PLAYING HARD TO GET

WITH HUGE LOSSES AFTER 9/11, THE INSURANCE AND REINSURANCE INDUSTRIES MUST REVISE THEIR RISK MANAGEMENT STRATEGIES IF THEY ARE TO SURVIVE IN THE HARD MARKET. **DAVID MARTIN** OF AON PROVIDES SOME REASSURANCE.

The so-called hard market in insurance has returned with a vengeance. After almost 10 years of readily available cover and comparatively low premiums, rates rose rapidly in 2002 and are set to rise again in 2003. According to the respondents interviewed for Aon's European Risk Management Survey[1], property rates will rise by 64% in 2003, with another increase expected in 2004.

These increases in rates come about because of commercial insurers' requirements for more risk exposure information and more premium – and attributing these to the World Trade Center (WTC) disaster is just part of the answer.

INSURANCE INDUSTRY DYNAMICS. The main reason for recent premium rate increases has been the huge outflow of capital from the insurance industry. Insurance and reinsurance company balance sheets have lost about $200bn worldwide over the past three years, according to Standard & Poor's. This outflow of capital has been caused by a combination of incurred losses (both catastrophe losses and the ever-growing frequency and severity of larger everyday losses). Over the last 18 months, there has also been a need to continually increase claims reserves for losses from the past, such as asbestos, as well as huge write-downs on insurers' investment portfolios.

Following the WTC disaster and the general increase in premium rates some new capital has come into the industry, around $30bn – leaving a shortfall of about $170bn. Despite the premium rate increases imposed to date, most insurers and reinsurers are still posting financial results that are not acceptable to their shareholders. Additionally, they need to rebuild their balance sheet capital position and resist the downward pressure on their credit ratings.

Current estimates of the total insured cost of the WTC disaster appear to have stabilised at around $40bn so this is only a minor part of the $200bn lost to the industry. However, one way in which 11 September has had a direct impact on underwriting practices has been the request coming from reinsurers to their insurers, and therefore from insurers to their commercial lines policyholders, for much more risk information on exposures.

The nature of the WTC loss alerted the insurance industry to the potential concentrations of risks and losses, both within a class of business, such as property, and business interruption with the many separately insured tenants of the WTC complex.

The industry also became aware of accumulations of risk across different classes of business, with the WTC event leading to major losses on property, liability, workers' compensation, life and many other classes.

Providing all this extra risk information requires a much greater investment in time and resources by policyholders and their insurance brokers, but this is necessary to get the appropriate attention from underwriters and obtain the best terms and conditions available.

FINANCING A HARD MARKET. The other impact on companies of these hard market conditions is a general increase in premiums across most lines of business, tougher terms and conditions, and less readily available cover. In particular, in the UK employer's liability and directors' and officers' liability market, the ability to find cover has become critical.

To date, it is mostly the smaller companies in higher risk industries that have been hit the worst. In Aon's experience, none of its clients have yet been unable to secure employer's liability (EL) coverage, although some have faced severe increases in premium.

This position is likely to worsen over the next few months as insurers' reduced capacity to write risk because of the drain on their balance sheets starts to hit some larger accounts. Aon is confident that its clients will continue to be able to obtain EL cover, but increases in deductibles may either be imposed or selected in order to mitigate the overall premium cost of obtaining cover in the current challenging market conditions.

In the long term, there may be a need for radical reform of workplace compensation. The Association of British Insurers (ABI) and the British Insurance Brokers Association (BIBA) are pushing hard for this to happen. It is argued that the current system cannot be maintained, while insurers have little prospect of making a reasonable profit on writing EL risks.

ASSESSING THE RISKS.

Formulate a strategic approach to risk management. Rather than take purely tactical decisions on insurance provision, as advisers, we recommend that clients adopt a strategic approach to risk management. No insurer or broker can promise that insurance premiums will return in the foreseeable future to the relatively low prices of three to four years ago. For this to happen, there would need to be an immediate downturn in the frequency and severity of all types of insurance claims, no further deterioration in the long-term liability claims and at least a 50% rise in the stock market.

Evaluate and manage risk on a company-wide basis. Sometimes this is referred to as holistic or enterprise-wide risk management. Historically, risks within companies have been dealt with in separate silos. Therefore, some risks are dealt with by the Health and Safety department, while other property and liability risks are transferred through the mechanism of insurance. In more recent times, instruments such as futures and derivatives have been developed to transfer financial exposures.

A strategic risk management approach requires a more top-down identification and treatment of the risks that face a company. This process should include the evaluation of the frequency, severity and, most importantly, impact of the risks upon the company's performance and maybe ultimate survival. Such an analysis may identify one or more 'killer risks' that threaten the continuing viability of the company.

In a recent study by CFO International[2], respondents said they were motivated to implement a strategic risk programme by the following factors:

- an improved response to the full range of risks (38%);
- better capital allocation (28%);
- competitive advantage (27%);
- reduced earnings volatility (27%); and
- lower cost of risk transfer (18%).

Allocate resources effectively. An enterprise-wide evaluation of risks allows companies to devote scarce resources to managing these risks with the most serious potential impact. Resources can then be allocated in the most cost-effective manner, whether through improving internal business processes, expenditure on risk control mechanisms, or purchase of insurance or other financial instruments.

Make risk a board-level issue. Naturally, such a strategic approach to risk management raises the whole issue of risk management to a board level issue.

Too many companies still see risk management as a function of their compliance obligations, and only carry out risk audits in those areas in which audits are required, such as Health and Safety, Property Damage, or Disaster Recovery. But new risks, such as Business Interruption and Reputation Risk, are now climbing up the agenda.

Evaluating risks across your business will also give you an idea of where your insurance money will be best spent – as well as highlighting areas of opportunity for your business. Aon's European Risk Management Survey has revealed that, while risk managers saw reputation risks as the second biggest threat to their businesses, they also recognised that reputation risks present the greatest opportunity for them if they are properly managed.

Take the wider view to cut costs. If a company takes an enterprise-wide review of risk management, they will find it more cost-effective. Especially in the current insurance market conditions, they will be able to retain more risk within the business and finance that risk themselves. This opens two further options, either of formalising the internal risk financing through an in-house vehicle such as a protected cell captive or captive insurance company, or outsourcing the administration of claims management or pensions and benefits.

Given that the hard market will continue for the foreseeable future, we are advising clients to adopt an ongoing commitment to risk management as a means of controlling costs in the medium term, and – more importantly – anticipating the threats faced by their businesses now and in the future.

David Martin is Chairman of Aon's Corporate Division.
www.aon.com

Notes

[1] *The Aon European Risk Management Survey was undertaken among more than 100 leading European companies from a wide range of sectors, based in 13 European countries including the UK.*
For further information or a copy of this survey, contact James Wood on 0207 216 3205, or email james.wood@aon.co.uk

[2] Strategic Risk Management: New Disciplines, New Opportunities *CFO Research Services, March 2002, sponsored by Aon.*