

Financial Crisis and Insurance

The view of an Insurance Broker

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The intention of this presentation is to provide background to some dramatic events in the recent history of the insurance market, to show how they were addressed, what lessons were learned and to try and draw parallels with current events in the financial markets

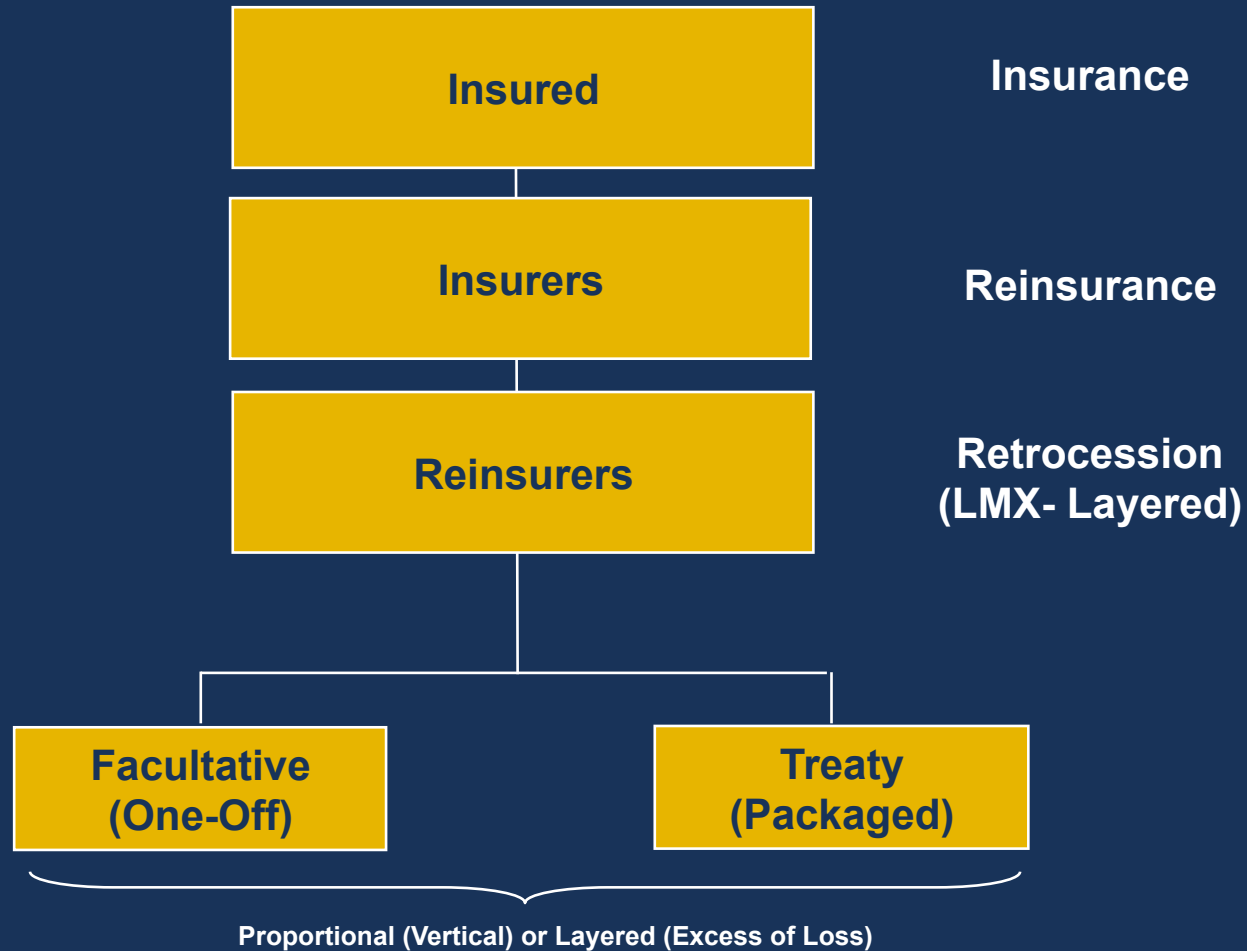
The UK Financial Services Authority on the Current Financial Crisis

The Turner Review – Published March 2009

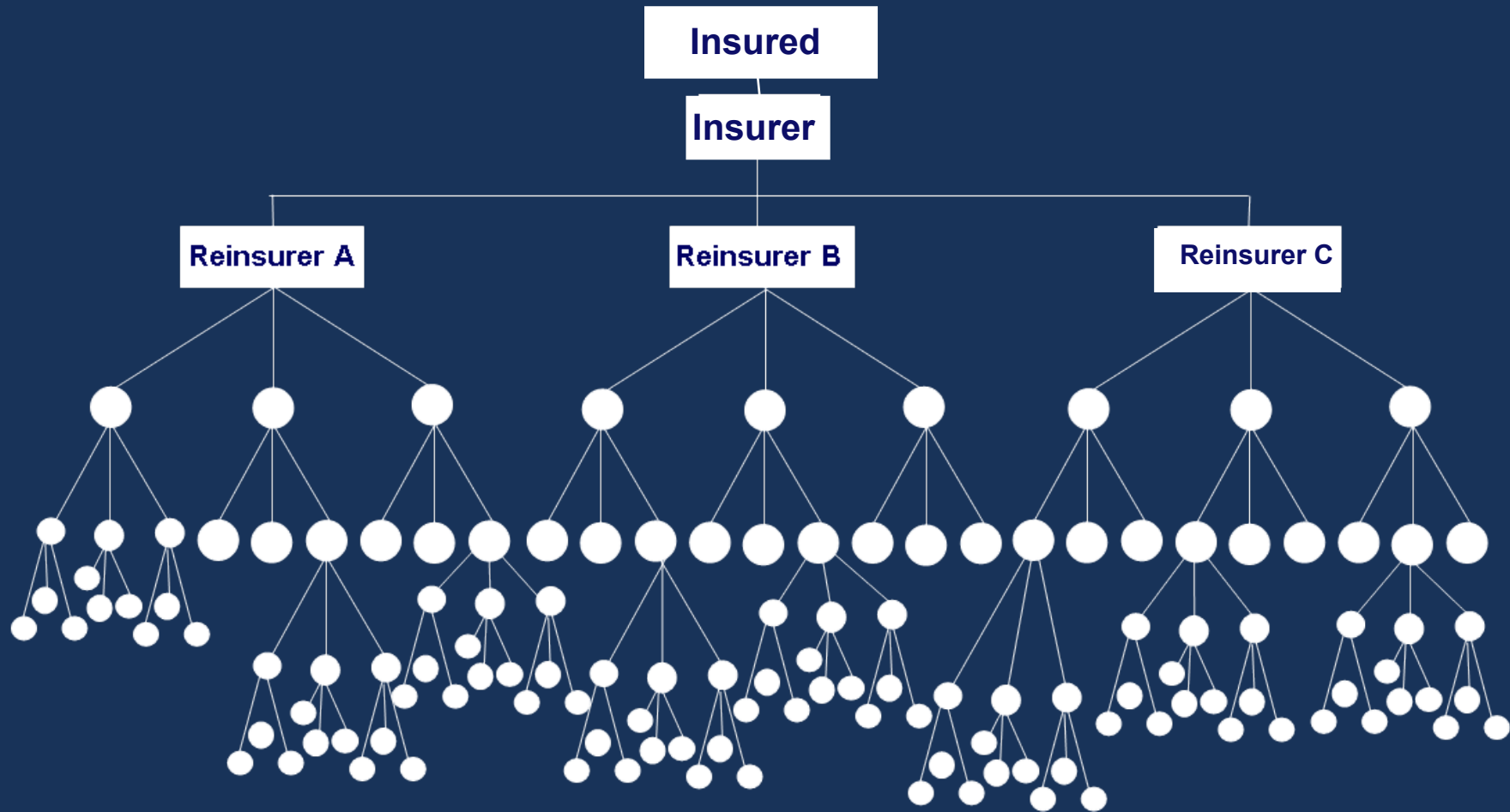
The key drivers of the current financial crises:

- The massive growth and increasing complexity of the securitised credit model.
- Risk retained on banks' balance sheets (spiral)

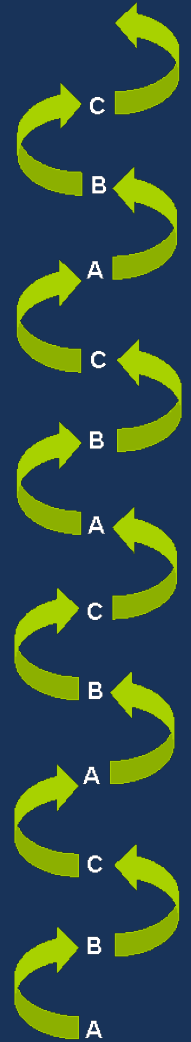
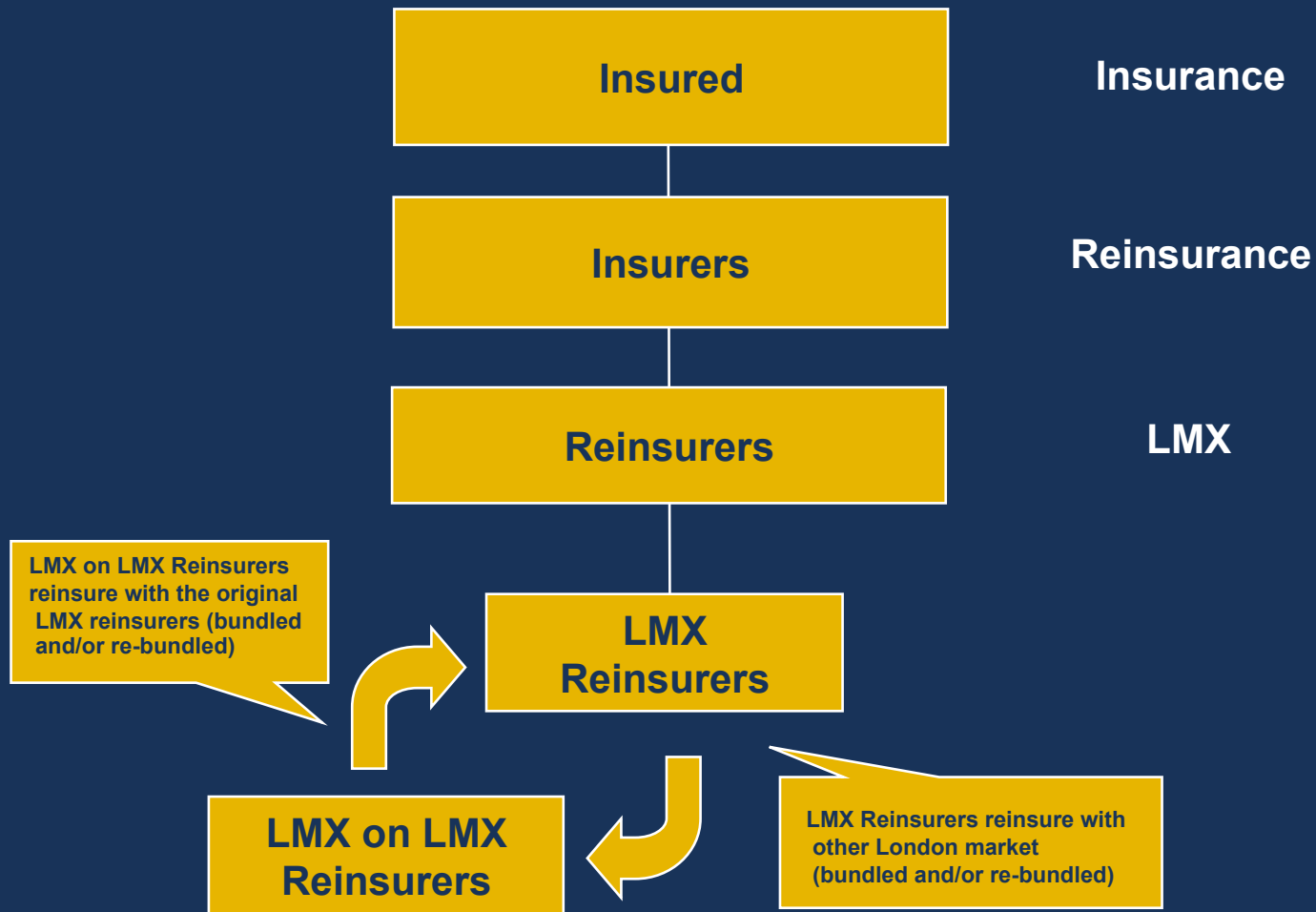
How the Insurance Market Works



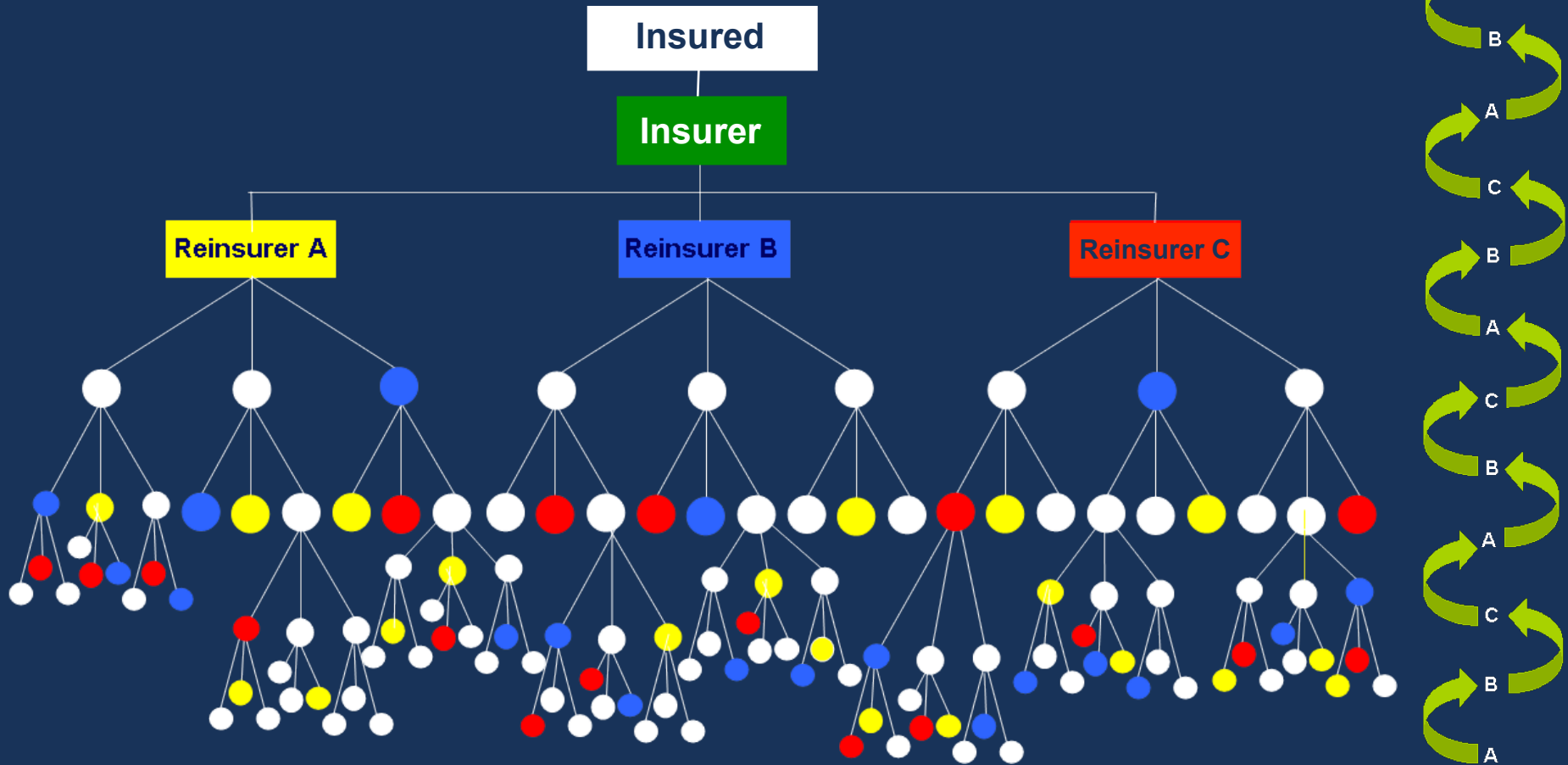
A Reinsurance Structure



How The LMX Spiral Market Works



How the LMX spiral happened

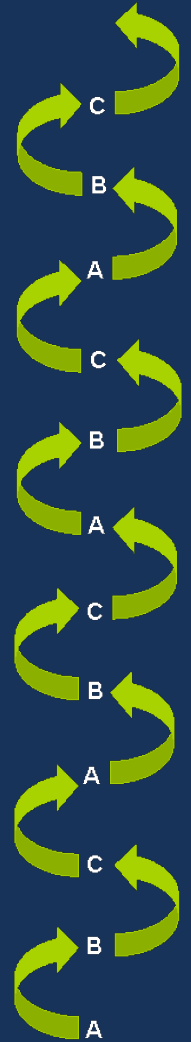


Causes of the Reinsurance Spiral

- Lack of central Lloyd's control or discipline, self-regulated by its own members.
- Competition in the insurance/reinsurance markets led to collapse of market segmentation
- Loss of control of the sale of retrocession to other London market participants
- Trigger: series of catastrophic claims
- Reinsurers business plans/models were not aligned with sound risk management practices
- Little understanding of the likely vertical exposure

and

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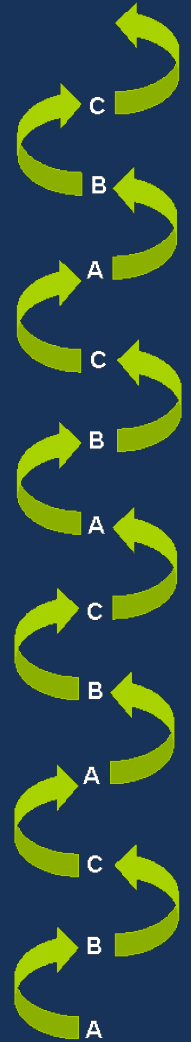


Claims

Piper Alpha Loss

43,000 LMX claims on 11,500 policies

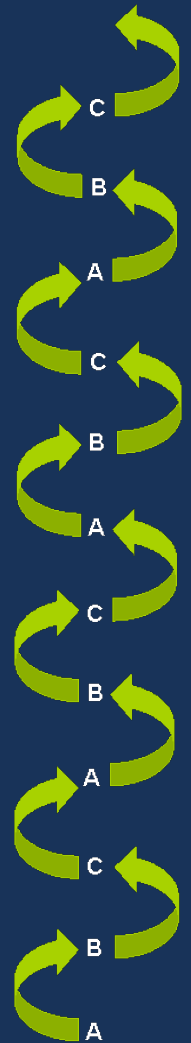
	1988	2007 Equivalent
Actual	£1,400,000,000	£2,700,000,000
LMX Loss	£15,000,000,000	£29,000,000,000



Why were the losses so bad?

- The LMX market was primarily in Lloyd's
- Many underwriters were writing to premium income not exposure
- LMX underwriters were ultimately writing their own risks as well as others
- LMX underwriters' own treaty protections became exhausted
- Large uncovered losses were therefore being retained by syndicates
- 30% of the LMX market was with one Lloyd's Members' Agency (Gooda Walker)

However some underwriters *did* write on sound practices and made money!



Present Day

- Central Lloyd's (professional & independent) management
- Clear differentiation between syndicates, managing agents, members' agents and brokers
- The LMX/RI Assumed Exclusion Clause prohibits 'spiral' business
- The Lloyds franchise board take a very critical view of any syndicate involving itself in a reinsurance spiral
- The spiral is no longer possible and first tier retrocession protection is bought and written by reasonable underwriters who understand the risk and plan their business accordingly
- Net Underwriting has led to a disciplined and consensus driven market

The LMX Spiral was the major contributory factor to the near collapse of Lloyd's

The Securitised Credit Model Parallel

LMX Spiral

- Names sued managing agents and syndicates
- The market now looks at risks as cross-class not as individual exposures
- Tighter regulation
- Creation of a market solution – Equitas
- Modelling improved but still imperfect

The Credit Crisis

- Class actions
- Recognition that Securitised credit creates specific and inherent risks
- Complete change in global regulatory environment
- The creation of a banking equivalent – “Bad Banks”
- Understanding that many important risks cannot be managed by sophisticated mathematics alone

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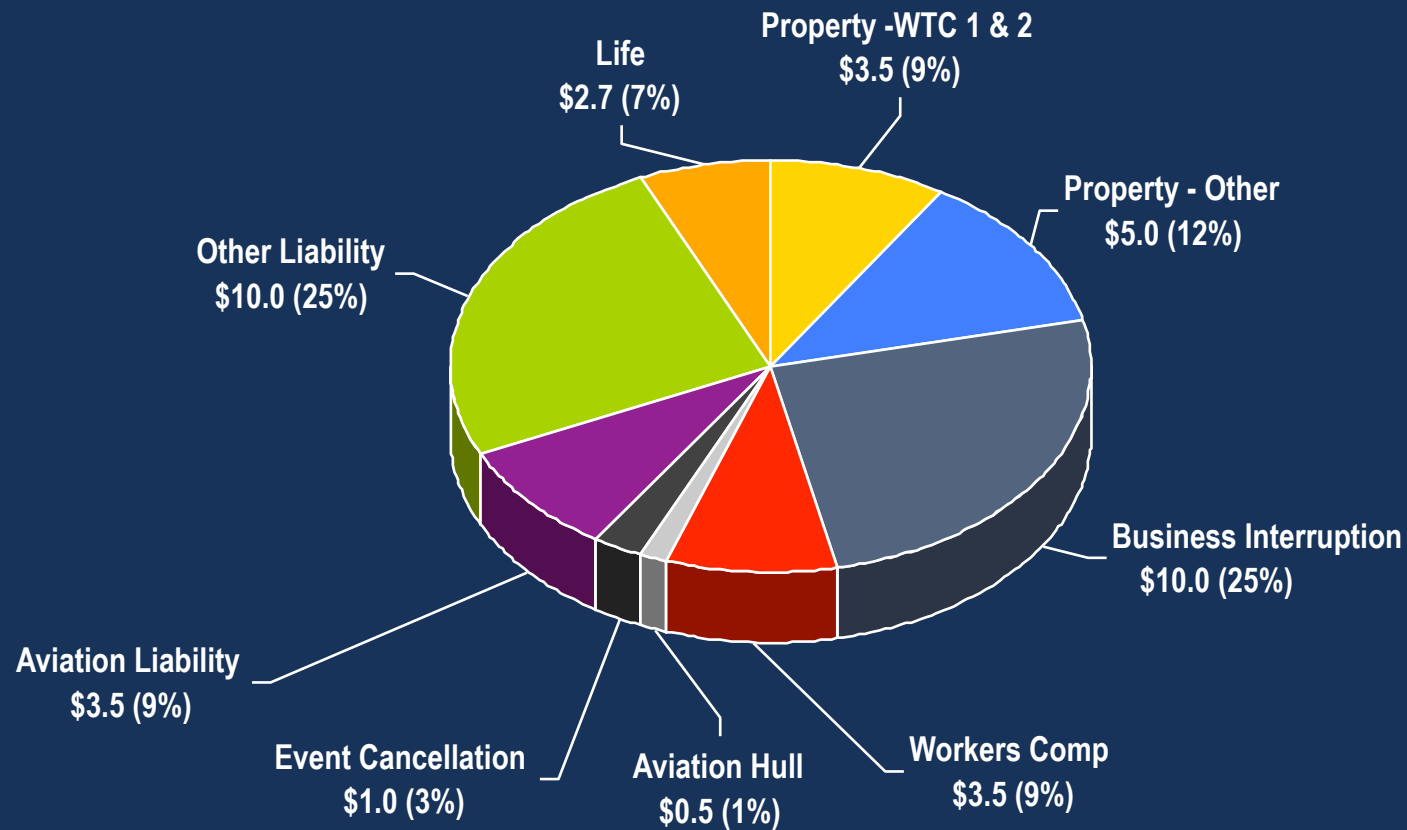
The key drivers of the current financial crises:

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- Increased leverage in multiple forms

9/11 – World Trade Centre



Estimated Insured Losses (billion)



Consensus Insured Losses Estimate: \$39,700,000,000

What went wrong?

Underestimated potential for catastrophic terrorism losses

Underwriters did not understand cross-class aggregation

- largest workers compensation loss in history (by multiples);
- the most expensive aviation disaster in history (by multiples);
- one of the largest property losses in history;
- the most expensive business interruption loss in history (by multiples);
- the largest life insurance catastrophe loss in history (by multiples);
- one of the largest liability claims in history
- Largest single fine art loss and frozen fish loss!

The 9/11 Parallel

9/11

- Insurers & Reinsurers focused on exposures never before contemplated to clash
- Across the board pricing increases and coverage restrictions (e.g. terrorism)
- Injection of new capacity/capital with no “legacy” liabilities
- Development of risk modeling techniques
- Premium Increases
- Rating companies downgraded insurers and reinsurers overnight

The Credit Crisis

- Focus on uncovering the true extent of sub prime liabilities. Banks are over leveraged
- Seizing up of credit markets and libor spiking
- Injection of public capital
- Re-evaluation of role of risk management and modelling in financial institutions
- Global recession
- Sudden downgrading of seemingly secure financial institutions

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The key drivers of the current financial crises:

- The massive growth and increasing complexity of the securitised credit model.
- Risk retained on banks' balance sheets (spiral)
- Increased leverage in multiple forms
- The complexity and opacity of the structured credit and derivatives system built upon a misplaced reliance on sophisticated mathematics.
- Lack of adequate capital buffers

2005 Caribbean Storms



2005 Caribbean Storms

Hurricane Losses	Storm Severity	Estimated Insured Losses
Dennis (6 th July)	Category 4	\$ 2bn
Katrina (24 th August)	Category 5	\$ 45bn
Rita (20 th September)	Category 5	\$ 34bn
Wilma (16 th October)	Category 5	\$ 8bn

Source: Swiss Re

Insurance Market Reaction

- Katrina was rated as the 4th most intense hurricane on record in the Atlantic basin
- At it's peak wind readings as high as 175 mph; well above the Cat 5 threshold of 156mph!
- Property and Energy markets affected
- Several markets put on “negative” watch by rating agencies (again)
- All loss scenario models were reviewed (again)

The 2005 Caribbean Storms Parallel

2005 Windstorms

- Over reliance on Cat models that proved to be imperfect (flood)

- Several markets put on negative watch by rating agencies

Securitized Credit Model

- Complex financial modelling techniques have proved ineffective in managing and quantifying risk.

- Frequently changing ratings awarded to institutions. Uncertainty over security.

“Investors should understand that in all types of financial Institutions, rapid growth sometimes masks major underlying problems (and occasionally fraud). The real test of a derivatives operation is what it achieves after operating for an extended period in a no-growth mode. You only learn who has been swimming naked when the tide goes out”

Warren Buffet 2004 Annual Report of BH

Reasons to be happy

Risk Management and ERM	<ul style="list-style-type: none">• Airmic survey of its 450 corporate members says 59% increased their level of ERM over the past 2 years• ERM in insurance companies developing rapidly<ul style="list-style-type: none">– Cat modelling– Financial Modelling– Resultant Aggregation management
Risk Manager's Role	<ul style="list-style-type: none">• GRS consultancy forecasts that by end of 2009, 50% of financial service companies will employ a risk professional – compared to 12% last July• UK financial risk roles will increase by an estimated 1,000 – 4,000 over next 18 month
Provider of Contingent Capital	<ul style="list-style-type: none">• Reduction in traditional capital availability due to the credit crunch - Provisional IBS data shows a plunge of almost \$1.9 trillion (just over 5%) between the third and fourth quarters of 2008 in banks' international assets, their overseas loans and investments

The Modern and Stable Insurance Industry

Ahead of the Curve

- Most stable capital in global financial services
- Already engaged in government/private partnerships
 - Pool Re, TRIA, CEA etc.
- Core general insurance exposures not the issue – activities outside the core that have created crisis in insurance organisations
- Stringent regulation in many countries
- Transparency evolving globally

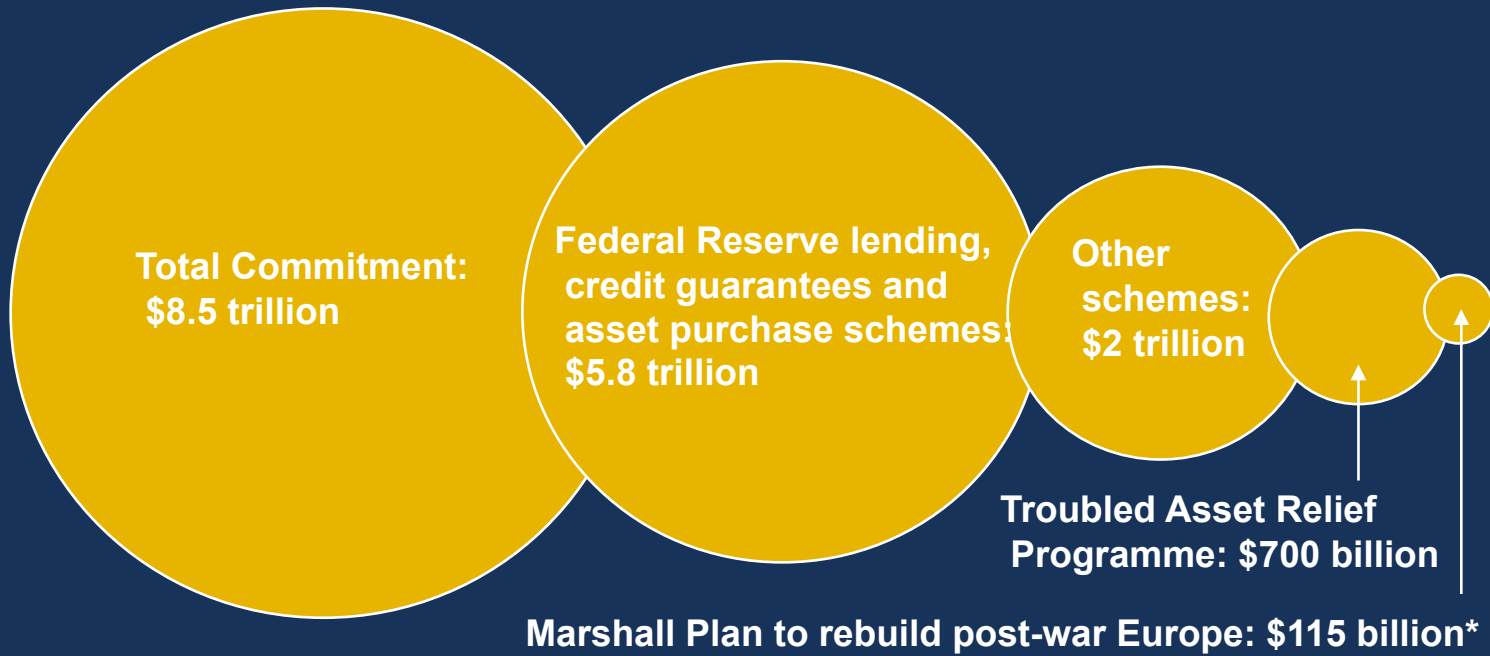
Let's Develop That Lead

- Continue to build on ERM – but use the models, do not become dependent on them
- Practice the pain of discipline vs. the pain of regret
- Get back to basics and focus on your core business of insurance – not “hobby businesses”
- Sustainable success means the client wins, the intermediary wins and the market wins – more partnership, less adversarial
 - Sustainable pricing, not “cycles” and “spikes”
 - Continue market reform – technology and process change
 - Work with regulators for the right environment – tough but fair and principles based
 - Use the opportunity to develop our talent – insurance has suddenly become more attractive as a career!
 - Global transparency

The Scale of the US Bailout

- In September 2008, \$700 billion made available for the purchase of distressed bonds
- In March 2009 the Federal Reserve announced it was increasing its purchases of mortgage debt to upwards of \$1,250bn and would buy \$300bn of government debt
- The US Treasury announced its "public-private investment programme" (PPIP)
- Lending also began through the \$1,000bn term asset-backed security loan facility (Talf)

The Scale of the US Bailout



* Adjusted for inflation

Source: Bloomberg, US Treasury, Federal Reserve, US National Archives

What is \$1 Trillion

1 million seconds is 12 days

1 billion seconds is 31 years

1 trillion seconds is 31,688 years