

# Insurance: Insurance companies never die.

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Sections of Quinn Insurance are in administration and it has been ordered to cease writing business in the UK. Quinn is not yet bankrupt, but brokers are already warning commercial clients that claims might not get paid. BRAVE Partners examines what happens when insurance companies go under.

April 10, 2010

## Court sanctioned administration

On March 30, 2010 the Irish Financial Regulator was granted an application to have joint provisional administrators appointed to Quinn Healthcare and Quinn Direct. Separately, the Financial Services Authority (FSA) in the UK instructed Quinn to cease selling new policies in the UK. The FSA stated that this was to prevent the company from “suffering further financial losses from its currently unprofitable UK business”.

## Course of events

The regulator claimed that subsidiaries of Quinn Insurance had made guarantees on the Group’s assets that had reduced the total assets by €448m taking the business from a surplus of €200m to a deficit of liabilities to assets of over €200m.

## Dead or alive?

In a recent commentary, “[Schrödinger’s Company](#)”, BRAVE Partners suggested that it was not really possible to tell the state of AIG from the news flow. Insurance companies failures are generally of this ilk. Insurance is a different business to most. An insurance company is a large pile of assets which are there to fund the liabilities that it takes on.

## Insurance or investment?

A good, actuary friend of BRAVE Partners once described an insurance company as an investment company with a bad habit: underwriting. That is certainly not always the case – but in the event that an insurance company makes an underwriting loss then it is true – the investors would have been better off if the insurance company had just invested their money and not underwritten any policies.

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In many ways an insurance company can be looked upon as a leveraged investment fund. The surplus is the main fund which is then leveraged by “borrowing” from policyholders by charging them a premium that is “repaid” through claims.

### Alive

A clearly live insurance company is one where the value of the assets demonstrably exceeds the value of its liabilities. There are a few hurdles on the way now. There is an insurance company in the UK where the financial statements clearly show that the firm has £160m of assets and £190m of liabilities. Whilst this firm can no longer write business because it is clearly in breach of its regulatory solvency requirements, it does still protest to be solvent. The argument used is that the interest on the assets before they have to be used to pay the liabilities, will be sufficient to fill the gap. Whether or not this is true will only be discovered when either the assets are exhausted or the liabilities are exhausted.

### Dead

An ultimately dead insurance company is one that cannot meet its liabilities, but an insurance company can always meet its liabilities while it has cash and assets and then claim that its remaining assets are sufficient to pay the liabilities – as in the case of the insurer mentioned above.

### Regulators

An insurer technically goes bankrupt at the point at which its assets are insufficient to meet its liabilities. However there is a lot of subjectivity to this assessment. Firstly the liabilities have to be estimated, then the asset values are calculated. After that there is an argument to be had on the asset values. What matters? The market value of the assets today – even if they do not need to be liquidated until much later to meet the liabilities? Maybe not. However, if the market value of the asset has fallen does this imply a permanent impairment in that value – that is, can the full value of the asset ever be realised?

It is probably not possible to define an objective set of criteria that determine for sure that an insurer is bankrupt. Many are now looking to the regulators to provide that definition. The regulator’s main purpose is to protect policyholders and it has the right to step in should it believe that the company will not be able to fulfill its obligations to policyholders – ie it will run out of assets before extinguishing its liabilities. Certainly the International Swaps and Derivatives Association (ISDA) documentation that supports the credit default swap (CDS) market now defines regulatory intervention as a trigger event for a CDS.

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### Ensure the health of your insurer

Ensuring that an insurer is healthy is an onerous task. At a high level the task is straightforward – all you need to do is to determine that the firm’s assets exceed its liabilities. Anyone

who thinks that this is a straightforward task has clearly not read (or if they have read, then not understood) AIG's consolidated financial statements. This is a complex task. Valuing both the assets and the liabilities are fraught with problems.

### Asset valuation

The first issue to deal with is the value of the assets. Insurance accounting is moving from a world where assets were held at book value and impaired assets were ignored and hidden to a pure mark-to-market world. In the latter, the recent liquidity crisis almost forced a number of insurers to raise capital in highly distressed markets because a few small trades were occurring where distressed sellers were having to accept low prices for sound assets. What is the market price if you are not a seller? In short, the value of the assets on an insurer's balance sheet can vary widely depending on the accounting system and even the accountant.

### Liability valuation

Valuing the liabilities is tougher still. Some claims are known and clear. A simple car crash with no personal injuries, for example. However, when we crash our car few of us call the insurance company immediately. So even on motor (or auto if you are American) business there is a large component of what is called IBNR or incurred but not (yet) reported. The idea here is simple. If I crash my car then I will expect my insurance company to pay, so the insurance company has a loss – which means an additional liability. However that loss is not yet reported, so the insurance company does not yet know that it has a loss. In estimating the full liabilities of an insurance company, the IBNR needs to be included.

Naturally IBNR and even loss reserves are never perfect. I crash my car and call the insurance company. I will give a description of the accident, but that will never be quite perfect. The insurance company has to estimate the loss from my description – is it a little fender bender – or did I bounce off every 100,000+ car parked outside the Savoy? The claim sizes are very different.

Just to add to the complexity: folk law dictates that there will never be a motor claim of tens of millions of pounds. Reality is that there has already been a very large motor claim in the UK. On February 28, 2001 a sleeping driver crashed a Land Rover off the motorway onto a train track. The Land Rover was struck by an intercity train which was then deflected onto another track and into the path of a freight train travelling in the opposite direction. With an estimated combined closing speed of 142mph this is thought to be the highest speed train crash in the UK and ultimately it is a motor insurance claim. Therefore, it is not that safe just to assume that all motor business claims are small.

The final piece of the liability puzzle is loss development. Losses are estimated, but are those estimates good or bad – consistently high or

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consistently low? An important component of estimating the liabilities of an insurance company is in estimating how its current loss reserves will develop over time. This requires a good knowledge of both the underlying line of business and the underwriters and underwriting practices of the company.

So insurance companies never die they just become regulated.

### BRAVE Partners' services

The news on Quinn is a reminder that the large piles of assets on insurers' balance sheets can quickly get swamped by asset losses and by liability increases. Credit risk is an important, but tough issue for insurance. There is no clear boundary between a solvent and insolvent insurer – until ultimately it simply cannot pay a claim. It is unlikely that the regulators would ever let a company get into that situation, so regulatory action really is the insurance equivalent of bankruptcy.

BRAVE Partners can assist those with credit exposure to insurers understand and mitigate that risk. The exposure can arise both through debt or as a policyholder. The BRAVE partners have experience of this and have structured a deal for a primary insurer to protect against the credit exposure to its reinsurers (<http://www.bravepartners.com/RIR.php>).

### Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on [commentary@bravepartners.com](mailto:commentary@bravepartners.com)

If you would like to comment on the content of this piece, then please send an E-Mail to [discussions@bravepartners.com](mailto:discussions@bravepartners.com)

- The regulatory intervention on Quinn Insurance is a reminder of the credit risk inherent in insurance.
- Assessing and mitigating credit exposure to an insurer is a complex task
- BRAVE Partners LLP is highly skilled and experienced in assessing and mitigating insurer and reinsurer credit risk.

[enquiries@bravepartners.com](mailto:enquiries@bravepartners.com)

[www.bravepartners.com](http://www.bravepartners.com)