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“The Credit Crisis, which began in 2007, is the worst financial crisis since the Wall Street Crash of 1929.”

DAVID SANDHAM, EDITOR
GLOBAL REINSURANCE

EDITOR'S NOTE

Financial and other storms

I AM VERY PROUD TO BECOME EDITOR of this magazine, especially after such an excellent predecessor. We wish a fond farewell to Helen Yates, who was with the magazine for three years, two of which were as Editor. A month after she was into the job, Helen was in Monte Carlo shortly after Katrina struck the United States. Katrina was later estimated to have caused \$81bn in damage, making it the most costly hurricane in U.S. history. Overnight, it changed the industry that Helen had only just started reporting on. But that baptism of fire was perhaps why Helen became so fascinated by reinsurance. I am very pleased to say she remains in close contact with the magazine, and I think you will enjoy her article on Surviving Monte Carlo on page 14.

Time will tell whether the present hurricane season holds any similar surprises in store for us during this year's Monte Carlo Rendez-Vous. But over recent months, the financial community has been struck by a storm of a different kind, though just as difficult to predict: the hurricane force volatility of the capital markets, and the rotting flood of bad credit.

If Katrina was the worst that Mother Nature could throw at the U.S., then the Credit Crisis is the worst financial crisis since the Wall Street Crash of 1929.

The Credit Crisis began with the bursting of the U.S. housing bubble in 2007. Arguably, that bubble was itself in part the consequence of a preceding bubble: too much cheap cash was available to be thrown at the housing market because, at the time of the bursting of the technology bubble in 2000, interest rates were cut in order to stave off recession. Bubble begets bubble.

The Credit Crisis is often called the Subprime Crisis, referring to the subprime mortgages that were so vigorously sold to those who had so little ability to repay. But it would be a mistake to think of the problem as limited to housing debt alone. It is also a crisis in securitisation, in which the bad loans were repackaged, and then repackaged again. Securitisation, and the flourishing of synthetic securities, spread the problems far and wide. The market in credit default swaps, a form of debt insurance, has ballooned to \$62 trillion, a staggering figure equivalent to double the size of

the total capitalisation of all the companies listed on the world's largest stock exchange (NYSE Euronext); or, to put it another way, equivalent to 15 times the world's total annual insurance premium income.

The Credit Crisis is hitting banks more than insurance companies, but the latter are not immune. Over the past three quarters, AIG has lost \$25bn on credit default swaps. Swiss Re, which last year lost \$1bn on two credit default swaps, has \$10bn direct debt exposure to troubled U.S. mortgage lenders Freddie Mac and Fannie Mae. XL Capital had to pay almost \$2bn cash, plus shares, to disentangle itself from bond insurer SCA, which had eight credit default swap agreements with Merrill Lynch. Allianz is hemorrhaging cash to its Dresdner Bank unit, which no doubt it would dearly love to sell. Bear Stearns was, last March, sold for a song to JP Morgan, but who knows what would have happened had it been allowed to default.

Many who have lost money in the Credit Crisis are looking for someone to blame. If just a few of those hundreds of legal suits succeed, the insured losses could be considerable. Gavin Coull, partner at law firm Steptoe & Johnson in London, recently told me: “It would be naïve in the extreme to ignore the fact that, with the U.S. litigation kraaken already awakened, a tidalwave of claims (but will these translate as losses?) will wash through the insurance and reinsurance D&O and E&O markets.”

Thomas Hess, Swiss Re's chief economist, told me that he estimates D&O and E&O credit crunch related losses, “at between \$3bn to \$9bn, roughly equivalent to a medium size natural catastrophe in the U.S.”

Not all storms can be blamed on Mother Nature.

David Sandham, Editor



GLOBAL REINSURANCE MAGAZINE
30 Cannon Street, London,
EC4M 6YJ, UK
Tel: +44 (0)20 7618 3456
Fax: +44 (0)20 7618 3420
www.globalreinsurance.com

Editor: David Sandham
Tel: +44 (0)20 7618 3480
E-mail: david.sandham@globalreinsurance.com

Deputy Editor: David Banks
Tel: +44 (0)20 7618 3454
E-mail: david.banks@globalreinsurance.com

Art Director: Paul Whitby
Design: Richard Graville & Paul Whitby
Cover illustration: Laura Eyres

Publisher: William Sanders
Tel: +44 (0)20 7618 3452
E-mail: william.sanders@ngsm.com

Associate Publisher: Rajesh Sidhu
Tel: +44 (0)20 7618 3423
E-mail: rajesh.sidhu@globalreinsurance.com

Account Manager: Donna Penfold
Tel: +44 (0)20 7618 3426
Email: donna.penfold@globalreinsurance.com

Managing Director: Tim Whitehouse

Digital Content Manager: Michael Sharp

Head of Research: Peter Joy

Group Production Manager: Tricia McBride
Senior Production Controller: Gareth Kime
Head of Events: Debbie Kidman
Marketing Director: Tracey Syrett

For all subscription enquiries please contact:
WDIS Ltd
Tel: +44 (0)20 8606 7506
Fax: +44 (0)20 8606 7441
E-mail: newsquestsubs@wdis.co.uk



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A RETURN TO THE THREE 'R'S

While some companies “limbo dance” their way to lower rates, others are increasingly concerned with a traditional sense of discipline, as **Gavin Coull** explains.

LIKE A VICTORIAN EDUCATIONALIST, talk in the coffee shops around Lloyd's is concerned with what to do about the “three Rs”, save that the “Rs” in question are Rates, Rating and Results. There is a sense that, as with the urchins of old, a return to strict discipline and methodology are required in order to lift the soul to visions of a brighter future. Without a doubt, rates are and remain low, with a sense that without a major catalyst the market is not going to change direction for some time. Conversely, certain market players seem intent on limbo dancing their rates ever lower, in a bid to not only undercut rivals, but to do so by offering discounted rates even on marginal at best business; witness the horror story of one July renewal where despite offering a rate cut of 10% to retain the client, one underwriter found himself outbid by a new player who offered a reduction of nearly 80% of expiring. Against the backdrop of ever closer rating scrutiny, where rating agencies themselves are being placed under the microscope after seemingly misreading (or were they misled?) the run-up to the credit crunch, strong and provable financials and business practices demonstrating a long-term stability and viability are in

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GAVIN COULL



demand, rather than short-term raiding parties for new business at unfeasibly uneconomic rates. With little to differentiate many of the deals on offer in a climate of scepticism towards financial markets, strong and consistent ratings may well become one of the key differentiators moving forward. The coalescence of credit crunch in the financial markets with the reduced premium base leads one naturally to the third R, Results. Recent weeks have seen a string of Q2 results showing up to 50% decline, compared to like-for-like Q2 2007 results, across a range of major international players. The pressure to perform for investors and capital providers may lead the unwary (as with Mr 80% above) to move into the game of trying something new or “innovative”, or to underwrite classes without real experience, and then cross every finger and toe that premium volume will justify the approach. History will of course show whether this leads to a bright future, or whether our Victorian forebears, with their focus on discipline, were correct.

Gavin Coull is partner in the insurance/reinsurance practice of law firm Steptoe and Johnson.