters, however, the prospect fills them with trepidation.

As one caustically comments: "It's a bit difficult to comment on the 2016 to date, as really there haven't been that many launches, but there are lots scheduled for the rest of the year, so there's plenty of time for things to go wrong." Indeed there is.

Space insurance: a duffer's guide

Material damage

Material damage insurance covers physical damage to, or loss of, a space object during one of the four stages of its life cycle. Contracts may cover the object during its manufacture, pre-launch, launch and whilst it is in orbit. The insured may be a satellite manufacturer, satellite operator or a provider of launch services. Space objects are moveable property.

Most territories treat space objects as moveable property and the risk location is determined by the physical location of the object. However, for regulatory and tax purposes, European Economic Area member states consider the risk location for launch and in-orbit risks to be the territory in which the insured's business establishment is located.

The location of risk for space objects in transit or temporary storage follow the rules respectively for goods in transit or normal storage risks.

If the object is in orbit for the entire period of the insurance, then the risk may not fall within any territory's regulatory or tax regime.

In some territories, for example Canada and the US, the location of the insured's residence or business establishment creates a risk location irrespective of the physical location of the insured property. Consequently, if the insured property is in a different territory from the insured's residence or business establishment, there are two territories for regulation and tax.

Consequential financial loss

Consequential financial loss insurance covers the service interruption, loss of profits, revenue or additional expenses that might be incurred if a space object cannot be used following material damage. The risk location is the territory in which the insured's business establishment is located.

Third party liability

Third party liability insurance covers the legal liabilities of the insured to third parties for bodily injury or property damage, when the space object is on the ground, during launch or in orbit.

The risk location is the territory in which the insured's business establishment is located.

Source: Lloyd's

Things fall apart

Like the protagonist in Chinua Achebe's postcolonial novel, the burgeoning terrorism market is in danger of failing to keep up with the times, says **Winifred Okocha**

Oral history plays an important role in various societies around the world, not least in the storytelling tradition found in south-eastern Nigeria.

Folktales, proverbs, songs and dance all serve the practical purpose of passing on cultural history, ensuring that traditions never die, but they also transmit lessons on morality and the changing world to the next generation.

It is this oral tradition that novelist Chinua Achebe employed in his postcolonial tale *Things Fall Apart* – the story of a strong man's fall from grace in a village in Nigeria, after the extreme changes British colonialism brought to his homeland.

Postcolonial African literature probably isn't the first thing that comes to mind when examining the state of the terrorism insurance market today, but the tragic story of the fall of the protagonist, Okonkwo, acts as a cautionary tale to any person – or in this case, any class of business – unable to deal with an evolving world.

The changing threat

The nature of terrorism is changing and the industry has tragically learned this over the last year in Paris and Brussels – and also in San Bernardino, California.

So said JLT Re's global head of analytics David Flandro at the Association of Lloyd's Members national conference on 23 May.

Video still from Nigeria's Boko Haram terrorist network

"The targets no longer seem to be right now the big buildings like we saw on 9/11, but smaller targets with smaller groups of people trying to get more bang for their buck as it were."

Flandro told delegates that the loss of life was the main goal rather than the loss of property, adding that there had been more attempts at terrorist atrocities.

"The number of attacks and fatalities has really increased over the last 15 years. What does that mean for how we write terrorism? Are we really modelling it correctly? Should we be modelling football stadiums in northern England instead of modelling realistic disaster scenarios in central London? That's something that is changing."

This changing risk was evident in the terrorist attack on the Westgate shopping centre in the Kenyan capital Nairobi back in 2013.

Although the methodology in this attack was to target people, there was still a big property loss.

Terrorism liability insurance is one of the newer terrorism products that could be used in any future attack similar to that seen at Westgate.

According to Sompo Canopius' head of sabotage and terrorism Tim Davies, the purchase of terrorism liability insurance is increasing.

"It covers errors and omissions and is quite a broad coverage and it is surprising that more people do not buy it," he says.

However, he adds that it is quite an underdeveloped market compared to the property damage space.

"It is a growing product and an important coverage and it is usually the big companies that buy it, although we are seeing some smaller companies are purchasing it too," Davies continues.

He adds that contingency cover for terrorism exposures has experienced similar growth.

"An example is when music concerts are cancelled – sometimes this can cover threat of terrorism. Over the last 18 months there has been a noticeable increase in demand for these types of policies," Davies says.

Market correction

Despite the changing threat, Russell Kennedy, divisional director for war and terrorism at Brit, has faith in the current suite of products available to customers.

"The first point to make is that I really believe that the existing set of products on offer do work. If you look at Belgium for example, the losses that are going to come out are relatively substantial."

Andrew Bauckham, political violence class underwriter at Chaucer, adds that for the most part, carriers do still offer what is needed.

"The market provides property cover and many other people provide products like workers' compensation – it is not as if the market does not provide the coverage required, so I'm not sure that there is a correction needed in the market."

However, Bauckham says that the market is already correcting itself in terms of property damage and business interruption.

When it comes to evaluating what's happening now in contrast to the past, Kennedy says that the market has changed a lot in the last 10 years or more and that there has been a broadening of cover in all sorts of ways.

"The product is totally unrecognisable from was offered at 9/11," he elaborates.

"I think it does need to develop and there are a number of risks that are uninsured.

"There is a lot of discussion about the ways in which the product and the market needs to change. There are a whole host of options that we could be selling to the market that clients really need, such as crisis management products," he adds.

The elephant in the room

In the US, terrorism (re)insurers compete with the Terrorism Risk Insurance Act (Tria), the federal backstop used in the event of a large-scale terrorist event.

Last January, US President Barack Obama signed a six-year renewal of Tria, ending a period of uncertainty over terrorism coverage triggered by the programme's lapse.

However, Davies notes that a substantial number of insureds will still buy from the standalone market.

"Carriers are scared that it is not an act of terror unless the government defines it as such," he explains.

"Insureds therefore want contract certainty. For instance, Boston [the 2013 Boston Marathon bombings] has still not been declared an act of terror by the US government," Davies adds.

An added complexity, however, is the question as to whether Tria covers cyber terrorism.

When it comes to the UK's state-backed scheme Pool Re, there have been calls for it to be broadened to offer cyber coverage.

The most recent call was from Mark Field, MP for the Cities of London and Westminster.

Writing in *City AM* in April, Field said that UK businesses and

Continued on page 36

Contingency payouts

Back in 2012, musician Lady Gaga cancelled a concert in Jakarta, Indonesia, following protests by fundamentalist groups, citing threats of violence against the singer and others associated with the tour.

The Islamic Defenders Front protested against the singer after claiming her show was too vulgar, and police refused to issue a permit to enter the country.

Gaga's concert promoters later sued insurers for non-payment of claims on their terrorism coverage.

The Gaga action was unusual in that such a loss would usually be expected to surface as straightforward event cancellation claims in the contingency market, rather than as a terrorism claim.

The coverage was led in the London market by Liberty Syndicates, which is understood to have agreed to pay out on the claim, but the following insurers disagreed and contested the claim.

Indonesia has the world's largest Muslim population, although is officially secular.

And in 2014, singer-songwriter Taylor Swift cancelled a performance in the Thai capital Bangkok, after the army took over and martial law was declared in the country.

The military decision followed months of anti-government protests.

In both cases, claims under contingency terrorism insurance were later paid.

Things fall apart
continued from page 35

infrastructure remained exposed to cyber attacks and highlighted that no product had yet been designed to insure against the risk.

However, rather than creating a standalone Cyber Re, industry and government could instead look at a broader catastrophe pool that could be expanded in response to emerging threats, he said.

"This could be achieved by broadening Pool Re's scope, something for which there is precedent – chemical, nuclear, biological and radiological attacks were added to its terrorism coverage in the aftermath of 9/11," Field explained.

His suggestion came after Lord David Blunkett and XL Catlin executive deputy chairman Stephen Catlin called for a state-backed indemnity pool for cyber attacks.

Speaking at CFC Underwriting's cyber symposium last December, Catlin said that the insurance industry could not currently cover the scale of potential losses arising from a cyber attack alone.

While those within and outside of the insurance industry have differing views on this, one thing remains certain: defining whether something is cyber terrorism or not is problematic.

"It is very difficult to figure out whether an event is a malicious act or an act of terrorism," Davies says.

"The difficulty is in establishing the intent behind the attack and the instigator, i.e. act of war or a malicious hacking act, or just a kid having fun!"

Davies explains that in these cases where there is a blurring of the lines, there could be a gap in cover.

"The worry is figuring out if something is terrorism, malicious or a naïve hack with no intention to cause criminal damage. In each of these cases there could be a gap in cover as they are insured by different insurance policies.

"Another problem is that cyber is a very new class of business. Insurers are being asked to water down their exclusions as a way to provide cover on a policy not designed to protect against cyber attacks.

"This is a concern, namely, buying cover not properly tailored to the needs and requirements of the insureds and not having certainty in the protection being offered."

> "In Nigeria, which is a big purchaser of political violence products, one of the biggest problems has always been the risk to the pipelines in the oil-rich Niger Delta area"

Davies continues: "Cyber is also quite diverse. Data breach falls into liability but the physical damage tends not to have a home so it gets pushed into the terrorism market."

Despite all the uncertainty, an appetite for cyber in the standalone market remains, but wordings are important, says Bauckham.

"The market is evolving and the wordings are evolving – you also have to be very mindful of different territories," he adds.

Hope for the future

In spite of the challenges the terrorism insurance market faces, there remains a lot to be proud of, according to Davies.

"Some insurers are still willing to write in places like Yemen, Syria and Nigeria. One of the biggest problems with Nigeria is the risk of kidnap and ransom," he says.

His colleague Simon Low, group head of political risk and crisis management at Sompo Canopius, has been working in Nigeria for a long time and says that one of the biggest problems has always been the risk to the pipelines in the oil-rich Niger Delta area of the country.

Davies says that Nigeria is big purchaser of political violence products and while this may not shock many, it may come as a surprise that the country is one of the biggest manufacturers and consumers of instant noodles.

"Nigeria is a big purchaser of political violence products and Sompo Canopius covers a diverse range of risks from oil to a big noodle factory in the country," Davies continues.

However, it is not just damage to oil pipelines and instant noodle factories that pose a risk to the West African nation, with the country also facing an ongoing menace in the form of terrorist group Boko Haram.

"There have been a large number of new enquiries from retail units as they are interested in cover in the north-east of the country due to the threat posed by Boko Haram," Low says.

It is apt that we end our story here in Nigeria, home of the story of Okonkwo. Unwavering in his aim to be unlike his father, his pugnaciousness and obstinacy eventually contribute to his undoing.

While the story highlights the destruction that can come with a proselytising outsider, it is also a reminder of the damage that can be caused by dangerous pride and an inability to tackle a changing world.

The terrorism insurance market today may need to take notes if it is to offer the right product to its customers, or risk the same fate as – arguably – Africa's greatest antihero.

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Freefall

As property reinsurance rates defy economic logic with their continuing downward plunge, industry executives seem unclear as to when a pricing floor will be reached, finds **Dan Ascher**

Property reinsurance prices continue to defy economic logic – and when the laws of supply and demand cease to apply strange things start to happen, according to speakers at this year's Insider New York event.

Rates have been in freefall for longer than anyone expected, with both brokers and reinsurers often reporting double-digit pricing declines year after year for at least the last decade.

The rating reductions don't just erode profit margins for carriers, they also breed a mistrust between insurers and their reinsurers and between reinsurers and their retro providers, said JLT Re CEO Ed Hochberg at Insider New York.

The executive said that a pricing floor was "in sight", but warned that the market was yet to hit rock bottom.

And as prices trend downwards towards that inflection point, the reinsurance broker warned that "stuff starts to happen", suggesting that carriers would look to recalibrate their view on assuming risk.

He predicted that a hardening in the market would occur as insurers started to question the reserve allocation of their opposite numbers.

"When reserves go upside down, when you don't believe the balance sheet of your counterparty, that's when things can get very sketchy," he said.

With a note of foreboding, the executive added: "We're not quite there yet, but maybe we're not that far away."

Punch drunk

Endurance Re's US president and chief underwriting officer Chris Donelan agreed that it was only a matter of time before prices started to increase.

"The property market continues to defy logic," the executive said.

But he explained that despite there being enough events in the first quarter of 2016 to at least "move the needle", the second quarter was proving to be even busier.

"Sometimes you need two punches to the head before you actually decide to do something," he remarked.

And the pricing declines have already taken some victims.

Scor's Jean-Paul Conoscente, head of the reinsurer's US operation, said the pricing trends in the property market had pushed some property cat mono-liners to the point of extinction.

He claimed that whilst the diversified continental reinsurers with a wide geographic reach had benefited from the market's move away from pure property cat business, others in the sector had suffered.

"A lot of the Bermuda players had to adapt very quickly because it's a little bit of a race against time," Conoscente continued.

"How quickly can you diversify before you become irrelevant?" the executive asked.

Arch Capital's chief financial officer Mark Lyons argued that the pricing declines were partly driven by the $100bn of excess capital in the market.

He said insurers and reinsurers were making questionable decisions as they struggled to grow in a market that is "dramatically" overcapitalised.

The executive explained that the capital fell into one of two camps. "We have intelligent capacity and innocent capacity," he said, albeit acknowledging that in some cases it could be both.

And he warned: "Investing organically and heavily in a soft market is – I think – questionable."

"You could leverage that through reinsurers and live off ceding commissions for a while, which is more of a short-term rather than a longer term view," he went on, adding: "You want to own the business after all."

He said that the only real hope was for an increase in the interest rate or a catastrophic event that "god willing" would not lead to a loss of life.

> "Rates have been in freefall for longer than anyone expected, with both brokers and reinsurers often reporting double-digit pricing declines year after year"

Juice it up

The executive also observed that the excess capital was no longer a US-centric phenomenon.

As an example, he pointed to the recent significant acquisitions by Japanese buyers, such as Tokio Marine's takeover of HCC and Mitsui Sumitomo's purchase of Amlin.

"I don't think we can be so narrow to just look at our own backyard," he said, claiming that Japanese carriers were facing 3-5 percent returns and were looking further afield to "juice it up".

Adding a further explanation for the surplus capacity, David Paul, executive director at professional services firm EY, said insurance-linked securities continued to be a big driver of capital in the industry.

"We don't see the interest from pension funds especially waning at all," he said.

"Whatever happens in the traditional capacity side of the business there's going to continue to be interest from third-party capital providers. I don't see any sign of that slowing down at this point."

Jack Kuhn, CEO of global insurance for Endurance, agreed that the market was looking at a new normal, saying it was unlikely that the traditional market cycle would continue in the future.

"When we look at the swings in those cycles...we probably are in for a new sort of order as we start moving ahead."

But in a rare display of optimism against this broad backdrop of pessimism, the executive said that whilst markets were unlikely to harden any time soon they were also unlikely to get much softer.

Kuhn went on to say that prices would stabilise as underwriting improves, adding: "There aren't going to be places for us to hide with the reserve releases and the investment income.

"When you have a hard market it's because so much capacity has been sucked out. Now the question is: are we and will we have one big event that will trigger that hard market?"

Taking the $100bn figure as an example, Kuhn said: "I'm not sure we get there [to $100bn] with that one event. We've seen some events over the last five years but they've been more regionalised than anything else."

Effective deployment

However, Hamilton's chief financial officer Jonathan Reiss seemed to have little truck for the complaints about dwindling pricing.

He argued that excess capacity meant that carriers were not effectively deploying the capital at their disposal.

"Obviously the market's soft but it's usually soft – and we've got to get on with it," he said.

Continued on page 40

Freefall
continued from page 39

The executive explained that the difference between economic losses and insured losses in most large claims was "huge" and that the disparity between the two was growing all the time.

"It clearly shows that as an industry...we're not insuring the needs of our customers sufficiently. I obviously recognise that there's a lot of capital in our industry, but if we can figure out ways to change I think there would be good uses for that capital."

AmWins CEO Steve DeCarlo suggested that wholesaler brokers provided a market for that surplus capital, as he strongly defended the role of firms like his as an essential part of the insurance food chain.

DeCarlo said the use of a wholesale broker was in the client's best interest.

"As the game is getting bigger and the game has got more complex, the art – and it is an art – of being a market feeder sometimes gets disrespected and they believe you can be disintermediated.

"And I can tell you as a finance guy and somebody that believes in data, it is a people business. Risk transfer is done by trust: broker to underwriter, retailer to wholesaler and, ultimately, insured to the retailer."

He argued that the wholesale broker's services were effectively free, claiming that AmWins would not be engaged unless it provided the best deals in the market.

"Ultimately, if I don't put the best deal on the table, I don't get paid," the executive surmised.

Strongest link

DeCarlo also defended the role of the retail broker, explaining that some market disruptors had jokingly labelled them dinosaurs.

"Insurers and reinsurers are making questionable decisions as they struggle to grow in a market that is 'dramatically' overcapitalised"

"The retailer is the most important person in the chain," he said.

"The retailer goes to church, plays golf, goes to the Rotary Club meeting to gain trust in risk transfer and that is not done through a call centre. It is not done through London, it is not done from Singapore – it is local."

And in a bid to further allay concerns, XL Catlin's reinsurance CEO Greg Hendrick predicted that emerging casualty reinsurance risks could eventually grow to exceed the current alternative capital base supporting the reinsurance market.

The executive highlighted cyber in particular as "the next big wave of the big risk", but stressed that reinsurers need to "measure, aggregate and package [these risks] properly".

"We're good at insuring things that exist, but we have a hard time at intangibles," he commented. "But I believe we will be able to harness the data and analytics. If we can do that then we will be able to harness capital far in advance of the alternative capital currently in the market."

Hendrick also attacked the notion that alternative capital is inherently less committed in the long term than traditional capital.

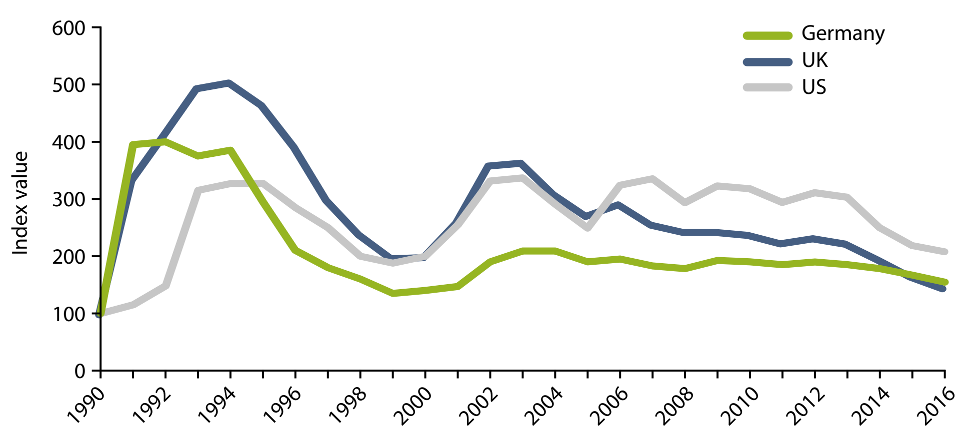
"A crisis will happen and capital will retrench, but that will be both traditional and non-traditional," he suggested, noting that past experience had demonstrated just how fickle traditional capital can be.

He cited examples of traditional capital withdrawing from the sector, including the US excess casualty market in the 1980s, the P&C sphere in the early 1990s and the dwindling support from Lloyd's Names in the mid-1990s.

Responding to a question from the Insider New York audience that suggested the industry was too risk-averse at present, Hendrick said that the key to a reinsurer's risk appetite was cycle-dependent.

"We are in a soft market now. The days of greater risk-taking were in a hard market, and being in a hard market tends to up the ante on taking a risk."

Property cat pricing trends



Source: Willis Re

LEGACY

The turning tide

Is a surge of third-party capital poised to flood into legacy?

From the publishers of Insider

High water mark

Having saturated the live P&C market, third-party capital has turned its eye on legacy. **Catrin Shi** assesses whether a flood tide is growing

As live carriers struggle against the tide of third-party capital flooding the market, investors are increasingly turning their attentions to the legacy space in the search for returns.

Perhaps the floodgates have not yet been flung open but alternative capital, frequently cited as the enemy of the live market, is definitely starting to trickle into the legacy space.

In the past 12 months a handful of structures harnessing these funds have appeared in the run-off market, alongside increasing private equity interest.

Aligned Re, the hedge fund reinsurance start-up backed by Enstar and UBS O'Connor, has launched its fundraising with a $700mn target in sight.

As of February, $220mn of this capital had already been pledged by Enstar, its private equity partner Stone Point Capital and management, before high net worth clients were approached.

Investor sources said that Aligned Re is being pitched as a total return reinsurer that will draw its investable assets from both live and legacy business, with an emphasis also placed on UBS O'Connor's history of relative outperformance in weak investment markets.

But where it differs from other total return reinsurers is this – the model is not based around upside from the run-off of the books of business.

Instead, the legacy transactions will be used to provide float that will allow the start-up to reach target investment leverage of 1.5x.

The upside from positive development on the reserves will be almost entirely returned to Enstar, with an 85 percent "run-off profit commission" written into the deal.

Additionally, using the hedge fund reinsurer for legacy deals should allow Enstar to secure higher investment returns on the assets, and would also allow it to fund deals partially via the use of third-party capital.

Meanwhile, Darag launched its Maltese protected cell company (PCC) in September last year, which acts as a vehicle to run off discontinued business.

The PCC serves as a platform for private equity capital to sit behind a book of liabilities, which would be run off by Darag.

It is understood that the legacy carrier would take a stake of at least 10 percent in any investment made into one of the cells.

This arrangement would see the German firm work in more of a third-party administrator role, albeit with more "skin in the game".

This was the arrangement thought to have been established between John Winter's Ruxley Capital and Chinese conglomerate Fosun, as they mulled bidding for Allianz's £185mn ($266mn) UK employers' liability book.

Of course, private equity has long been acquainted with the legacy market, with many legacy carriers owned or backed by private equity firms. But arguably this is the first time that third-party capital has started to noticeably disrupt market dynamics.

Carriers have seen a hike in the price of books in recent months due to a relative dearth of run-off opportunities. In *The Insurance Insider*'s annual legacy survey, competition and aggressive pricing were cited as two of the biggest challenges facing the market.

As these pricing pressures mount, it will be the smaller players that suffer unless they can find additional scale or capitalise on a niche untouched by the giants of the space.

On the other hand, with greater financial backing, the range of opportunities available to run-off carriers has significantly widened.

In any case, it's unlikely the growing volume of capital will dissipate now that it has saturated the live P&C market.

In the coming year, legacy carriers will face decisions on how to best harness these funds, whether via a hedge fund reinsurer, a PCC or otherwise.

Out of those looking to raise capital in the coming year, more than 90 percent surveyed said they would look to private equity to do so.

As to whether alternative capital enjoys the same level of success in legacy as it has in the live market, perhaps it's a question of sink or swim…

A better balance

FTI Consulting's **Ian Marshall** details the first solvent scheme of arrangement sanctioned under the UK's revised PRA/FCA regime

A solvent scheme of arrangement for reinsurance business in run-off – a solution thought dead by some – was sanctioned by the English courts on 3 May. This scheme, for which FTI Consulting acted as principal business adviser, is for a UK subsidiary of one of the Japanese insurance groups.

Our client sought ways to both conclude as much of the remaining run-off as possible and for it then to be dissolved. On the other hand, the Prudential Regulation Authority, as part of its consideration in meeting its statutory objectives, expects firms to ensure policyholders have an appropriate degree of continuity of cover. This creates a potential conflict with the finality objectives.

The solution was to develop a scheme of arrangement that provides continuity of cover and then for the scheme to be implemented in conjunction with a Part VII transfer. Both of these features are believed to be firsts in the UK.

So how could continuation of coverage work whilst still cutting off the claims tail? The reinsurance run-off has been in progress for 30 years, yet there are still open liabilities for LMX catastrophe losses and US long-tail claims. Despite the age of the run-off, copies of slips for most of the business exist as rudimentary un-indexed scanned images.

Ian Marshall is managing director of FTI Consulting

With this background, two bases were examined in order to develop the continuation of coverage concept. Firstly, on the policy side we converted the rudimentary images to OCR files. The end product was a schedule of policies by the reinsured. However, there was no means of knowing that all policies ever issued were found.

Therefore, the first basis of providing continuation of coverage was to limit the scheme to the identified policies relating to those policyholders that could be located. So, if a cedant reports a claim in the future on a policy not identified, this claim will not have been cut off in the scheme and would be paid in the ordinary course of business.

The second basis required identifying the claims profile by type of claim, which we analysed to produce known types of claim subject to the scheme. Any new claim type that might be reported in the future would not have been cut off in the scheme, as it deals only with the known types of claim.

We feel that these twin bases of continuing coverage provide a response to some of the past criticisms of schemes. The scheme is definitive as to the policies to which it applies, and does not seek to force unknown policies and unknown types of claim to be cut off. The scheme does cut off all liabilities of which the company is aware. On a Solvency II basis, the only claims not dealt with will be the "events not in data".

The solvent scheme deals with part of the exit strategy. Because of the continuing coverage the scheme company would not be able to be dissolved. Therefore a Part VII transfer was implemented. This transfer moves all the policies to the parent company, together with the now effective scheme of arrangement. The result is that the continuing coverage is being provided by the parent company and the scheme company can be dissolved.

What does this mean for the insurance run-off market?

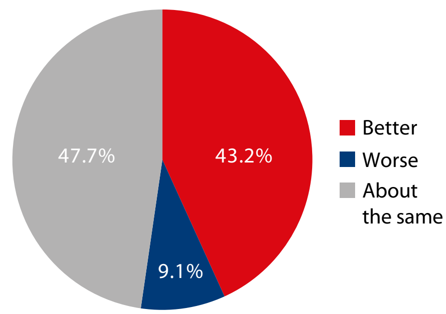
There is unlikely to be a return to the days of multiple solvent schemes. But this transaction shows that in appropriate circumstances a solvent scheme of arrangement can deal with all known liabilities, but still provide a mechanism for unknown claims to be presented outside the scheme.

This should achieve a better balance between the interests of insurer and policyholder.

Business as usual?

With increasing interest from private equity and third-party capital, how will legacy market dynamics alter in the coming year?

Is the picture for legacy carriers looking better or worse in 2016 than it was this time last year?



The majority of respondents were relatively upbeat about the prospects for the remainder of the year. Jointly, some 90.9 percent of those surveyed felt the current picture for the legacy market was the same or improved on last year, with just 9.1 percent taking a more pessimistic view. The implementation of Solvency II and the soft market were common reasons why the prospects for the year were viewed as better than in 2015.

Industry comment:

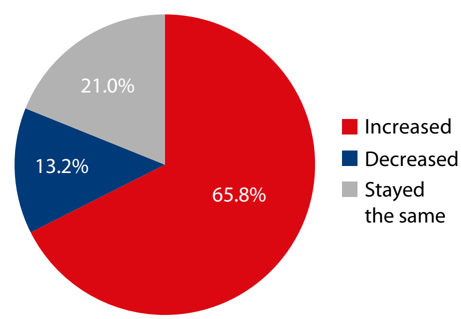
"Solvency II is in effect. The soft market continues to challenge (re)insurers and M&A activity continues. All of this will drive the sale of non-core business."

"There has been a significant increase in M&A activity from this time last year, which has opened up lots of opportunities for legacy carriers to expand. It's particularly interesting to see carriers move into spaces such as med-mal and motor, which traditionally haven't been targeted."

"Pressure to de-scale and proactively manage legacy books is only going to increase – that situation hasn't changed over the last 12 months and most prudent legacy managers would already have plans in place. If they haven't then the pressure will only grow."

"Asbestos still a concern as is head trauma in the US. US courts continue to be problematic in certain jurisdictions such as California."

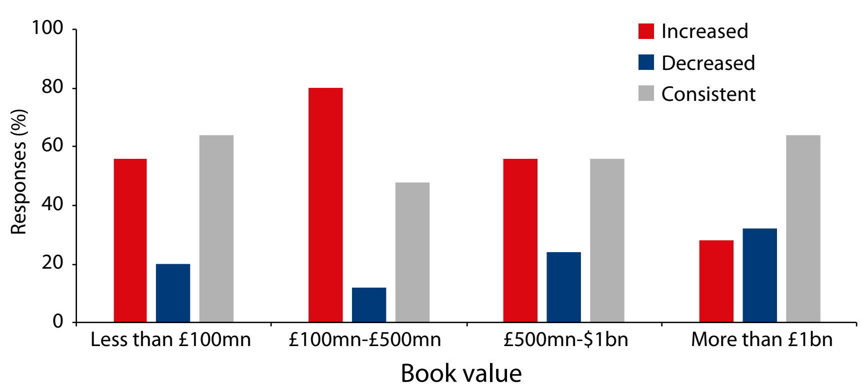
Has the overall number of books for sale increased, decreased or stayed the same in 2016?



The majority of respondents agreed that the number of books being put up for sale has increased overall during the year. One participant said they believed more live operations were dealing with legacy in a proactive manner.

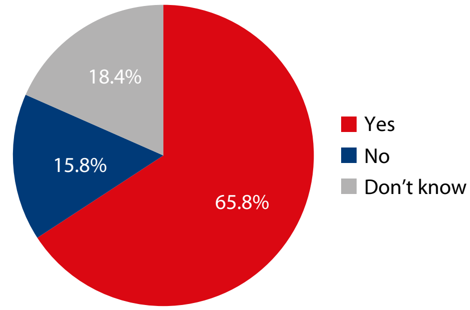
Has there been an increase, decrease or a consistency in the number of books being auctioned?

As you can see from the chart below, most participants felt they had seen a particular increase in auctions of books with between £100mn and £500mn ($144mn-$721mn) in gross liabilities, whereas the majority of respondents felt that the number of £1bn+ books brought to market had stayed the same.



Do you expect to see more cross-border transfers and mergers of legacy business?

Some 65.8 percent of those surveyed said they expected to see more cross-border transfers and mergers of legacy business in the coming year. Again, Solvency II was frequently cited as the main factor behind this trend, along with the rise of new European domiciles.



Industry comment:

"Solvency II is driving efficiency gains, while regulators are also pressurising groups to rid themselves of branches. There is also a flight away from the chaotic dual regulation in the UK to more efficient regulation in Malta, Gibraltar and Luxembourg."

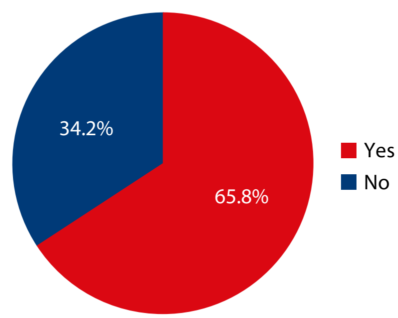
"Certain specialists have international capabilities and are offering cross-border deals as exit strategies – this makes the possibilities more comprehensive and appealing to sellers."

"Capital and operational efficiency are two key watchwords for the sector and this is driving more M&A activity in general, including cross-border transfers and mergers."

"The rising prominence of jurisdictions such as Malta and Gibraltar, where people have easier access to regulators."

Is there a trend towards the management of legacy liabilities in-house for larger live carriers?

Almost two-thirds of respondents said they expected more legacy business to be managed in-house at larger live carriers. Nevertheless, 69 percent of respondents (see chart below) *thought this could be a positive for the legacy market, with larger and more diverse books of business being brought to market.*



If yes, do you expect this to lead to larger, more diverse portfolios of business to come to market in the future?

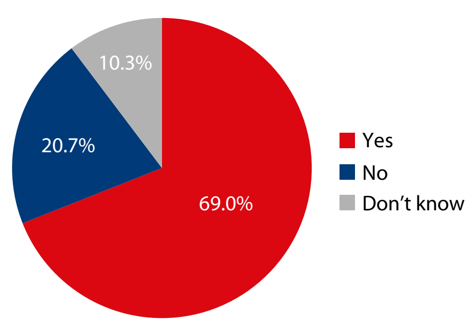
Industry comment:

"Once live carriers realise the true implications of the drag caused by legacy, they will seek market opportunities with increasing regularity."

"Larger carriers will build portfolios of diverse run-off in 'internal consolidators' which will allow them to increase their efficiency in dealing with them in the present, and then when they decide to sell these portfolios in the future, they will inherently be more diverse."

"Carriers will look to extract some initial value through workout of legacy books before proceeding with sale processes."

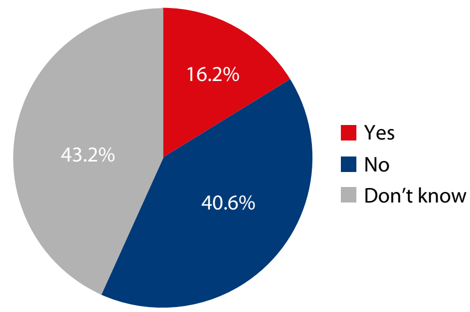
"Much of the old run-off business was in pools, hence was managed by outsourcing. That business has largely been dealt with through schemes of arrangement and portfolio transfers. Current run-off has arisen in-house, therefore that is where it is being managed. The larger live carriers are increasingly aware that it is currently a seller's market and they can sell pretty much anything."



Does your company plan to raise capital to acquire new books of business over the next 12 months?

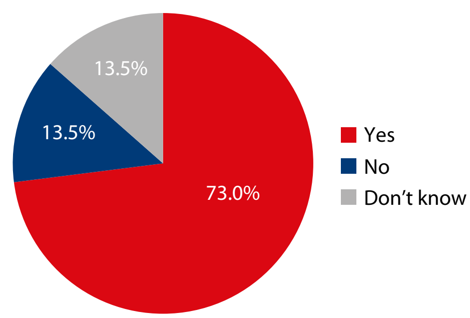
Respondents were largely divided on this subject, with just 16.2 percent confirming plans to raise extra funds for acquisitions. Of this 16.2 percent, 91 percent of participants said they would look to private equity firms to find this capital, with the remaining 9 percent saying they would raise debt.

Industry comment:
"We have no definite plan but a strong maybe if the right opportunity arose."
"We are creating a hedge fund reinsurer model for run-off."

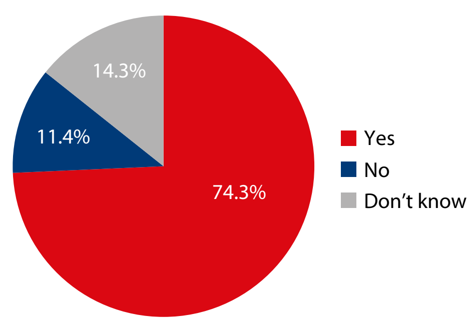


Do you anticipate increasing interest from private equity and other investor types in the legacy sector?

Some *73 percent of those surveyed expect increasing interest from private equity firms in the legacy sector. This is an increase on the 68.4 percent which said the same last year, but given the launch of Darag's Maltese protected cell company and Enstar's hedge fund reinsurer, this perhaps is not surprising.*



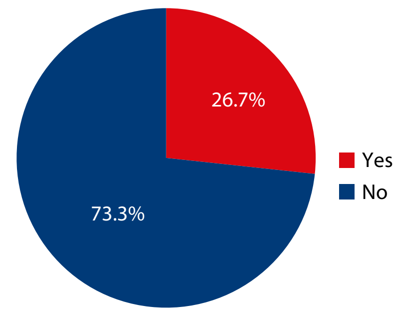
Do larger legacy players have more of a competitive advantage now than they did five years ago?



Industry comment:
"Capital and reputation are important. Established players have the edge here – so long as they maintain their reputation."
"To the extent that the larger players have been profitable, they have more resources to compete with."
"The larger players already have the scale and capital behind them, which makes conversations with regulators around Solvency II capital easier. They also have the infrastructure to effectively invest assets at a low cost and manage claims efficiently. While smaller players are trying to catch up, it's difficult to edge the larger players out on bigger (>£100mn) deals, as they would have to win by sacrificing profit on the deal."
"Larger legacy players may have a competitive edge for the larger deals in the market, but there are plenty of smaller deals where the size of the acquirer is less relevant."
"If you are talking buy side, then their larger balance sheets and ability to access rated paper where required does give larger players a competitive advantage with regard to the bigger portfolio deals."
"They continue to have a competitive advantage in the larger transactions. For example, to take a £200mn employers' liability book by portfolio transfer you would need capital of around £600mn to get through the Prudential Regulation Authority. That's not economic for the smaller players."

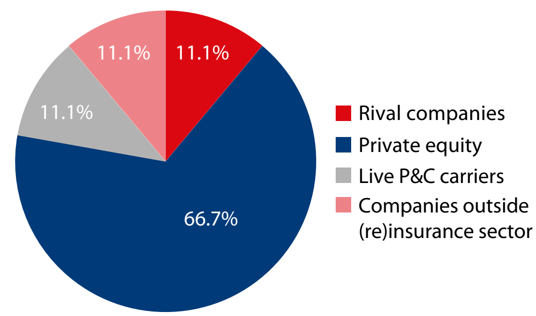
Have you seen an uptick in approaches from potential buyers of your company?

Nearly three-quarters of respondents said they had not had any takeover approaches from buyers. This is an interesting result given the wave of M&A that has coursed through the live sector, which has seen high takeout multiples and all sizes of companies targeted by buyers both from within and outside the (re)insurance industry.



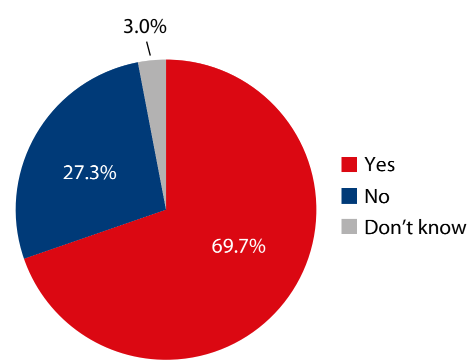
If yes, where have these approaches come from?

Out of the 26.7 percent of respondents that had been approached, almost two-thirds said they had been approached by private equity firms, confirming last year's expectations that private equity interest in legacy companies would increase. Others were approached by rival companies, live P&C carriers and companies outside the (re)insurance industry.



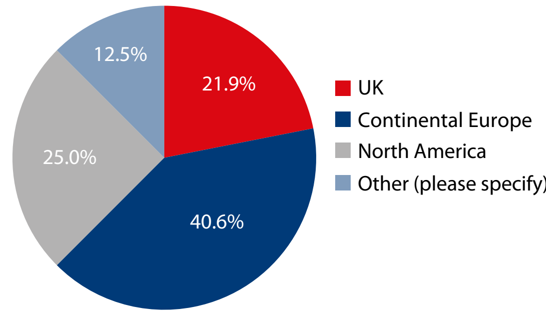
Do you anticipate consolidation between players within the legacy market?

Even though takeover approaches have been few and far between in the past 12 months, the legacy market expects consolidation between its carriers. In comparison, opinion was divided equally in last year's survey. The bid for scale appears to be the main driver for market consolidation.



Industry comment:
"Certain...aggressive...pricing will cause certain players to fail. Once they do, those that remain will pick up the inventory."
"Small to mid-sized companies need to have more critical mass to compete."
"I think there will be consolidation amongst middle-tier consolidators to create an entity that becomes dominant in consolidating continental European run-off."
"There is a lot of desire to get bigger quickly, and there is not enough large portfolios coming to market to satisfy aggregate demand. One way of getting there quickly is to acquire another player's portfolios."
"Many run-off managers have reduced head count, but as more sale transactions take place there will be a greater requirement for outsourced, managed de-scaling of legacy books. Some of the capital partnerships lack the head count to deal with this. Therefore, I see those managing agents that have retained head count having a competitive advantage and therefore becoming attractive acquisition targets."
"Everyone has their own backers, it's only if they look for an exit that merger might be considered, but IPO is a more likely exit route."

Which jurisdiction holds the most promise for legacy market growth in the next 12 months?

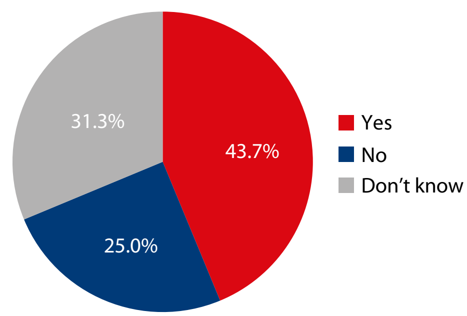


Continental Europe comes out on top as the region expected to hold the greatest opportunity for the market. When questioned separately about whether Solvency II had brought the run-off volumes it was expected to, more than half (51.2 percent) of respondents said it hadn't, but many were optimistic that once the regime's implementation was seen in black and white, the business would slowly but surely come forward.

Meanwhile, in the US, respondents noted that legislation changes in Rhode Island around Part VII-style transfers could generate new opportunities in the coming months.

Is there scope for live companies to pool their UK employers' liability legacy business into a single vehicle, ahead of a large reinsurance transaction or run-off sale?

The market is fairly split on this much-discussed topic. Although 43.8 percent thought there was scope for an Equitas-style vehicle for UK employers' liability business, many respondents believed that ship has already sailed.

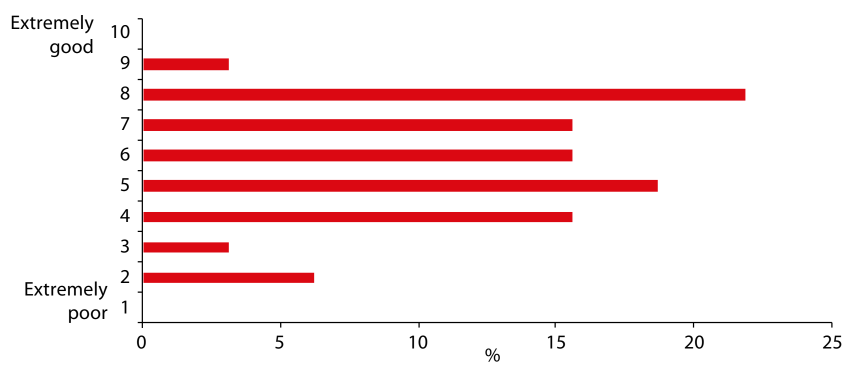


Industry comment:

"Market solutions are difficult. Shareholders will have slightly different agendas."
"I don't believe the regulators would be comfortable having all eggs in one basket."
"This would have been possible, but time has passed this by."
"Why go to the cost and effort of a double transaction?"
"There was, but RSA has an adverse development cover from Berkshire Hathaway, Aviva has reinsured to Swiss Re, Axa to RiverStone, and AGF sold to Catalina. So the deals have happened by reinsurance where they are part of the live carrier – no need to restructure first."
"Live operations are still too competition-focused."

How would you rate the legacy sector's own Solvency II compliance (where 1 is extremely poor and 10 extremely good)?

Most respondents gave the legacy sector's own Solvency II compliance a solid eight out of 10, an improvement on last year's result. However, the responses ranged between two and nine out of 10, meaning the sector is by no means unanimous on its view of Solvency II compliance in the market. Furthermore, 45.5 percent of those surveyed felt that there has not been a consistent approach to Solvency II implementation across Europe, with the continental regulators being far more flexible in their approach.



Industry comment:

"Larger players, especially those within Lloyd's, are well prepared. Smaller companies less so. Are the regulators prepared or flexible enough for the challenges of Solvency II for legacy though?"
"Regulators lose many of their tools once a company is in run-off."
"The larger players have Solvency II nailed down, but some of the smaller players or remaining standalone run-offs are having difficulty complying."
"Small, pure run-off entities are still a long way behind."
"The most proactive are well placed and have trained and recruited well to deal with Solvency II's challenges. The lead-in time to implementation has been extended year-on-year which has given more time to risk carriers to get themselves organised."
"The run-off market feels Solvency II is disproportionately heavy on them."

On a scale of 1-10 (where 1 is low and 10 is high), what level of confidence do you have that non-US legacy companies will receive a fair hearing in US arbitration?

Industry comment:

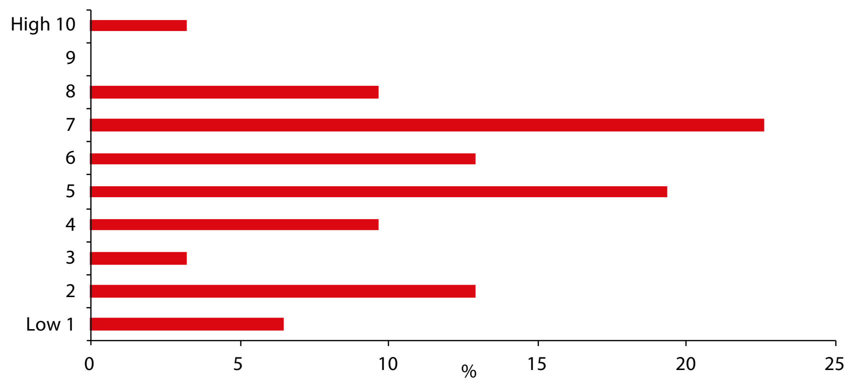
"The US arbitration system is hopelessly broken. Party-appointed arbiters have zero neutrality and are most concerned about the next cheque."

"There's a reasonable expectation that decisions will be fair."

"I am not sure how often anyone will receive a fair hearing in a US arbitration."

"Arbitrators get their work from the large US carriers. They are unashamedly biased in how they do their work."

"It's never occurred to me that they wouldn't, but employing a US law firm would be prudent."

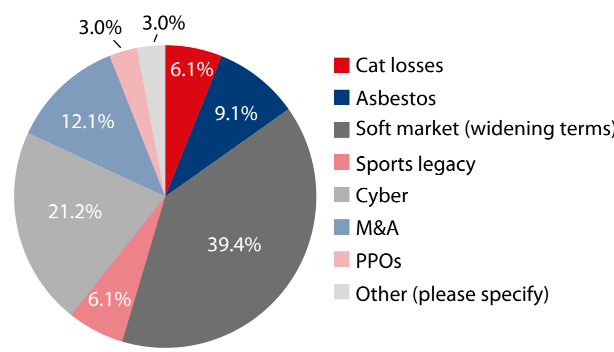


What will create the next legacy market?

Respondents gave a range of responses to this question, however the majority of those surveyed highlighted the softening pricing environment in the live market as the biggest generator of legacy business.

Cyber liability business was the second most popular answer, which is not surprising given the recent surge in demand for a product that is still in its infancy.

Separately, respondents were also asked what emerging claims trends they were seeing in the market. Here, sports head injuries and sexual abuse claims were highlighted frequently, as well as cyber, directors' and officers' and medical malpractice claims.



What do you view as the biggest challenge for the legacy market?

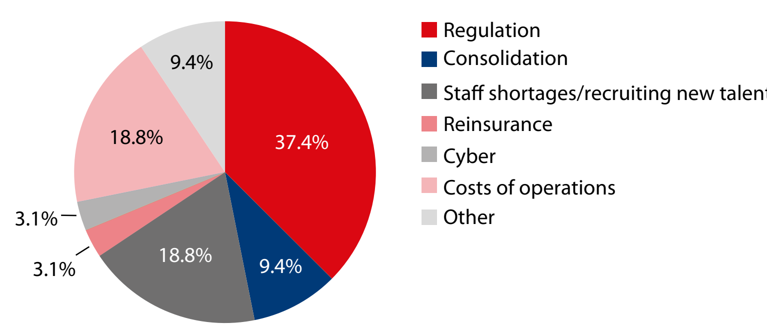
Increasing regulation is causing the greatest concern in the legacy market, much like in the live space. Staff shortages and attracting new, younger talent to the sector was ranked as the second greatest challenge, alongside the increasing cost of operations.

Industry comment:

"Aggressive pricing."

"The lack of run-off awareness and expertise at some companies."

"Competition!"



Embracing alternatives

Arndt Gossmann tells *Insider Quarterly* that letting third-party capital into the legacy market is a necessary and advantageous move

With run-off transactions growing in number and size, legacy carriers are increasingly looking to partner with investors outside the (re)insurance industry in order to gain a competitive edge.

DARAG CEO Arndt Gossmann explains the logic behind the launch of a new protected cell company (PCC) in Malta, and why letting third-party capital into the legacy market is a necessary and advantageous, rather than dangerous, move.

***Insider Quarterly (IQ)*: How do you foresee the structure of run-off transactions changing in future?**

Arndt Gossmann: There is a significant shift in terms of the overall volume brought into the market. Compared to last year, in 2016 we see more – and larger – transactions, which means also that today the need for financing has increased as well. Large multinationals, such as Allianz and AIG, are bringing their run-off to the market and this is only the tip of the iceberg. Nonetheless, even big legacy carriers have their own limitations, so even for them capital is becoming increasingly sought after.

> "Given the growth of run-off, bringing third-party capital in is a necessary move"

The need for capital will positively correlate to the investment trend, but this will also lead to a higher number of structured deals. What we have seen so far are straightforward, plain vanilla acquisitions or Part VII transfers. In the future I think we will see transactions with several parties involved – members of a consortium or a pool, and of course transactions with reinsurers and/or other third-party investors; such a development will give us the possibility to remain competitive, in terms of pricing, and enable us to take on those big volumes.

***IQ*: Do you expect a change in the way those deals are funded?**

Arndt Gossmann: Third-party capital would be required, and this makes a lot of sense. The large deals that are coming to the market are not necessarily diversified portfolios. For instance, a EUR1bn ($1.1bn) employers' liability book is anything but diversified. There will only be a few carriers able to take that on, and even for them it is going to be quite demanding on their balance sheet. By splitting the book between several parties, pricing will be better for the ceding insurer.

***IQ*: DARAG recently launched a risk-carrying PCC structure in Malta. How does that work?**

Arndt Gossmann: A PCC is an insurance company with the possibility to act as an administrator for distinct portfolios. Under one regulatory umbrella we can manage several portfolios, segregated and independent from one another, with their own legal or tax identity. It is like a hotel renting out rooms. We can share the ownership of the cells through issuing preferred shares on each cell. The benefits are several: tailor-made structured solutions, flexibility, efficient use of capital, speedier set-ups and cost-effective, shared solutions. Moreover, we can offer access entry to those investors willing to participate in run-off risks and gains without them worrying about acquiring the whole insurance company. This is now possible through DARAG's run-off platform, the R-pad.

IQ: What was the main driver behind your decision to launch DARAG's run-off platform in Malta?

Arndt Gossmann: Early last year there was a global survey about investors' appetite for insurance and run-off products; that particular survey showed us that the interest for such investments is surprisingly high, and that the risk-return profile such investors are going for is something that we can accommodate. At that point we had already started setting up our PCC, initially as an internal reinsurance vehicle for our group, but later on we realised the benefits of this proposition for external investors.

IQ: Has DARAG completed any transactions using the PCC structure?

Arndt Gossmann: We have just launched the first cell, which is now officially approved. Moreover, we expect to complete a second transaction this year that investors are really keen on.

IQ: Are you perhaps worried that an influx of third-party capital could make the bidding process for legacy books even more competitive?

Arndt Gossmann: No. We're always looking for cases that allow a certain level of margin, otherwise it doesn't make any business sense. I understand that sellers would like to get the best price possible, but on the other hand the core interest of the sellers is the appropriate handling of their books after the sale, because reputation is key. Right now, we see offers and prices that are hard to understand. That means that economic stability and a reasonable level of return are prerequisites.

> "Financial investors love the legacy market, however they are looking to co-invest with sound and established acquirers"

Another element which I expect will have an impact on prices is the fact that our competitors rely on a rather high level of leverage. However, I think that regulators will soon start imposing strict limits on the grade of leverage used, which means that an important element of pricing will be taken out of the equation, leading to a certain normalisation of prices.

IQ: Is it possible that the influx of third-party capital could force small and mid-sized legacy carriers out of the market?

Arndt Gossmann: No. We have seen a shift in the market between 2015 and 2016 – in continental Europe, the average transaction size has jumped from EUR20mn to EUR200mn. The larger multinationals have started to dispose of their run-off piece by piece – but this development will not be exclusively for large multinationals only. Large national players or mid-sized international players will follow through and provide smaller transaction sizes for the legacy market.

IQ: Do you expect consolidation among legacy players in an attempt to gain scale and relevance?

Arndt Gossmann: We don't have a situation where we have too many acquirers in a limited market. We have a pretty stable number of acquirers and a growing market. Typically, consolidation comes when the growth of the market has attracted new competitors and the market is saturated. Furthermore, expertise and track record are prerequisites for entry; legacy is a complex business, not just a good investment opportunity.

IQ: Are we going to see the traditional legacy players look increasingly like third-party administrators for alternative capital providers?

Arndt Gossmann: This could happen, of course. It is much too early for it to become a trend right now, but it could well be the case. Financial investors love the legacy market, however they are looking to co-invest with sound and established acquirers.

IQ: Do you expect increasing use of offshore domiciles for regulatory and tax reasons?

Arndt Gossmann: I think there will definitely be a move towards new domiciles. Legacy business is still an emerging industry, at least from a continental European perspective. Emerging industries usually develop best in emerging conditions. So any new environment secure and organised enough to serve as a hub could be of interest, but such a domicile would have to be within the EU for the continental Europe market to accept it. We identified Malta as an excellent place. It is onshore EU, it offers protected cells, it has a firm regulator. And we understand others are to follow. So maybe Malta is the future hub for run-off. Tax is not a consideration.

IQ: Is bringing more third-party capital into the legacy market a dangerous or a necessary move?

Arndt Gossmann: Diversification is always a good thing – either on the risk side or on the liabilities one holds. So it's good to have that same diversification in equity. Given the growth of run-off, bringing third-party capital in is a necessary move. I don't think it is dangerous. If it is well-managed, it definitely has benefits, as long as the approach remains balanced.

Risks for sale

With regulatory and economic drivers set to increase disposal transactions, **Jerry Perrins** and **Richard Lawson** explore how run-off specialists are adapting to the new market environment

Unprecedented market conditions are forcing more insurers into making tough strategic decisions about their future. The wave of M&A activity that started two years ago seems set to continue, while other companies intent on going it alone are also examining their options for refocusing or realigning their businesses.

Either way, with more and bigger portfolio disposals on the cards for so many insurance industry players, proactive run-off management has become a live issue across the industry.

But what's brought about this market turmoil?

An overabundance of underwriting capital, exacerbated by the entrance of alternative investors into the reinsurance space, has fuelled competition across the primary and reinsurance markets, piling pressure on rates.

Lacklustre economic conditions mean that organic premium growth has been hard to find across most lines – and all this is happening against a background of zero interest rates bearing down on investment returns.

If that isn't enough to deal with, regulation around solvency and new, tougher capital requirements continues to impact markets everywhere, particularly in Europe where Solvency II has finally been implemented.

It's hardly surprising that insurance industry bosses are being forced to look into their operations and ask hard questions about operational costs and the future profitability of certain underwriting portfolios – or the sustainability of their business as a whole.

Banner year for M&A

As Willis Towers Watson noted in a recent report, "Reflections on a Gravity-Defying Year for Insurance M&A", 2015 was a banner year for global M&A activity in the sector. Transactions worth EUR129.3bn ($143.5bn) were announced in the first nine months of the year – more than three times the value of all 2014 deals and way above the previous annual high of EUR97bn ($107.7bn) recorded in 2010.

Not only was there a big leap in deal numbers, there were also some large and very large transactions. During the year, 33 insurance sector deals each worth more than $500mn were recorded, compared with 18 in 2014. There were also four megadeals worth more than $5bn each, versus one such deal in 2014.

While it's looking unlikely that the level of M&A activity witnessed in 2015 will be repeated in the coming year, most market watchers expect the deal flow to continue as insurers large and small put businesses up for sale.

In a recent note, Standard & Poor's analysts said that favourable financing conditions, which are bringing in new classes of buyers ranging from corporate conglomerates to high net worth and sovereign wealth funds (particularly from the likes of China and Japan), will keep the deals coming.

Legacy set to grow

The legacy insurance market is sure to be a beneficiary. It's already huge and is estimated to comprise run-off reserves of EUR247bn in Europe alone. That number is likely to grow as a result of the continuing fallout from insurance industry consolidation around the world, especially in North America.

Continued on **page 60**

Earlier this year, Allianz Re and its US affiliate entered a reinsurance and consulting agreement with run-off specialist Enstar. The transaction involves the transfer of $1.1bn of US long-tail liabilities to Enstar via a 50 percent quota share reinsurance of selected portfolios carried by San Francisco Reinsurance Company, part of Allianz Resolution Management.

Meanwhile, American International Group has signalled that it is ready to sell a significant portion of its legacy P&C business, possibly in the $5bn range according to some reports.

A recent survey by the Insurance and Reinsurance Legacy Association (Irla) with PwC found that Irla members certainly expect more disposal transactions, driven by the combination of overall business strategy moves and regulatory pressure.

Over half (55 percent) of respondents think the implementation of Solvency II will lead to an increase in their workload and new opportunities.

Two-thirds of the survey's continental European respondents think there will be more than 10 disposal transactions in Europe over the next two years. Over three-quarters of respondents believe the most commonly disposed portfolio size will be between EUR10mn and EUR100mn.

The types of business most likely to be disposed of include reinsurance, asbestos, motor, aviation, property, professional indemnity, employers' liability and medical malpractice.

Legacy market watchers expect to see an uptick in employers' liability related transactions especially, with environmental liability business stabilising as a reduction in market litigation brings more certainty to portfolios.

In the US, amendments to Rhode Island's Insurance Regulation 68 have created new options that allow insurers to restructure and manage run-off legacy liabilities, a move certain to bring more transactions to market.

New approaches

With more insurers opting to place portfolios into run-off as a result of the books no longer fitting in with their business plans, the role of third party service providers like Pro Global has grown more critical. For a long time, the service providers have supported restructuring, M&A processes and outsourced claims management, and this continues today.

However, the increasing number of mega-transactions and the added complexity of having multiple parties involved in risk-sharing arrangements further underlines the need for an independent administrator to coordinate the different parties.

> "Closer partnerships are being developed between legacy and live companies to help smooth the transfer of discontinued business in order to protect reputations and to potentially share in any profitability"

This is a critical factor in managing conflicting agendas and offering each party control in the claims administration. Closer partnerships are being developed between legacy and live companies to help smooth the transfer of discontinued business in order to protect reputations and to potentially share in any profitability.

Jerry Perrins is global head of legacy at Pro Global

Richard Lawson is global head of client engagement at Pro Global

Meanwhile, regulation is adding to the key considerations around run-off disposals. Solvency II (plus its equivalent regimes) creates broader risk management obligations, including more onerous administrative reporting and documentation requirements.

The ability to execute a run-off transaction and continue to remain compliant to ever-changing regulation post-transaction are key considerations for both buyer and seller. This function can remain with the seller or be taken on by the buyer, but increasingly is the domain of the specialist service providers.

The surge of new capital with limited insurance sector knowledge and active players looking for smaller deals of less than $50mn also frequently call on third party administration providers because they don't always have the necessary specialist knowledge.

Different insurance classes behave in different ways and insurers increasingly recognise that outsourcing books of specialist business such as employers' liability and medical malpractice requires significant technical expertise from third party providers, compared to the more predictable property classes.

For the acquirer, working with a qualified service provider enhances the deal value and importantly improves the chances of a bid being successful, through keener pricing and lower regulatory execution risk.

Preferred exit routes

What's clear is that insurers and reinsurers increasingly rely on advisers to assess, execute and coordinate their potential run-off business, examining all the options for disposal and how their operations as a whole will be affected from a capital perspective.

Different exit tools are available to insurers, ranging from reinsurance to outright sales or using Part VII transfers for solvent run-off portfolios. There has been an average of 18 so-called Part VIIs per year since 2004, with a total of over 250 transfers of life and non-life portfolios successfully carried out by the end of December 2015.

Looking to the future, it seems likely that capital markets "technology" will be applied to legacy business. Investors from the insurance-linked securities market and other alternative insurance capital sources are already discovering that P&C business in run-off can offer risk returns in the same way that legacy life business has already done.

Again, the services of third party providers like Pro Global are being sought by established players as well as capital market entrants that lack the necessary specialist claims infrastructure.

It's another sign that the run-off sector is evolving to help insurance companies take the tough restructuring decisions they're faced with in a relentless, financially challenging market and an increasingly tough regulatory environment.

Reconstruction, renewal and rebirth

Institutions only survive through the actions of determined people, writes **Andrew Duguid**, recalling the Lloyd's market's dark night of the soul

It's hard to believe that 20 years ago this summer, no-one knew whether Lloyd's of London would survive. Huge losses had hit the market, provoking a full-scale solvency crisis.

After much complacency, fresh thinking produced a bold survival plan. Its chances of success would depend on a few extraordinary people.

This crisis stemmed from insuring US liability business. Over decades Lloyd's syndicates had underwritten huge amounts, directly and indirectly, on terms that would be thought crazy today: without limits on the amount or the timing of claims.

Meanwhile, US courts drove an escalating bill for asbestos injuries. Congress said that corporate America should fund the soaring cost of cleaning up decades of irresponsible pollution. Very slowly, Lloyd's syndicates realised they were in the frame. Many of them managed to shift their obligations to a few others.

Losses were concentrated in other ways too. The normally prudent habit of reinsurance had become perverted into a wild game of pass the parcel. Easy profits attracted pitiful amateurs to the field. Inevitably, when catastrophes came, losses were funnelled to the syndicates at the top of the spiral.

Personal horrors

In those days the profits and losses of Lloyd's syndicates went to the private individuals, known as Names, who supported them. There was no limit to their liability. Many people faced debts they could not pay. Others could afford it, but refused. Thirty suicides were attributed to this crisis. Across the English-speaking world, Names felt like cannon-fodder.

Furious members of loss-making syndicates overcame many obstacles to sue their managers, alleging incompetence and negligence. Leaders emerged who won spectacular court victories. Levels of compensation set new records, but could not all be met.

Disaster loomed. Regulators in the US and UK were rattled. The British government said there could be no bail out.

On his first day in office, the New York superintendent of insurance, Ed Muhl, was advised to stop Lloyd's trading throughout the US. Understanding the enormous ramifications for the US insurance industry and its clients, Muhl courageously insisted on a different approach. Lloyd's suave and able chairman, David Rowland, flew by Concorde to New York to persuade Muhl to give his rescue plan a chance.

A battle took place between the Names' leaders who wanted the plan to work and those intent on getting revenge. After leading his followers to victory in the courts, sharp-witted pop music impresario Michael Deeny thought he could get them and others a better deal – raising extra funds from players with a stake in the market's future. The Association of Lloyd's Members pitched in, helping to shape the offer as fairly as possible.

Suddenly, the Lloyd's chief executive Peter Middleton, one of the plan's architects, trusted by Names as a new broom, shocked everyone. He walked out for a much higher paid job elsewhere.

Fortunately, his successor, Ron Sandler, proved a far better finisher. Interminable negotiations, many concessions and a huge persuasion effort ensued, for 15 long months.

The whole plan nearly came to grief in the US courts on

Continued on page 64

Reconstruction, renewal and rebirth
Continued from page 63

several occasions, notably when a Virginia judge prevented Lloyd's making its offer to all 3,000 US Names. This was overturned on appeal in record time. In the English courts, a last-minute attempt at judicial review also failed.

Key people

The final offer saw a convincing majority (95 percent) accept the deal. Rowland, the conductor of the orchestra, Deeny and Sandler each played crucial roles. They had some excellent hand-picked advisers.

But how were the old US liabilities to be managed? Under the plan, a new vehicle called Equitas would be born, charged with this mission. Its creation raised two vital issues: how much money should it have? And who should run it?

A young Swiss-American actuary, Heidi Hutter, led the project to quantify the reserves needed. Several friends had told her not to touch the job.

When newly appointed chairman-designate David Newbigging asked about possible chief executives, he was mistakenly given the list of those considered for his own role. His name was at the bottom of the page: all those better-known characters above him had turned it down. He felt he had something to prove.

When insurance consultant Victor Caleo heard about the Corporation's efforts to find a chief executive, he was incensed. He reasoned that Equitas faced the toughest job in the insurance world – containing the US liabilities that had already bankrupted many British and American insurers and nearly destroyed Lloyd's – but until then the search had only been among insurance people in London, thousands of miles from the source of the problem.

Caleo knew that only a team of experienced American streetfighters had a chance of success. He approached Newbigging directly, flying to London at his own expense to plead for a chance to find the right person.

He recalls an intimidating inquisition, surrounded by crusty Englishmen, doubting his credentials. This took place in the same 18th century Adam Room in which thousands of unsuspecting people, often somewhat over-awed, had eagerly signed up to become Lloyd's members.

> "Disaster loomed. Regulators in the US and UK were rattled. The British government said there could be no bail out"

Caleo was allowed to try. He came up with the quietly spoken Michael Crall, who had shown his mettle in turning around a Californian insurance company troubled by similar claims.

Crall set about building a team completely focused on its task. London's market culture tended to see claims-handling as secondary to the more prestigious role of underwriting. Crall knew his priorities were different.

He and his American sidekick (and successor) Scott Moser devised a new approach. They struck early deals with reinsurers, helping them to remove uncertain liabilities from their balance sheets. A zealot for succession planning, Caleo also found Moser.

This team also replaced foot-dragging with accelerated deals, designed to stop festering claims from getting worse. They struck a new, tough posture with more dubious claims, insisting on documentary evidence. They were locked on their mission, lobbying intensely to help change US attitudes towards liability claims.

Many doubters thought Equitas was a rusty ship that could only steer clear of the day of reckoning for a few years. In fact, the management team did so well that 10 years later Warren Buffett's Berkshire Hathaway, one of the world's strongest companies, approached them with a reinsurance deal. This eventually removed all residual doubts that the ghost of Lloyd's past might return to haunt its old members.

New capital

When the crisis first broke, all Lloyd's capital was provided by Names, each trading with unlimited liability. Robert Hiscox and Michael Wade defied tradition, leading a campaign to put capital on a less risky basis, involving shareholders in corporate members.

At first they were told this was not legally possible. Persistence and fresh advice found a way round all the obstacles. From 1994 onwards, corporate membership has grown steadily. Nowadays, nearly all Lloyd's capital takes this form – much of it from investors from the insurance sector.

Since the terrorist attack on America in 2001, the Lloyd's market has been exceptionally profitable, amply justifying the efforts of those who helped its reinvention at a very uncertain time, 20 years ago.

Although the actions of many men and women were involved, each of those named in this article played a critical role. Without them, the institution's survival instinct would not have prevailed.

The full story is told in the author's book, On The Brink, *published by Palgrave Macmillan*

Andrew Duguid is an author, former insurance industry executive and strategic planning director at Lloyd's

Raising the standard

Graham Sheppard provides an update on what managing agents need to know about the new Lloyd's review process

Managing agents (MAs) are required to meet the "Principles and Minimum Standards" set by Lloyd's and this applies equally when ensuring that there is an appropriately detailed, regular file review process.

According to Lloyd's, the process for claims file review should be documented and allow for the results to be reviewed with the relevant claims handler.

Under the current system, when a handler adjusts a claim a percentage of their claims under Lloyd's "Minimum Standards MS2 – Claims Management" have to be reviewed by a peer internally. Indeed, a number of MAs use external reviewers or review firms for their "internal" peer review required under the minimum standards.

It might be someone in their team, their manager, or someone in another team that understands their class of business. The reviewer will essentially check over work, record what they've checked and flag any errors they think may have been made.

Internal peer review will continue but under the new Claims File Review system, set to go live in October 2016,

Graham Sheppard is business development manager of Docosoft

Lloyd's requires a "quota" of files to be reviewed by an external independent reviewer against a consistent, market-wide question set.

Lloyd's Claims Minimum Standards does not specify the number and/or percentage of files to be peer reviewed. However, it does refer to the fact that a written rationale for the sampling methodology should be in place and take into account the frequency of review, the open claim count, the mix of business and the claims portfolio. The sample size should be representative.

As it currently stands, MAs review selected claims files using a documented range of criteria for evaluating performance in terms of procedure, accuracy, quality of service and timescales appropriate to the matter. Such reviews may be carried out by a peer.

According to Lloyd's, a typical file review process would involve regular consideration of a number of files, including those both open and closed.

Current MA file review criteria need to consider the accuracy of adjustment, compliance with authority limits and external expert management, as well as identification of and, where appropriate, follow-up on subrogation and recoveries.

Other important factors to consider include:

- File management
- Following of applicable procedures
- Whether there is a proactive approach
- Reconciliation of claims reserve and settlements between claims file and systems
- Accuracy and timeliness of claims reserves, application of the reserving philosophy
- Service (e.g. communications, availability, timeliness)
- Documentation of the claim

MAs should take a proactive approach and achieve prompt resolution of the claim under the circumstances presented.

The principal aim of the new Lloyd's initiative, Claims File Review, is to obtain a view of market themes and trends in claims handling via a consistent review of external independent reviewers. It starts from 1 October this year, after the Corporation conducted a pilot in 2015.

For every carrier Lloyd's will expect a certain number of claims to be externally peer reviewed, dependent on their proportion of claims in the market they are responsible for.

The top 10 Lloyd's MAs, for example, will be putting through a lot more reviews than the smaller players that have very few claims, so the initiative is based on the volume and percentage of the market and is proportionate to the MAs' market share of open lead claims.

Large or small, however, carriers will need to have reviewed a number of claims – whatever Lloyd's specifies – in the 12 months from October to September. Lloyd's is currently refining the question set it is asking these external reviewers to look for every time they review a claim.

The message for specialist London market technology companies is that they will need to consider aligning their peer review checklist with their current fields so that MAs can complete their own internal and external reviews along the same lines that Lloyd's wants. Where the previous file review might have had 20 fields of questions, the new one might have 45-50 fields.

The process is being managed through the Lloyd's Market Association Claims Committee.

When consuming claims content – whether it is photos, emails or peer review files arriving from a plethora of devices and in different formats – the responsibility is with handlers to put the correct content in the correct location.

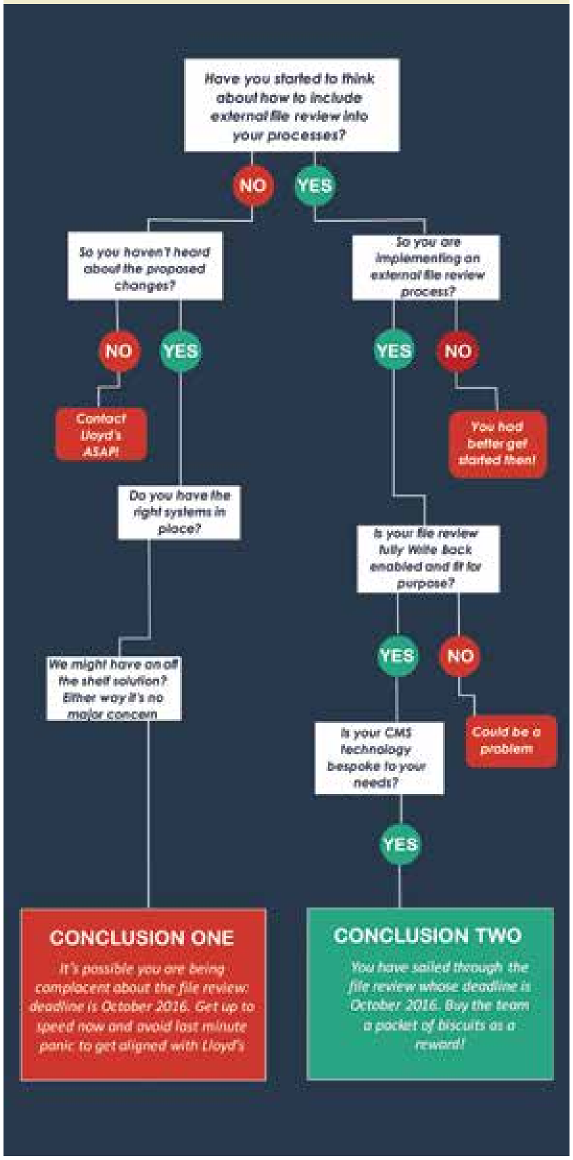
This method of manual content ingestion often results in content being lost or misplaced. To avoid this scenario it therefore makes sense to employ the services of a specialist insurance software developer like Docosoft to build in technological functionality that allows claims teams to receive and organise claims content within automated capture solutions.

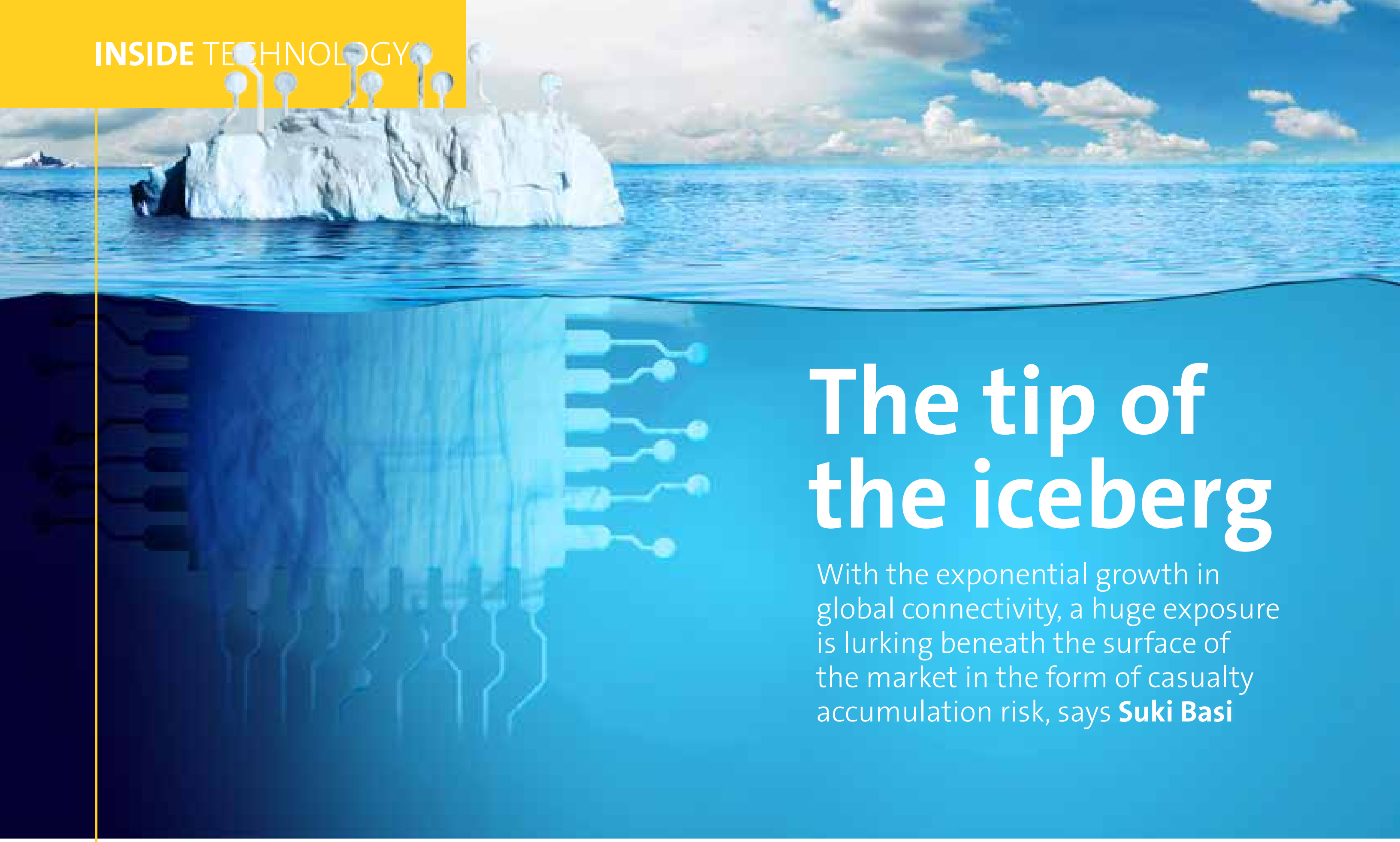
Such solutions assign specific metadata to pieces of content, according to predefined rules that automate content availability – resulting in time savings as well as error minimisation.

Lloyd's claims file review

The new Lloyd's Claims File Review initiative starts from 1 October this year, following a pilot conducted by the Corporation in 2015.

The message for specialist London market technology companies is that they will need to consider aligning their peer review checklist with their current fields so that managing agents can complete their own internal and external reviews along the same lines that Lloyd's wants.





The tip of the iceberg

With the exponential growth in global connectivity, a huge exposure is lurking beneath the surface of the market in the form of casualty accumulation risk, says **Suki Basi**

Every company with physical assets also has a number of liabilities, such as those to its employees, which end up in the casualty market. At issue here for insurers is the possible accumulation risk these liabilities represent.

A quick glance at the FTSE 100 and the plethora of liability covers associated with these companies brings home the true size of these exposures. In addition to product and general liability, there are a number of different sub-classes such as directors' and officers', errors and omissions and employment practices liability.

The foreword to the January 2016 UBS White Paper for the World Economic Forum (WEF) Annual Meeting 2016, "Extreme automation and connectivity: The global, regional, and investment implications of the Fourth Industrial Revolution", suggests a further dimension to casualty exposures with the following opening paragraph:

"The global economy is on the cusp of profound changes that are comparable in magnitude to the advent of the first industrial revolution, the development of assembly line production, or the invention of the microchip. Technological advances are permitting ever greater levels of automation. Meanwhile, the near universal ownership of smart devices in many parts of the world is leading to a degree of interconnectedness that was previously unimaginable."

Many insurers give a lot of autonomy to underwriters in individual markets who will inevitably be pricing in hubs and creating pockets of accumulation. What the UBS white paper reveals is that extreme connectivity also increases the risks posed by cyber security breaches.

"Unless we as a market embed accumulation risk controls into our culture, we will end up with uncontrolled risk accumulating across hubs"

The energy sector is a prime example, says UBS. "In particular, the rise of extreme automation and connectivity via 'smart grid' systems, while improving energy efficiency and helping match supply with demand more effectively, may be vulnerable to hacks which shut down electricity transmission or generation systems entirely."

According to Symantec, energy is now one of the five sectors targeted most by hackers globally. In 2012 Saudi Aramco spent weeks repairing its computer systems after a virus attack, while in 2013 Austrian and German power grids were threatened after an IT accident led to the network being flooded with data.

Uncontrolled accumulation

Unless we as a market embed accumulation risk controls into our culture, we will end up with uncontrolled risk accumulating across hubs. For instance, an underwriting portfolio in one location might accumulate risk exposure together with others in different locations within the same organisation. The problem is that there is no effective control across companies.

The insurance carrier results that have been published recently are instructive and the manner in which many companies have suffered significant losses is interesting. A lot of these results point to a lack of control over insurance carriers' true accumulations.

Losses could be averted if more attention was paid to internal reporting of exposures prior to events, as regular and accurate aggregate reporting is crucial.

Solvency II has introduced a number of more stringent reporting requirements as part of Pillar III, but it does not deal properly with aggregate risk.

Eurasia Group's cyber risk index, which rates the threat to businesses from 1 to 100, signposts a high risk reading of 88 for Chinese firms, against a safe score of 14 for Swiss firms. The US, despite its comparatively robust cyber environment, is deemed an attractive target by foreign states and dissidents. As a consequence, Eurasia Group rates it at 77 – a significantly bigger risk than the majority of rich nations.

Silo mentality

In an insurance market boasting more than 300 years of experience, insurers have to begin to understand what their exposures to a risk are, even if they are often theoretical.

However, many risk carriers remain unaware of the underlying accumulating nature of the risk at the time of binding. Some classes may be more effective than others in this regard, with the aviation and offshore energy markets examples of those that have a good grip on their exposures.

It is clear, however, that the oldest specialty class of them all – marine – is not so advanced. Just look at Tianjin.

> "The manner in which many companies have suffered significant losses is interesting. A lot of [recent financial] results point to a lack of control over insurance carriers' true accumulations"

The problem is that too many underwriters think and operate in a silo. It is the view of Russell Group that in today's connected world, this mentality is not an option.

The situation is improving but it is not easy to solve. Lloyd's is asking syndicates for better information on war and nuclear risks, but if we look at casualty and marine risks they can be broken down into multiple sub-classes.

A broader issue is the sheer scale of these exposures. The marine market has global premium income of some $40bn, of which cargo comprises $18bn. And the size of some of the cargo exposures is staggering.

Factor in the size and scale of the mega-ships around today and there is the potential for a multi-billion-dollar loss, given the accumulation of risk. A large cargo vessel will be insured in the marine hull market, but depending on the situation we are also looking at cargo, war and casualty covers all coming into play.

Extreme connectivity is also fostering geopolitical tensions in several ways. According to UBS it increases "the ability of diverse groups to organise protests and offers the potential for greater publicity to violent extremists. Recent examples have highlighted the convening power of social media across the world. Widely distributed images of Mohamed Bouazizi, and his self-immolation in protest over police corruption, helped give rise to a mass movement that displaced the Tunisian government and triggered the broader Arab Spring in the Middle East."

Suki Basi is managing director of Russell Group

Modelling casualty accumulation risk is not straightforward. It takes a considerable amount of time and effort to create the in-depth analysis for the detailed modelling that the modern market requires for these casualty accumulations.

A number of managing agencies have reached a point where they now have a much greater degree of confidence when it comes to casualty exposures and they are thinking much more seriously about casualty accumulation risk. But really, there's an awfully long way to go.

Systemic casualty risks

There is a clear market opportunity here but, as the WEF report explains, any downside risk of adverse selection by customers is exacerbated by insurers expanding into areas where they lack experience.

Connecting and aggregating these multiple insurance lines with all the extra connectivity could pose a risk by systemising underwriters' exposures in ways that we are far from able to understand today.

More competition in casualty, however, is leading to softening in this class, which means that we would expect underwriters to be more selective.

In the current casualty climate, it becomes an imperative to steer capacity towards better risk selection in order to deliver superior underwriting returns.

Getting a grip on data

As the sheer volume of data threatens to overwhelm (re)insurers facing regulatory compliance, **Richard Brown** says technology can help

Participants in the insurance industry have no choice but to invest in technology if they are to survive in today's increasingly competitive and regulated market.

Solvency II has placed a huge burden on insurers and reinsurers in all 28 EU member states, including the UK. Following the completion of Solvency II implementation in January this year, insurers have had to re-examine and re-think many of their internal processes to ensure that they meet the new regulatory requirements.

With many companies heavily reliant on manual processes, legacy systems and inadequate or unreliable data, the new regulations have certainly posed a challenge to the market. Historical practices are simply not up to the job of supporting a modern regulatory regime that relies heavily on understanding a business's underlying data – which in turn will highlight potential weaknesses and threats.

Currently, the sheer volume of data that insurers face means it is almost impossible to properly analyse and manage it all manually. Yet, almost unbelievably, in several parts of the market this is precisely what's been happening for years.

Delegated authority

A prime example is in the area of delegated authorities. This is a rather grand title for the age-old tradition of an underwriter granting underwriting authority to an agent in the field.

The various insurers that make up the market currently manage thousands of individual relationships each with multiple contracts. That all adds up to a lot of data that needs to be fed back to the insurer on a monthly basis.

How many risks have been written? What are the sums insured? What premiums have been paid? Where are the risks located? What claims have been incurred?

These are just some of the pieces of data an insurer needs in order to properly understand the business that has been written on its behalf, where the risks lie and what its exposures are.

However, for many years this data has been provided by their agents, or coverholders as they are more commonly known, in a range of formats including PDFs and Excel spreadsheets – or in some cases, not at all.

What is even more astonishing is that there has been no agreed format for the submission of this data, so it arrives in a variety of formats with different column headings, unstructured data and no standardisation. This makes it almost impossible to understand, validate or report on.

In some cases, these spreadsheets can run to tens of thousands of rows of data, several columns wide, meaning hundreds of thousands of individual cells of data which all need checking and validating – an impossible task without the assistance of technology.

Structured data

With the advent of Solvency II insurers are now having to rely more than ever on their data and must also demonstrate that they have a handle on it. Unstructured and disorganised data will no longer be acceptable and will make regulatory reporting an inconceivable task.

It is now a legal requirement to ensure that insurers are not only collecting the right data but also that it is accurate. Only system-driven tools will enable this to be carried out effectively.

Imagine the scenario. A typical insurer might have 200 coverholders out in the field in many locations. These coverholders could have between them 300-400 individual contracts with the insurer across different product lines. They may, for example, be authorised to sell property insurance under the terms of one contract and public liability under another contract, all with different terms and conditions governing the limits within which they may write business.

At the end of each month the coverholder has to report back with details of each policy, as well as detailing any premiums that have been paid and any adjustments. All this amounts to a lot of data submitted in an unstructured format.

With 300 to 400 different contracts functioning in this manner, it is easy to grasp the size of the problem.

Without suitable technology in play the only options to date have been to attempt to carry out validation checks manually, to rekey the data into some kind of standard format or to simply accept the data for what it is. None of these are anywhere near providing a credible solution to the problem.

Checks and balances

So how can technology help? There are now systems available in the market that will allow the user to import their data in a variety of formats and then standardise it. Data can be imported as Excel spreadsheets, CSV files or XML.

"A core principle of Solvency II is that insurance companies must have a handle on their data, understand where the risks are in their business and be able to report on the same"

For the system it doesn't matter if the data is presented in a disorganised or unstructured format as the data is mapped into a standard format. This enables the data to be quickly and easily verified, cleansed and validated against the contract terms.

For example, the system will check that a correct data format is used – i.e. that a date field includes a date or a zip code field includes a zip code. It will also cleanse the data to ensure that correct ISO codes are present and will convert data to the correct format where there are issues.

More importantly, the data is validated against the contract terms and the system will raise alerts and warnings where it identifies breaches. All this can be carried out by the system in a matter of seconds, rather than the days and weeks taken to do it manually.

Richard Brown is co-founder and director of VIPR

Once all the checks have been carried out and any problems with the data have been fixed, it can then be loaded into a data warehouse for reporting.

This means all data ends up standardised, producing reliable and accurate reports for management information purposes as well as for Solvency II reporting. All the data will be cleansed and validated.

In addition, the systems can check back against previous spreadsheets and ensure that aggregates are not being breached.

They can also check that where claims are made a premium has been received, or where a premium is being refunded the refund does not exceed the original premium paid, thus potentially saving insurers thousands of pounds.

Getting a handle on data

This is just one example of how technology is key to Solvency II compliance and to meeting the reporting requirements. Without modern technology it is simply impossible for today's insurers to manage such vast volumes of data, not to mention the threat of incurring a heavy fine if the new regulatory requirements are not met.

A core principle of Solvency II is that insurance companies must have a handle on their data, understand where the risks are in their business and be able to report on the same.

Without technology insurers will be severely hampered in their ability to do this and will ultimately be restricted in the types of business they can transact.

Technology is no longer a "nice to have" – it is an essential tool for transacting business in a modern, well-regulated market.

Maintaining virtue

Heneg Parthenay and **Simon Richards** explore credit investors' options when a virtuous credit cycle threatens to turn vicious

Credit investors have had little respite from volatility since the beginning of 2016. Credit spreads initially reached three-year highs before a round of accommodative central bank action and rhetoric saw them reverse sharply back to year-end 2015 levels.

For now, fears of a sustained rise in credit spreads have been allayed. However, at some point, fundamentals and the business cycle may reassert their influence.

Since the height of the financial crisis, investors have become increasingly used to supportive monetary policy. There are few signs of this ending in the short term.

The Bank of Japan and People's Bank of China have both eased further in 2016, while the European Central Bank has announced the addition of corporate bond purchases to its monthly quantitative easing programme.

Since the Eurozone debt crisis dissipated in 2011, central bank announcements like these have helped sustain a virtuous cycle in credit. Meanwhile, the substantial expansion of central bank balance sheets (see chart right) has driven down yields on government bonds.

This has crowded out other investors and incentivised them to purchase riskier assets to earn reasonable yields, driving demand for corporate bonds (see diagram opposite).

However, no cycle exists in a vacuum, impervious to external forces, and a virtuous cycle can always at some point turn vicious. In the second half of 2015 and the start of 2016, this became a threat.

Central banks have expanded their scope of intervention so widely that there are limited options to escape their influence. One way to mitigate the potential impact of a change of sentiment in the credit market is to invest in securities that offer more robust protection in case of default.

A natural place to look for this type of secured credit risk is the securitisation market, where exposures are supported by underlying pools of assets.

The structure of the securitisation market has changed significantly since the global financial crisis of 2008/2009, with some areas of the market not yet fully reopened (e.g. European commercial mortgage-backed securities), while new regulations have imposed constraints on the underwriting practices of underlying lenders.

Heneg Parthenay is head of insurance at Insight Investment

Simon Richards is head of insurance solutions at Insight Investment

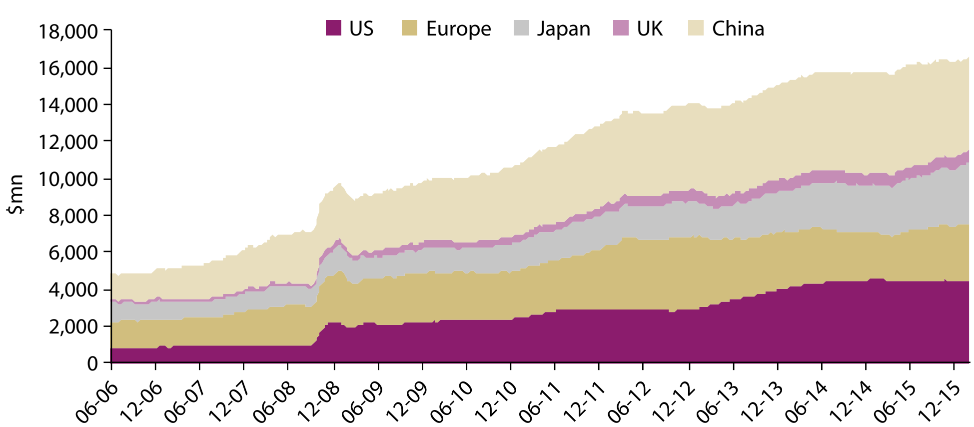
Regulatory changes also impacted investors in these asset classes, with further changes expected before the end of the year, for example the implementation of the Dodd-Frank Act in the US.

Historically, some insurers took advantage of the securitisation market and its imperfect correlation with bond markets.

In North America, where regulatory capital charges associated with these instruments broadly align with economic risks, this option is still available and attractive.

In Europe, the recent implementation of Solvency II makes investing in securitisations more problematic, both from an operational (type 1/type 2 classification) and a regulatory capital perspective, as capital charges are materially higher

Central banks continue to expand their balance sheets



Source: Bloomberg, February 2016

than for equivalently rated corporate bonds.

One potentially attractive alternative available to European insurers is to invest in secured loans. These securities usually present similar economic features to securitisations (e.g. they are floating rate instruments, senior secured) but are not tranched, are not listed in public markets and are typically not publicly rated.

However, under Solvency II, the nature and level of collateral supporting the loan can often mitigate the lack of public rating.

As an illustration, we consider commercial real estate (CRE) loans. CRE loans are floating rate instruments collateralised by a commercial property or a portfolio of properties, for example offices or warehouses.

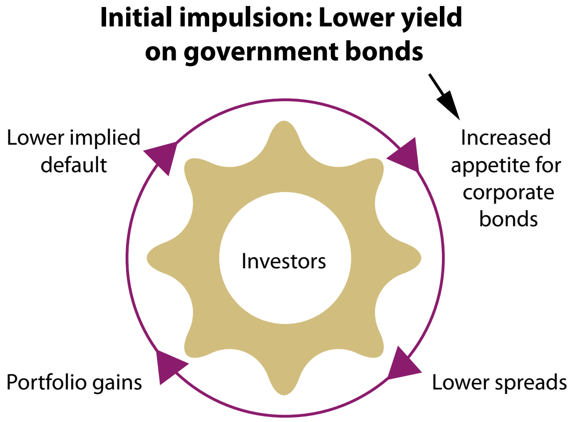
In the European market, CRE loans are typically written at a loan-to-value ratio below 65 percent (principal amount of the loan divided by the value of the underlying property).

This means that CRE loans are "over collateralised" – the value of the underlying property can decrease by up to 35 percent before the value of the underlying collateral becomes insufficient to fully compensate the lender in the event of default by the borrower.

This level of security is recognised by the Solvency II regulatory capital framework, subject to certain criteria being satisfied as per Article 209, 210 and 214 of the Solvency II delegated act 2015/35. For example:

- The insurer has the right to liquidate the asset(s) in case of bankruptcy of the counterparty
- The loan to value of the CRE loan is lower than 75 percent
- There is no material positive correlation between the credit quality of the counterparty and the value of the collateral

The virtuous credit circle



Source: Insight Investment

Assuming these conditions are met, the capital treatment of an unrated CRE loan would be broadly similar to the treatment of an A-rated corporate bond for European insurers using the standard formula.

This is consistent with the economic credit quality of CRE loans and is circa half the capital charge of an A-rated securitisation instrument, even one meeting the 20 criteria to qualify for preferential treatment as type 1 (see chart, below).

There is an extremely limited secondary market for CRE loans, which means that investors have to factor the illiquidity of these instruments into their liquidity management framework.

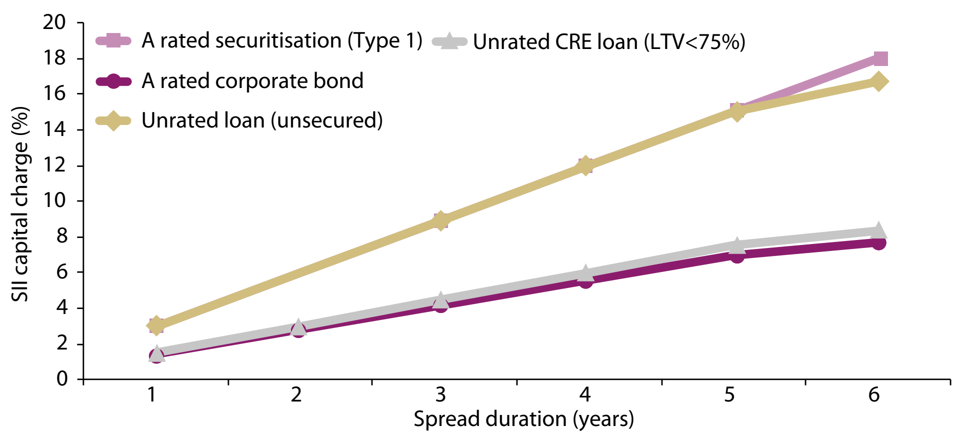
However, this illiquidity usually comes with a premium compared to equivalent liquid securities providing the investor with a potentially attractive yield pick-up. This is referred to as the illiquidity premium.

In practice, a portfolio of CRE loans can be constructed and organised with other types of secured loans to ensure that the maturity of the portfolio allows the investor to access liquidity every year if needed.

With European banks continuing to deleverage and European securitisation markets still recovering from the global financial crisis, there are plenty of opportunities for insurance investors to deploy capital in secured loans.

In order to seize the opportunity, insurers need access to specialist managers with origination capabilities and the platform to negotiate, close and administrate these loans, as well as the ability to support the insurer's ongoing regulatory requirements.

Solvency Capital Requirement for European insurers using the standard formula



Source: Commission Delegated Regulation (EU) 2015/35 of 10 October 2014

Special relationship

In the second of RPC's series of articles on M&A, **David Wallis** outlines what commercial teams need to know about US/UK deals

There are differences in private M&A market practice between the US and the UK that we believe commercial teams need to know in order to avoid these issues coming up too late in the process if lawyers are only engaged later on.

By some measures, 2015 saw an increase in the value of insurance sector deals, although volumes globally were down compared with 2014. A good proportion of the deal activity in the UK market tends to be driven directly or indirectly by US capital (the relative proportion of US money versus money from other jurisdictions ebbs and flows of course, but rare is a process where there is no US involvement).

Our work so far in 2016 has seen a continuation of US buyers looking at a range of assets, both carriers and brokers.

Deal teams on either side of the Atlantic often approach negotiations differently, and bring different experiences and market norms to bear. To avoid unnecessary friction in any process, those closest to the negotiations need to appreciate the differences in culture, style of negotiation and documentation, and bear these in mind at the very start.

Culture and approach

Many M&A advisers will say that a "US-style" approach to negotiation can be more direct and more confrontational than a "traditional UK" approach. Whilst there is some truth in this, we also see large differences in style between individuals and teams from across Europe.

As all readers will know, dealing with people from different countries and cultures can involve additional complexity, and requires special care to be taken in communication. Even amongst English speakers, as the joke goes, we can often be divided by a common language.

Governing law

The choice of governing law can make a difference. Cross-border deals around the world are done under many governing laws, but most US/UK deals will either be done under English law or New York law. Both US and UK-style acquisition agreements tend to be longer and are more heavily negotiated than agreements under the laws of continental Europe, which are often very different.

Subject to exceptions, under English and New York law, the parties can essentially record what they want in their agreement. A US-style acquisition agreement can be more buyer friendly – the converse of a UK-style acquisition agreement. The approach to "representations and warranties" and "disclosure" is the clearest example of this.

Limitations on liability under UK-style agreements can, however, be more buyer friendly – so there is some balance here. There are differences in the approach to "walk away rights" too.

Warranty breach

Under English law, a buyer usually needs to prove that the target company is worth less overall as a result of a warranty breach. So the fact that an asset is missing, for example, does not necessarily mean that a successful claim will be able to be made.

US buyers often find this incomprehensible – they are used to being able to recover on what is called "an indemnified basis" – i.e. on a dollar for dollar basis.

The US approach to disclosure against warranties requires the seller to list qualifications to warranties (i.e. the exceptions to the statement that make the statement untrue) in a disclosure schedule. It is far less typical under a US-style deal to allow a seller to qualify a warranty by general reference to documents in the data room.

The US approach puts a lot of risk on the seller, and the disclosure exercise can be expensive and time-consuming for management as well as external advisers.

Whilst always a matter for negotiation, it is common under the UK approach for a seller to benefit from information contained in the data room. Buyers almost always require a seller to make "specific disclosures" too, but there is the

potential safety net for the seller of being able to rely on information provided to a buyer in the data room. This could be abused, of course, with sellers looking to hide needles in haystacks, and this has led to the concept of a "fair disclosure" override, whereby (in short) the information needs to be reasonably obvious to qualify a warranty, but the fact that it wasn't included in the disclosure schedule (usually a separate "disclosure letter" in the UK) doesn't in itself mean the seller is sunk.

Financial limitations

There is a great deal of "market" information available about US deals, given the filing requirements of EDGAR (the Securities and Exchange Commission's publicly available database of US securities filings, including sale and purchase/merger agreements), and lots of reports are written each year profiling, for example, liability caps.

Liability caps tend to be lower under US deals, with 10-20 percent of the equity value of a target common. Practice is currently very mixed in the UK, and from the position 15 or 20 years ago where liability caps of 100 percent of the equity value were seen, especially for smaller deals, a number closer to 50 percent is now more typical.

We increasingly see caps closer to the US level, particularly in competitive auction sales.

Under US deals, claims cannot usually be brought until the aggregate amount claimed exceeds a deductible level, whereas under UK deals a so-called "tipping basket" is more common (i.e. once a threshold amount has been reached, all claims up to and beyond that amount are claimable, subject to any de minimis exclusions).

David Wallis leads RPC's private equity work in the financial services sector

Walking away

Whenever the closing of an acquisition takes place some time after the deal is signed and announced (e.g. because the regulators' consents are needed), buyers often require a material adverse change (MAC) clause, sometimes referred to as a material adverse effect (MAE). This concept protects the buyer if something of significance happens between signing and closing.

US buyers, especially those that are listed, almost always insist on a MAC clause. Unlike in the UK, there is a relatively sizeable body of law on MAC clauses.

Such clauses are always heavily negotiated. From a seller's perspective, a "narrow" clause will provide the greatest deal certainty. A buyer will, however, want the broadest clause possible.

One relatively recent development in US/UK practice has been to include Delaware law-governed MAC clauses in English law-governed acquisition agreements.

Typical Delaware-style clauses tend to be construed by the state's courts in a way that makes it difficult for a buyer to walk away. US buyers are generally comfortable with these clauses. What we are seeing though is that buyers then seek to add further specifics – for example around capital requirements.

Actuarial matters

It is difficult to draw too many jurisdictional conclusions on the approach to actuarial matters. As a gross simplification, we tend to see US buyers looking for greater levels of warranty protection on actuarial matters than is typical in a UK context. This can be a really difficult area on insurance deals, as these matters obviously go directly to value.

Legal points?

Mention of even a few of the differences between what a US and a UK party may expect shows that what might be seen as "legal" points are in fact anything but, and it is beyond the scope of this article to highlight other important differences such as financing conditions and break fees. We have seen problems arise when commercial negotiating teams aren't familiar with these differences (and unless they've done a lot of US/UK deals, why should they be?), and/or they don't involve appropriate legal advisers early enough.

A reference to "customary terms" in a US/UK term sheet almost always leads to some difficult discussions...

This article is provided for educational and information purposes only and is not intended and should not be construed as legal advice.

Turning the screw

In the post-financial crisis environment new classes of claims are expect to increase the pressure on the property, casualty and professional liability markets, says **Jennette Newman**

The global recession continues to affect the insurance industry, with new forms of claims and risks emerging on a regular basis.

Over the course of the last year we have been working closely with economic and policy specialists at the Institute of Directors to produce extensive research into exactly what the major effects have been, and the impact on claims in the London market across the UK and Ireland.

Our whitepapers focused on three distinct areas: professional indemnity, property and casualty. Through these, we connected with senior members of the insurance industry to identify and discuss these important areas of London market insurance claims trends in the UK and Ireland.

Drawing out the drivers behind these claims, we looked to explain how they are shaped by wider macroeconomic factors, as well as to project future market trends.

Professional indemnity

In the current macroeconomic environment, which includes an apparent property boom, professionals who provide advice and services to customers need to be aware that they face a potential increase in new classes of claims being brought against them.

In planning there is certainly a risk of rising claims against surveyors, seller's agents and party wall surveyors. Firstly, the current vagaries of the existing housing system mean it is failing to address the current shortage, which is being caused by a range of economic factors including

increased population, restrictive planning laws and a lack of skilled labour.

Changes to the planning rules are needed; however, these changes could herald a rise in claims being brought against surveyors whose job it is to advise on planning prior to the purchase of land. During the previous property boom there were a large number of claims caused by surveyors' lack of awareness of changes and subsequent failure to inform their clients.

Both seller's agents and party wall surveyors are also at risk. The former is likely to see greater claims from instances where they fail to advise sellers of the effect of changes to the value of their land, while the latter could be vulnerable to claims from failing to adequately prepare a schedule of condition or arranging money held in escrow, as a result of relaxed legislation.

In drafting, the release of developable land banks by their owners inevitably exposes valuers to potential claims. In particular, complex sale structures for the release of this type of land, or indeed in the novel and unfamiliar area of pop-up tenancy agreements, puts additional pressure on the solicitors involved in drafting the agreements.

Both the UK's right to buy and buy to let schemes carry further risks. With right to buy there is likely to be an increase in the number of mis-selling or negligence claims against solicitors or brokers for failing to explain mortgage conditions or interest rates, with the decisions in the cases *Goldsmith v Williams* and *Mathew v Mathew* likely to be pivotal.

Meanwhile, managing agents will see a rise in issues such as personal injury in tenanted property and tenant referencing and management claims.

Property and environmental

Insurers need to take action to keep property damage claims at an acceptable level, as the industry has the potential for claims to rise across numerous areas.

Extreme weather conditions are likely to have the largest impact, with the flooding over the recent winter estimated by the Association for British Insurers to have cost £1.3bn. In November

2015, the Association of Drainage Authorities reported to the government that the UK had experienced the five wettest years since 2000, further highlighting the issue.

This is not aided by the fact that net migration, along with births to foreign-born parents, has accounted for 85 percent of population growth in the UK since 2000. An expanding population places an enormous strain on the housing market, with planning applications to build on flood plains increasing over the last five years.

In total, over five million people currently live or work in flood risk areas in England and Wales, increasing the risk for flooding claims.

This expansion of the property market has the potential to hit hardest in London. With a growing demand for qualified builders, the threat of skills shortages is very real and inevitably brings a rising number of claims.

The damage caused by water escape in the construction of multi-storey buildings is one such example, leading to average claim costs for property damage more than doubling in the last 10 years.

From an environmental perspective, new forms of energy are also set to create new types of claim. In particular, wind power brings with it a number of new risks. With the UK the sixth-largest producer of wind power globally, the level of investment in turbines is extremely high.

As wind turbines are particularly sensitive to natural phenomena, and with the potential for design defects from new unproven technologies, claims are always on the horizon.

In addition, with the continuing decline of oil production in the North Sea the UK has continued to investigate the value of fracking. As we have seen from a number of high profile cases in the US this can often lead to litigation, with potential nuisance claims including gas migration, seismic action activity and pollution.

> "The present post-crisis environment does not mean that professionals and organisations will see a drop in the number of claims made against them"

Jennette Newman is a partner and head of Lloyd's and London market at BLM

Casualty: accident or emergency?

As well as the professional indemnity and property spaces, the casualty market is also changing. Advances in technology enable flexible and innovative working practices. However, the issue of whether this adversely affects the mental and physical wellbeing of the staff is set to be questioned, which could result in new claims.

The advent of home working also restricts traditional staff supervision, taking away businesses' ability to adequately protect themselves, including by monitoring when breaks are adhered to, which again leaves employers liable.

This is likely to become even more important with the introduction of new sentencing guidelines in this area, with considerably higher fines for both organisations and individuals compared to previous offences.

When it comes to catastrophic injury, it is true that the changes in the cost of future care packages will remain a significant factor in terms of overall claims costs. But a new risk is emerging in the form of driverless cars. Questions remain about exactly when this will have an effect and what the impact will be.

In a true driverless environment the type of motor incidents that usually cause catastrophic injury claims should reduce or disappear if, as claimed, the software recognises the potential incidents and avoids them.

This is also set to be a key issue for product liability. In addition, the manufacturing industry is likely to find itself under considerable pressure as a direct result of lengthening supply chains and global shifts. In particular, product safety is likely to be threatened by margins, while quality control is set to be undermined by a reduction in funding for regulators.

Liability claims fraud is also on the rise, reaching a total value of £343mn in 2014. Despite detection rates improving in recent years, this must continue to be a priority for the insurance industry as cultural attitudes towards fraud need to be changed.

With the UK government focusing heavily on whiplash claims in recent years fraudsters have not seen this as a deterrent, instead switching their attentions to the less heavily protected area of casualty fraud.

The present post-crisis environment does not mean that professionals and organisations will see a drop in the number of claims made against them. In the current climate, we expect new classes of claims, resulting in continued evolution of all three of these markets.

The insurance industry must leverage its influence to counter these emerging trends by attempting to influence government policy either through responding to consultations or by targeting particular claims.

drone's eye view of the Tianjin blast site

Right skill, right place, right time

Neil Gibson highlights the challenges of responding to major losses in an increasingly complex world

The loss environment in the last several years has been relatively benign, but there have still been a number of major events to test the responses of insurers, brokers and loss adjusters.

Dealing with expensive and complex casualties is the very opposite of a faceless, process-driven approach. The commercial angle to any major loss is a significant and delicate issue, with the policyholder and their insurer often having a differing understanding of the policy wordings or desired outcomes.

Adjusting such a loss demands technical excellence, but this alone is not enough. Expertise is only effective if it is delivered promptly, to the exact point of need, and supported by the appropriate technology and specialist expertise.

New technology

Technology such as iPads, video and unmanned aerial vehicles (or drones) is changing the way that loss adjusters work.

The ability of drones to film inaccessible or unsafe areas after natural or man-made catastrophes is unique. As well as providing invaluable intelligence about what is happening on the ground, the footage and images can be shared with the client, as well as surveyors and other building specialists.

Such technology can offer 360 degree views on demand, and has the potential to deliver savings on professional time and travel costs, as well as providing a "live" file report on the claim, which would take hours to put into a document.

Recently the use of drone technology has come into its own. In August, following the massive explosions in the port of Tianjin, which caused widespread damage, the Chinese authorities restricted access to the site due to fears of follow-up explosions and chemical contamination.

Clients with goods due to be shipped from the port were anxious to know the extent of the damage, and insurers wanted to begin loss assessments. Drones were used to give a bird's eye view of the blast zone, allowing the extent of the damage to be plotted on maps and helping to provide initial loss assessments to clients before access to the site was permitted.

The scale of the assistance required could also be established, which enabled resources from across Asia to be mobilised into China, so remedial and loss estimate work could begin as soon as site access was permitted.

Flood response

The flooding caused by UK storms Desmond, Eva and Frank in December 2015, while catastrophic for those affected, was significantly less severe than the record-breaking flood events of the summer of 2007.

Nevertheless, the proximity of the storms and their geographic concentration made for some particular challenges from a loss adjusting perspective – and smart use of technology was often the answer.

These floods were the first major widespread surge event in the UK for several years, which meant that it was the first time adjusters were sent into field fully equipped with the latest technology.

The first advantage of this was speed, with technological advances making for a more rapid response from the insurance industry in dealing with the claims surge. For example, Cunningham Lindsey adjusters were equipped with iPads so that they were able to submit video footage, helping insurers to better understand the exposure, arrive at a decision faster and make initial payments more swiftly.

Insurers can now come back with a decision in hours, whereas previously it might have taken days. In a world where reputation rests on prompt claims payment, this technology is a tremendous enabler.

Drones were also deployed significantly for the first time in response to the UK floods, flying over the affected areas to build up a picture of not just a claim but also of the general environment. It was a helpful aid in determining the extent of floodwaters, and built a more accurate picture of the event than relying on third party footage from television news, which often fails to show the whole picture.

Drones also provide a view of the exposures before they can be reached on foot and help to determine how many people need to be deployed in a certain area. In Cumbria, the drone footage helped identify three flooding hotspots: Carlisle, Cockermouth/Keswick and Kendal down to the South Lakes.

The video footage from drones can be used in a number of ways by the adjuster. It can be helpful in preventing fraud – for example, in cases where a claimant says their car was parked outside when footage shows it wasn't. It also helps with business interruption, and with conveying to an insurer the seriousness of the situation when there is a wide area damage scenario.

This smart use of technology helps us to keep the customer at the centre of what we do. It doesn't replace face-to-face contact, however – our experience in Cumbria demonstrated that there are many vulnerable clients who welcome the reassurance of human contact.

But the shape of loss adjusting is altering with new technologies – and the industry mantra needs to focus on being quicker, more cost effective and delivering an altogether better experience for the customer.

Under the skin

With businesses now operating on an increasingly global stage, with subsidiaries, customers and suppliers in multiple countries, the result is often loss scenarios that had not been contemplated when the policy was being negotiated and written.

For example, high degrees of interdependency can create significant upstream or downstream losses that were not anticipated at policy inception, and which can only be accurately quantified by experienced forensic accounting experts.

The forensic accountants provide economic loss quantification, financial analysis and valuation services to really get under the skin of a claim.

In one recent claim a minority shareholder in a group of property development companies and joint ventures became aware that, during the 13-year period that the development group had existed, he may not have been properly appraised of the dealings in the group and the entitlements due to him.

Once these concerns were raised with his fellow shareholders, the client was prevented from accessing the various company records for all of the businesses within the group. Legal action was then commenced in order to regain access to these records, and help to uncover the truth.

By having specialist forensic accountants research the accounts, tax returns and all the company information and notes, significant issues relating to the conduct of the businesses and the treatment of the minority shareholder's interests were unearthed, which resulted in a settlement to the shareholder in excess of $22mn.

> "Drones provide a view of exposures before they can be reached on foot and help to determine how many people need to be deployed in a certain area"

It is not that traditional loss adjusting is no longer required, but rather that extra expertise is required. A combination of the two leads to better outcomes for insureds and insurers alike.

It is a myth that the insured wants to maximise the claim, while the insurer wants to reduce it as far as possible. In our experience, all parties are looking for the right answer in order to reach a fair settlement. By being proactive and sensitive to the overall claim life cycle, forensic accountants can help to achieve this.

Dealing with major and complex losses and arriving at the right solution requires a potent combination of a high level of technical skill and industry specific knowledge, client co-operation and pre-loss planning, as well as access to the appropriate advice at critical times, supported by the latest technology. Put simply: the right skill, at the right time, in the right place.

Neil Gibson is loss adjusting services director at Cunningham Lindsey

Should I stay or should I go?

John Shepherd, CEO of Shepherd Compello, makes the case for staying in Europe

***Insider Quarterly* (*IQ*): Why are you passionate about the UK staying in the European Union (EU) following the referendum on 23 June?**

John Shepherd: There is no doubt that the forthcoming referendum is dividing the nation and for some emotions are running high. I respect the views of those who want to leave, but I am clear that we should stay in. Also, I do not think that it is helpful to confuse passion with emotion.

An emotional vote to exit without being clear on the ramifications is very dangerous. Lord Heseltine summed this up recently when he called on Boris Johnson to avoid "illogical" rhetoric about EU control of bananas – which is untrue – and comparisons between Hitler and the EU.

Heseltine is absolutely right when he states that "this is the most serious decision this nation has faced in a generation" – for this reason I hope that voters take a considered, rational view.

As a businessman my decision is based on the commercial facts that I see directly around me and is supported indirectly from a number of other sources.

***IQ*: Can you elaborate on some of those direct factors behind your decision?**

John Shepherd: At Shepherd Compello we believe that much of our success, both now and in the future, comes from the fact that we are a family. I feel a personal responsibility to that family – they have mortgages, families and bills to pay. I genuinely believe that our family will be impacted by a leave vote.

Before I am accused of the kind of emotional decision-making I want to avoid, here is an example of what I mean. We run a multi-lingual service centre in Stratford, helping clients across many countries. The vast majority of this team are not UK citizens, but benefit from freedom of movement. They come from a number of nations including France, Bulgaria, Belgium, Ukraine, Italy and Germany.

This isn't a case of uncontrolled migrants taking jobs from UK citizens. These are roles that would be very difficult to fill without these highly skilled people. What would happen to them? There would be uncertainty about their ability to work in the UK.

Then there is the fact that our ability to trade and support clients across these diverse countries could be hindered or even blocked. So you can understand the huge risks our family faces.

It is all very well talking about our ability to trade in the future outside of the EU, but we as a

business trade substantially in Europe now. Neither I, nor my team, can afford to wait and see how those trade deals can be renegotiated sometime in the future. How long would this take and what would happen to my business in the meantime?

IQ: Isn't it risky for employers to get involved in political decisions?

John Shepherd: We need to respect and celebrate the fact that we live in a democracy. When we enter that polling booth on 23 June it is a private and individual decision. Nobody will be under any pressure to vote in any other way than the way they choose.

So for that reason I see no danger at all in employers stating the case. I think this just reflects how important they believe it is for business that we stay in. As I said earlier, I am a businessman who is stating the case based on commercial reasons.

It comes as no surprise to me that major multi-national firms like Microsoft, HP and Aviva have made their feelings clear and have actively discussed with their staff or shareholders the fact that they want to stay in.

Aviva alone manages around £350bn of assets across the world and has 33 million customers and both its CEO and chairman have publicly stated the business risks of an exit. Aviva commissioned a report from their team of economists and investment professionals and believes that a vote to leave the EU would be costly for the UK economy.

It expects an immediate and sharp fall in sterling with the economy falling into recession by the end of the year. So it strikes me that you would need a very powerful argument against this to justify the risk. I have yet to hear this compelling argument to leave.

IQ: And what evidence from indirect sources supports your pro-EU position?

John Shepherd: From an insurance perspective the London market is hugely important to my business and the wider economy. According to Lloyd's, the London market is currently the largest global hub for commercial and specialty risk – controlling more than £60bn of gross written premium.

> "Independent research has shown that two-thirds of insurers, brokers and service providers in the London insurance market say leaving the EU would be bad for their £60bn market"

It is a diverse market made up of over 350 firms contributing over 20 percent of the City's GDP and employing 48,000 people. Its capacity to take risk within a regulatory framework and tax environment has been attractive to the inward flow of capital.

So what is the relevance? Well, Lloyd's has made it abundantly clear that this capability will be put at risk if we vote to leave the EU.

The Corporation has taken a very reasoned view and stated that: "The Council of Lloyd's and the Franchise Board have carefully considered the question of British EU membership in the context of the interests of the Lloyd's market. We have unanimously concluded that the best outcome is for the UK to remain a member of the EU."

IQ: Do you think the market supports the position Lloyd's has taken?

John Shepherd: Yes, I do, based on the discussions I have had in the market. Also, independent research has shown that two-thirds of insurers, brokers and service providers in the London insurance market say leaving the EU would be bad for their £60bn market. Only 6 percent think it would be a good thing.

IQ: Are there any other arguments outside the insurance sector that you feel reinforce your view that the UK should remain within the EU?

John Shepherd: It is very interesting to note that the Bank of England and the International Monetary Fund (IMF) have both come out in favour of the UK remaining within the EU. Rather like employers getting involved this has created a bit of a storm, mainly from those in favour of a Brexit as it doesn't suit their narrative. You do have to wonder how much capital they would be making if the reverse were true!

Christine Lagarde, the IMF chief, has said a vote by the UK to leave the EU would have "pretty bad, to very, very bad" consequences. She can't see any positive reasons to leave and has warned that it could lead to recession.

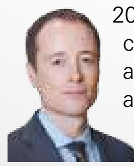
This view and warning of recession is echoed by Mark Carney, governor of the Bank of England. The bank's monetary policy committee said that a leave vote may cause both growth and sterling to fall and unemployment to rise.

As I said at the beginning, let's take the emotion out and consider the financial facts and risks. The economic warnings are stark, and sideshows about bananas are just that – bananas. If people have real concerns about the EU, I believe we are better off seeking reform from within rather than walking away and having no say at all.

Executive moves

Following the news that **Tad Montross** is to step down as CEO of Gen Re, **Kara Raiguel**, a senior executive from Berkshire Hathaway's reinsurance division, has been announced as his successor, according to an internal memo seen by sister publication *The Insurance Insider*. Raiguel has worked with Berkshire reinsurance chief Ajit Jain for 15 years.

Following the announcement that Aspen Insurance CEO **Mario Vitale** intends to retire, the company has appointed **Stephen Postlewhite** as chief executive of Aspen Insurance and **Thomas Lillelund** as CEO of Aspen Reinsurance. Vitale has been insurance CEO since 2012. Postlewhite has been reinsurance CEO since 2014. Lillelund was previously managing director for the Asia Pacific region.



Sean McGovern, chief risk officer and general counsel at Lloyd's, is to leave the Corporation after 20 years of service to take up the newly created role of chief compliance officer and head of regulatory and government affairs at XL Catlin. In his new role, McGovern will report to the audit committee and CEO Mike McGavick.

Lloyd's chairman **John Nelson** has confirmed that he will relinquish the role after the market's annual general meeting in May next year. Sister publication *The Insurance Insider* reported last September that Nelson would step down ahead of the end of his contract in October 2017, possibly in the first quarter of the year.

Eight months after long-serving president and CEO **Frederick Eppinger** announced his intention to step down, The Hanover has unveiled **Joseph Zubretsky** as his replacement, effective from 20 June. He joins from Fortune 500 insurer Aetna, where he spent nine years, most recently as CEO of Healthagen Holdings.

AmTrust founder and chairman **Michael Karfunkel** passed away at the age of 72, the company announced on 27 April. Karfunkel launched the business with his brother George in 1998, before appointing son-in-law Barry Zyskind to the position of president and CEO. The company said the chairman's role would be filled by president **Barry Karfunkel**.

Emmanuel Clarke (pictured) has been officially named CEO of Exor-owned PartnerRe, with John Elkann, chairman and CEO of Exor, appointed chairman. It was first revealed in September that Clarke was to become CEO following Exor's purchase of PartnerRe. He takes the reins from interim CEO David Zwiener, who is leaving the company.

Generali has appointed **Philippe Donnet** as its new CEO, replacing **Mario Greco** (pictured), who has left to lead Zurich. Donnet has worked as Generali's Italy country manager since July 2013. He will retain this responsibility alongside his new role. Donnet also becomes chairman of the investment committee.

Munich Re has confirmed that CEO **Nikolaus von Bomhard** (pictured) will step down from the role on 26 April 2017, following reports that the executive had decided against renewing his contract once he reaches the age of 60. **Joachim Wenning**, board member responsible for life reinsurance and human resources, has been named as his successor.