

Insurance Industry: Mirror Mirror

Predicting is a dangerous game. Predicting in writing is a very dangerous game, but this is BRAVE Partners – so here are the firm's bold statements about the insurance industry in 2010.

JANUARY 3, 2010

We have all just made it through the Christmas break and all the associated fairy tales. Just to give the fairy tale inspired title a seasonal flavour, a Northern Irish friend of the firm would pronounce this title as "Myrrh Myrrh". That aside, it is time for a few imaginative stories of our own. Here are the BRAVE Partners' predictions for the insurance industry in 2010.

As the firm has noted in previous commentary, predicting is a dangerous game. Many a prediction has proven wrong – such as:

"The horse is here to stay but the automobile is only a novelty – a fad." — The president of the Michigan Savings Bank advising Henry Ford's lawyer, Horace Rackham, not to invest in the Ford Motor Co., 1903

However, in the spirit of adventure for the New Year (and the New Decade if you subscribe to the astronomical calendar), BRAVE Partners makes three predictions for 2010.

At risk of eternal pillory from ten years into the future when all of our predictions turn out to be badly off, the BRAVE partners make the following forecasts for 2010:

- Emergence of financial risks insurance.
- Life reinsurance as a main stream business.
- Increased M&A activity in Bermuda.

- A vibrant specialty financial risks insurance business will emerge.
- Dedicated life reinsurers will emerge. These businesses will develop to become a vibrant sector, similar to the P&C reinsurance sector.
- A four way merger of P&C companies in Bermuda.

2010: Prediction 1

A number of specialty financial risks insurers will emerge during 2010. There is currently an open opportunity to build a diversified financial risks insurer covering a number of lines including: financial guarantees, surety bonds, trade credit, sovereign risks and residual values. BRAVE Partners can see a number of potential synergies between these lines.

BRAVE Partners believes that 2010 will be the year in which a vibrant specialty financial risks insurance business emerges.

1: Emergence of financial risks insurance

Financial risks and insurance are three words which do not sit comfortably together. Financial risks have been the underlying cause of the near death experience of at least three insurance companies: AIG; XL Capital and Swiss Re. These three companies definitely do not do credit business any more. BRAVE Partners visited Swiss Re HQ at Mythenquai in Zurich shortly after the company retreated from the credit business. The partners found an organisation in flux! The only clarity was that Swiss Re is not currently a major participant in credit business any more.

Bathwater

Trouble is, AIG and Swiss Re were actually good at the credit business that they had traditionally done – trade credit. It had all gone wrong for the insurers when they had hired a bunch of bankers to do banking business: a business that they did not understand – in fact in the opinion of BRAVE Partners – very few people understood. The firm's commentary "Don't build a condo on Mars", available from the ARCHIVE¹ section of the BRAVE Partners website presents the reasons why the firm takes this stance. When AIG and Swiss Re backed out of the credit business they backed out of some lines at which they were exceptionally good.

Capital and expertise again

The BRAVE partners can never resist the opportunity to use the phrase: "the business is solid, all it lacks is capital and expertise". The phrase is borrowed from a board member of Allianz Group when commenting on the bank that they then owned; Dresdner.

¹ Visitors are required to register to access the ARCHIVE section of the BRAVE Partners website. There is no cost or other penalty attached.

Expertise found

The fact is that there is expertise in analysing and taking credit default risk. Much of it resides neither in banks, nor insurance companies, but in specialist businesses called credit derivative product companies (or CDPCs for those who like tongue twisters). A CDPC, such as Primus, is a business that is established purely to provide default risk protection to commercial banks to cover their loan portfolios. Unlike the credit monoline insurers, the CDPCs have weathered the credit storm. The main difference between a monoline and a CDPC is the fact that the CDPCs stuck to their knitting and the monolines did not. CDPC knitting is making a detailed analysis of the financial strength of the high grade corporate that sit in commercial bank portfolios: Verizon, Caterpillar, Rolls Royce, Carrefour, etc... and then takes the default risk on these names. The monolines ran into troubles by moving away from fundamental analysis and relying on models and ratings agencies to assess default risk.

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Christopher Cloke-Browne
Managing Partner
BRAVE Partners LLP

To put the phrase into context, AIG and Swiss Re had both capital and expertise in their trade credit businesses. AIG was one of the pre-eminent primary writers and Swiss Re was the dominant reinsurer. However, in their more banking orientated credit insurance businesses, the firms perhaps only had capital. The past tense on the capital component is particularly pertinent – especially in the case of AIG.

Even strong successful insurers, such as Axis, have had their losses in the credit insurance business. Axis found itself on the wrong side of a default guarantee on \$399m of bonds for the Blue City development in Oman.

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So there is enormous expertise available to analyse default risk, it rests in the CDPCs.

There's something wrong my parrot's died

The Two Ronnies were one of the UK's most successful comedy partnerships. Their show always included a song. One song was an adaptation of Kid Creole's "There's something wrong in paradise", entitled: "There's something wrong my parrot's died". The song

included the enduring line: “Now there’s one thing left to do – that’s fricassee my cockatoo”.

In much the same way there is something wrong in a section of the credit business that once appeared to be paradise.

Although the CDPCs have weathered the storm, they are suffering from the aftershocks. The CDPC model relies on taking exposure to a portfolio of low risk (ie high grade) credits. The low risk means that the premium is also small, so to get the required return on capital the business must be leveraged. Traditionally, a CDPC has been allowed to leverage by writing considerably more credit protection than its capital base – much like a P&C insurance company is leveraged. The CDPC has relied on its rating, usually AAA, to give its counterparties comfort.

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Credit derivative counterparties have observed AIG and changed their requirements. Commercial banks, the main CPDC client base, now demand collateral from everyone. Overnight the CDPC business model ceased to work.

Demand for collateral has peaked at a time where the cost and availability of collateral has plummeted. Bank balance sheet pressures are partly to blame for the sharp reduction in available LOC capacity. However, the \$15bn of outstanding LOCs issued to AIG which, to put it politely, were on terms that reflected the AAA rating of the company, also has some bearing.

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Financial risk insurance

In the early days of the credit derivatives market there was doubt as to whether or not the product was insurance. The issue was finally settled with the standardisation of the documentation through the International Swaps and Derivatives Association (ISDA). The ISDA credit default swap documentation clearly allowed for buyers of default swap protection to profit from a default as the documentation provided a mechanism to settle the contract without the protection buyer having to own the risk. In the intricate world of financial regulation this makes the contract a derivative and not insurance.

However, given the nature of a credit derivative, it lends itself readily to being adapted to an insurance contract. All that is really required is for the buyer of protection to have an exposure to the credit and to be able to produce a proof of loss.

Derivative; insurance – what's in a name?

Apart for the regulatory issues, which are important, there should not be too much difference between running a CDPC as a derivative business or an insurance business. If counterparties want collateral from a CDPC then they will similarly want collateral from an insurance company. Let's face it; AIG's demise stemmed from the fact that it agreed to post collateral!

For real ratings

One of the issues faced by CDPCs is that no one believes ratings on structured vehicles or products. The CDPC achieves its AAA rating from a ratings driven risk, or capital, model. This model is approved and monitored by one, or more, or the ratings agencies. Given the lack of success that the ratings agencies had with a variety of AAA structured notes, the value of a model based rating has plummeted.

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Simply put, counterparties do not believe CDPC ratings any more.

In addition CDPCs who rely on rating agency approved models also tie their business to the rating agency. The agencies insist that the risks are input according to their own ratings. This means that the CDPC cannot accept a credit risk that is not rated by an agency.

Diversity

BRAVE Partners believes that business diversity is the key to building a credit risk business with solid ratings that counterparties believe in. There are two ways to achieve diversity: by yourself, or with a little help from your friends.

Diversity: With a little help from your friends

The Lloyds market has emerged from the debacle of the 1980s to become a strong, vibrant market. The attraction of Lloyds is the fact that it derives its rating from the central fund and the whole market. A syndicate therefore benefits from the overall market diversity to an extent. The downside of Lloyds for financial risks business is the fact that the market has had a few bad experiences in the business and the Franchise Board is therefore wary.

Self diversity

The major hurricane losses in 2004 and 2005 caused regulators and ratings agencies to increase the capital requirements for insurance businesses that concentrate on a small, or even a single, risk. The recent market volatility and the demise of most of the credit monoline insurance businesses has increased this pressure. A financial risks insurer that only underwrote financial guarantee business is therefore likely to have stringent capital requirements. BRAVE Partners recommends establishing a suite

of financial risks businesses which will provide diversification benefits. There are opportunities in trade credit, surety bonds and residual values.

Synergies

In addition to the capital benefits of diversification, there are also synergies between the different business lines. For example, the upfront premiums received in the residual value business can be used to collateralise 3 to 5 year financial guarantees in the comfort that there will be no claims payable on the residual value for 8 years.

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2010: Prediction 2

A vibrant, professional life reinsurance industry will emerge. This will be driven by accomplished asset managers who seek the access to funds and leverage that the business brings. However, the successful businesses will be led by the core of available underwriting and actuarial talent. These businesses will develop to be mainstream core franchises over the next five to ten years.

BRAVE Partners believes that dedicated life reinsurers will emerge in 2010. These businesses will develop to become a vibrant sector, similar to the P&C reinsurance sector.

2: Life reinsurance as a main stream business

If BRAVE Partners were to hold a general knowledge quiz at the Robin Hood bar in Bermuda, perhaps the epicentre of the reinsurance industry, then the partners would be surprised to see many correct answers to the question: “name a specialist life reinsurer”. There simply aren’t that many firms that are dedicated to life reinsurance. Swiss Re was one, but has backed off following its recent losses. There are some private equity backed specialists, such as Wilton Re and Aurigen. Scottish Re is infamous and no more. There is one large, international life reinsurance business. It is St Louis based Reinsurance Group of America – or RGA. RGA has been in the life reinsurance business since 1973. Its outstanding CEO, Greig Woodring, has been an employee since 1979.

Half life

All of the life reinsurers only really cover half of the business written by primary life businesses. Aspiring actuaries, and others with a keen eye, will know that most life insurance businesses are Life and Annuity companies. Life reinsurance, however, has very much concentrated on the mortality risk that arises from protection business (ie classic life insurance – a pay out if a person dies) and has not covered the longevity and investment risks that arise from annuities. For many years Swiss Re took the view that there was no offset of risk between the mortality and longevity in life insurance products.

The need for large scale reinsurance of annuities began to become apparent in the early Noughties when market conditions put considerable pressure on a type of pension saving business in the UK called “With Profits” business and UK pension funds began to experience significant problems with their funding levels. The mainstream solution in the UK was not to reinsure, but to buy out. Few annuity reinsurers existed at this time. The risk was often taken by businesses that are viewed as P&C carriers, who entered the annuity reinsurance business in increase assets under management and to diversify into more stable earnings. The opportunity drove a flurry of start up pension buy out insurers in the UK, but these have not proven successful. BRAVE Partners believes that the issues derive from the fact that the founders of these companies thought that the opportunity was so clear, insufficient thought was put into the structure and operations of these businesses.

That old nut: capital and EXPERTISE

In the current market, asset intensive life reinsurance (annuities) is potentially a highly attractive business. A good credit asset manager can leverage themselves to about 15:1 through a life reinsurance

The problem is that the attractive leverage is attained through taking on the annuity liabilities and: Credit Managers Can't Underwrite. Several life reinsurance businesses, Scottish Re for example, have demonstrated the danger of taking on life liabilities without a detailed underwriting by a knowledgeable underwriter.

business. In an environment where leverage of any description is practically unattainable this proposition becomes highly attractive.

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Talent contest

Whilst Britain's Got Talent, or the X-Factor, are unlikely to yield results, there are talented annuity reinsurance underwriters and underwriting teams. In fact BRAVE Partners is currently working with one such team.

2010: Prediction 3

A four way merger in the Bermuda market might seem impossible. There is a definite element of herding cats about achieving such a transaction. However, the software and IT services company EDS seems to believe that herding cats is possible (see <http://www.youtube.com/watch?v=Pk7yqITMvp8>). The need is at its greatest for a while and conditions are right for significant M&A activity. Major mergers would consolidate the industry into fewer, but globally competitive, businesses.

BRAVE Partners believes that in 2010 might just be the year of the four way merger of P&C companies in Bermuda.

3: Increased M&A activity in Bermuda

The rumour mill is working overtime on Bermuda M&A. (It is probably all the bored execs. sitting in the Robin Hood unable to name a pure play life reinsurer). The two deals from 2009 (Validus buying IPC Re and Partner Re buying Paris Re). The BRAVE partners have recently heard talk of a four way merger on The Island – and we don't mean large numbers of reinsurance executives merging with the Four Ways restaurant – that already happens.

Reminiscing is not what it used to be

Bermuda is a unique domicile. For the last 20 years, it has been the destination of choice for all entrepreneurs looking to set up an excess insurance or a reinsurance business. Glacier Re, sitting in Switzerland, looked very much the odd man out. Bermuda is full of start up insurance companies that have progressively grown and diversified their business. Ace and XL Capital are the founding fathers of the Bermuda market. Following them, the Bermuda companies tend to come in "classes". Each class follows a large industry loss and represents opportunistic capital seeking to profit from hard rates. For example, the Class of 2005 consists of Ariel, Lancashire, New Castle, Validus and Flagstone which were set up following the two major hurricane seasons in 2004 and 2005 which culminated with Katrina. The Class of 2002 consists of Arch, Endurance, AWAC, Goshawk Re, Axis and Montpellier; all established to benefit from hard rates post either 9/11 or Hurricane Andrew. Interestingly, the purest play on hard aviation rates was Glacier Re, the one that "got away" and established in Switzerland.

School's out

Over the years these waves or classes have capitalised on an immediate opportunity, but as the opportunity has waned and rates have softened the businesses have had to seek to diversify their earnings. The Bermuda market therefore consists of a number of mid-tier insurer / reinsurers that were established to capitalise on hard rates in the name type of business, property catastrophe, but now need to diversify out into fully fledged, multi product companies.

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companies. This diversification has become increasingly important. Rating agencies and regulators are placing increased emphasis on the importance of diversification following the exceptional hurricane activity in 2004 and 2005. The industry fared well enough through it, but enough companies went out of business and there was sufficient damage to make regulators and raters think. As the Classes of '02 and Class of '05 begin to graduate to become main stream reinsurance businesses, they need to diversify their business lines.

Top table

For years Ace and XL Capital were in their own league in the Bermuda hierarchy. The two companies had founded the market and grew and competed with each other. The other companies in the market were niche players – the new kids on the block.

In 2009 things changes. XL Capital had a near death experience. At points, its market capitalisation dipped below \$2bn. This; combined with the success of Class of '02 player Axis changes the Bermuda pecking order for good. Now a company did not have to be Ace or XL Capital to be at the Bermuda Top Table. In fact there was doubt as to whether XL would be around at all, let alone at the Top Table. It is a great credit to the new CEO, Mike McGavic that XL Capital is in business and at the Top Table in Bermuda.

However, Axis had emerged. There are now three global reinsurers, headquartered in Bermuda. When you consider that Axis began in a basement with a small black and white sign AXIS on a gatepost, that the wits of Bermuda used to graffiti to TAXIS on their way home from the Robin Hood, the company has come a long way.

Catalyst

In chemistry, a catalyst is a substance in the mix that remains unchanged itself, but that speeds up a reaction. Catalysts work by lowering the activation energy of a reaction. This allows less energy to be used, thus speeding up the reaction.

There are currently several catalysts for M&A activity in Bermuda.

Mr. Softy

BRAVE Partner, Richard Enos, wants to run a Mr. Whippy ice cream van in his spare time. "It is the only business where customers run after you waving money"; explains Richard. P&C insurance, and commercial lines in particular, is likely to be exactly the opposite in 2010. Insurance Insider, repeated on the BRAVE Partners website, is already reporting that: "Reinsurance brokers see disciplined softening at 1/1". Insurance are reinsurance rates are softening fast and this must be a major driver for consolidation. Markets are over capacity, so fewer players is a good thing and all businesses will be seeking lines where rates are holding up.

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Ego sum qui sum

The direct translation of the Latin ego sum qui sum is I am who I am. In Bermuda CEO circles it possibly refers more to egos. Bermuda is a special market. It has been the destination of choice for entrepreneurs looking to start an offshore insurance or reinsurance business for about two decades. These companies have been started by entrepreneurs who have identified and captured an opportunity. The senior managements are used to their way and do not want to relinquish control over their business.

The year 2010 sees many of the founders and CEOs of Bermuda companies heading for retirement. This means that there is a rare opportunity to combine entities without the usual clash of egos.

BRAVE Partners services

BRAVE Partners LLP is a niche consultancy advising on Risk – Strategy – M&A – Financing for the insurance and renewable energy sectors. The partners have a track record in closing innovative and difficult transactions for small and medium sized corporates and for providing funding for entrepreneurs.

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- BRAVE Partners is a niche consultancy specializing in Risk – Strategy – M&A – Financing for the insurance and energy sectors.

- Current projects include:

- Advising on the strategy to acquire and develop a life reinsurance business.
- Advising on developing capacity for a financial risks business.
- Advising on developing a new P&C insurance product.

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