What Does The New Era of Liability Mean for the Regulator?

Russell

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The insurance regulator has a difficult job. Regulate too hard and they stand accused of stifling innovation and entrepreneurialism. Adopt too light touch an approach and they become a lightning rod for criticism when markets go bust. Who would want to be a regulator!

The regulator's dilemma was encapsulated by two CEO panellists at a recent insurance conference where one of the speakers observed that the PRA has nothing in its brief about growing and developing the insurance market as a way of closing the insurance protection gap. He was quick to receive pushback from another panellist for holding this view, however, who explained that solid regulatory structures make the market feel safe and more secure.

The senior executive from one of the world's largest brokers explained that regulation does not protect insurers from change but it does concentrate the mind on risk. For example, Solvency II has been one of the most productive calls to arms for the life insurance industry.

Source: cpajournal.com

Solvency II

Solvency II, of course, has also played a key role in its expectations of general insurance firms regulated by the PRA, in relation to significant general insurance loss events which might affect firms' solvency and future business plans. Russell Group has written extensively about Solvency II in previous white papers, which could also be considered an early call to arms for much of our thinking on connected risk. We have developed our thinking since then to argue that risk mitigation, as currently practised by firms operating in the global specialty insurance and reinsurance markets, lacks sophistication and fails to address the issue of how businesses might plan for and respond to a so-called "market turning event (MTE)."

In September 2016 paper, Dealing with a Market Turning Event the PRA wrote: "Solvency II Directive Article 138 and 139 sets out requirements for firms that breach or expect to breach their solvency capital requirement (SCR) or minimum capital requirement (MCR) within three months. In an MTE...firms may find themselves under stressed conditions and facing these situations."

As Russell Group has noted in a previous November 2016 white paper, it is our view that the interconnected world is creating a new era of liability. Meanwhile, previous events that affected the class such as the asbestos crisis, which nearly brought down Lloyd's of London, are moving out of the collective memory. Russell Group was instrumental at the time in helping the newly formed reinsurance giant Equitas to model its exposures but the experience provided us with an early lesson: the potential for systemic casualty class losses can unravel even the biggest and greatest names in the global reinsurance space.

Since then, the Russell Group interpretation of regulatory reports focusing on casualty underwriters and senior management is that they are not doing enough to address the complexity and dangers embedded within the class. This is an issue beyond Lloyd's, which has issued warnings from its Performance Director John Hancock, and addresses a more market wide level of risk. These concerns have been magnified by new risks that cut across traditional specialty classes, in what Russell terms our new era of liability, which is a topic we re-address in this white paper.

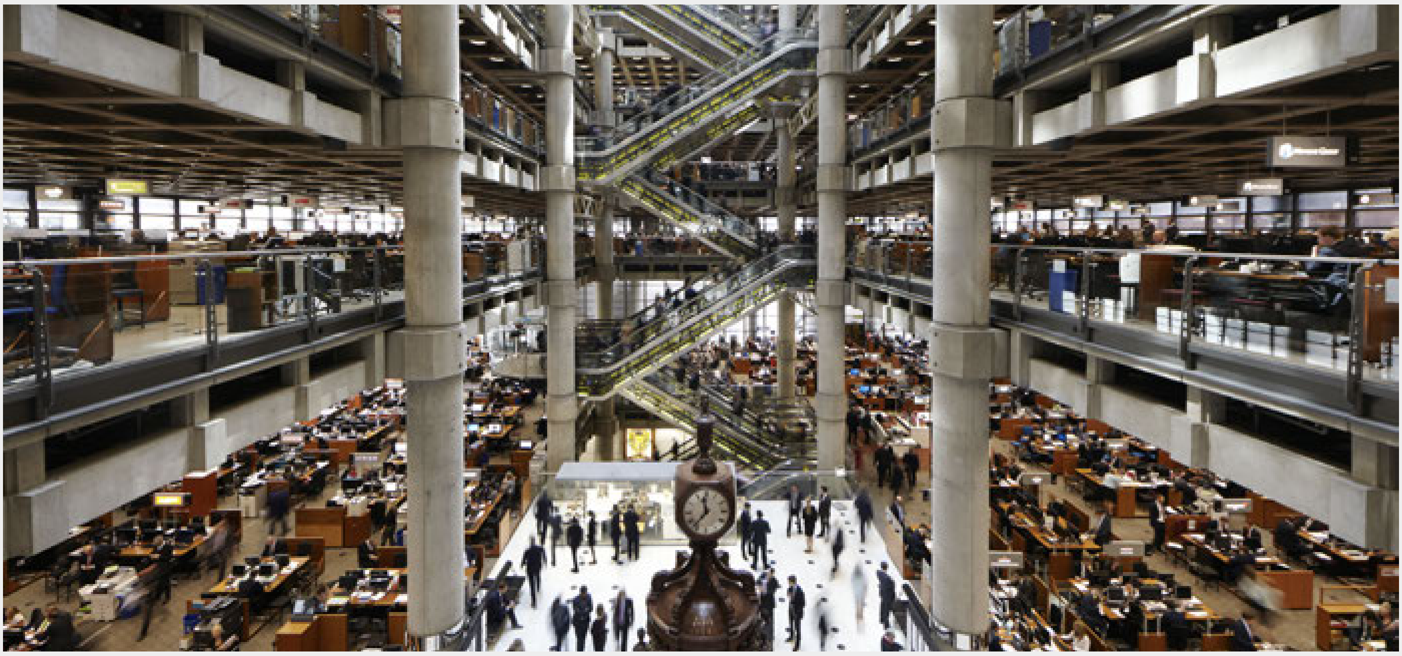
Lack of Underwriting Discipline

Lloyd's achieved 14% growth in a softening market, which is remarkable in its own way, but it came at the price of a lack of underwriting discipline. There has been no real underwriting profit since 2012 when you strip out natural catastrophe losses. Reinsurance pricing is flat while insurance rates are up 4%. Lloyd's is worse than its peers in this regard says the new Lloyd's CEO so the market needs a clear game plan. 87% of Lloyd's profits, for example, are eroded by a small number of poorly performing Syndicates.

What is unusual about the present soft reinsurance market cycle is that last year (2018) was the fourth most expensive on record for the insurance industry, according to estimates from Swiss Re. According to the reinsurance behemoth, wildfires in California and storms in Asia and the eastern US resulted in $79bn of claims pay-outs.

Meanwhile, according to the FT, rates more broadly have not been helped by the continuing availability of so-called alternative capital. The growth of this capital, which comes from institutional investors backing insurance risks via instruments such as catastrophe bonds, has been depressing reinsurance prices for nearly a decade.

As the FT report says: "Another problem facing alternative capital is so-called trapped collateral. Money put into funds or instruments that might face claims cannot be withdrawn until the claims have been paid. That can take years. In the meantime the investors have to decide whether to put in fresh



Source: Lloyd's of London

money to back new risks, or to wait on the sidelines until their existing collateral has been released."

Poor Performance

Against this background of poor performance, what is the regulator – in this case, the UK's PRA – focusing on?

Last year, Anna Sweeney, Director of Insurance Supervision at the PRA wrote a letter to insurance CEOs to explain that conditions in the general insurance market, particularly for specialty risks underwritten within the London Market, remain challenging.

She wrote: "There are signs that some of the longer-term prudential risks associated with a soft market, about which the PRA has been warning for a number of years, are now feeding through more demonstrably into firms' reported results. We believe boards of many firms may now benefit from reassessing whether their business models remain sustainable absent further action, and whether controls over underwriting and reserving in specialist lines are adequate in the light of some of the issues we highlight in this letter."

Market Trends

"Over the last year, the PRA has prioritised in-depth review work with relevant insurers to assess the adequacy of firms' oversight of underwriting and associated risks given these market trends. This work has included reviews of underwriting controls, exposure management, reserving, and trends in distribution such as the growth in delegated underwriting arrangements and specifically broker facilities."

Is it the case that a few firms are reporting underwriting performance consistently below the levels required to achieve sustained profitability? Despite the fact that many insurance firms are taking action to improve their performance, however, the jury is out on whether this will be enough to ensure the future profitability of the market as a whole.

Insurers tend to be natural optimists but to paraphrase a former Head of the U.S. Federal reserve, some carriers have been exhibiting signs of "irrational exuberance".

Sweeney then goes on to say: "As well as over-optimism in business planning, some firms appear optimistic in the level of assumed future profitability used when calculating their regulatory solvency position. If so, these firms may be understating the actual capital needed to support business being written. We expect firms to pay close attention to whether business plan assumptions used in regulatory solvency may be optimistic, for example when setting premium provisions and internal model assumptions, and to be prepared to justify their position."

Exposure Management Deficiencies

As numerous Russell Group reports and insight have outlined, there has been a growing trend for insurers to diversify from traditional underwriting expertise into new lines of business (for example, casualty classes). We have coined the phrase that we are operating in a new era of liability. When it comes to relatively new lines of business such as cyber there is a worry that such exposures are not subject to the right levels of underwriting expertise or oversight.

There are deficiencies in exposure management approaches. Some insurers could not produce quick high-level aggregate exposure estimates followings the 2017 hurricane season, even for important geographical areas. Meanwhile, as the PRA reports: "Other firms appeared to have risk appetites that were set too high to influence exposure management with no clear linkage to underlying underwriting limits. Firms would benefit from considering scenarios in which the 2017 catastrophe losses were even more severe than occurred, to identify opportunities to strengthen their underwriting controls and risk management.

"Given these issues, we have also looked at how recent underwriting experience has informed the assumptions driving firms' reserving best estimates and, in turn, the level at which reserves are booked. Reserving data highlight that reserve releases have been flattening out and we have seen instances where firms' reserves have required significant strengthening. There is also some emerging evidence to suggest potential weakening of case reserves, particularly on casualty lines, which could point to potential future reserve deterioration."

Trends?

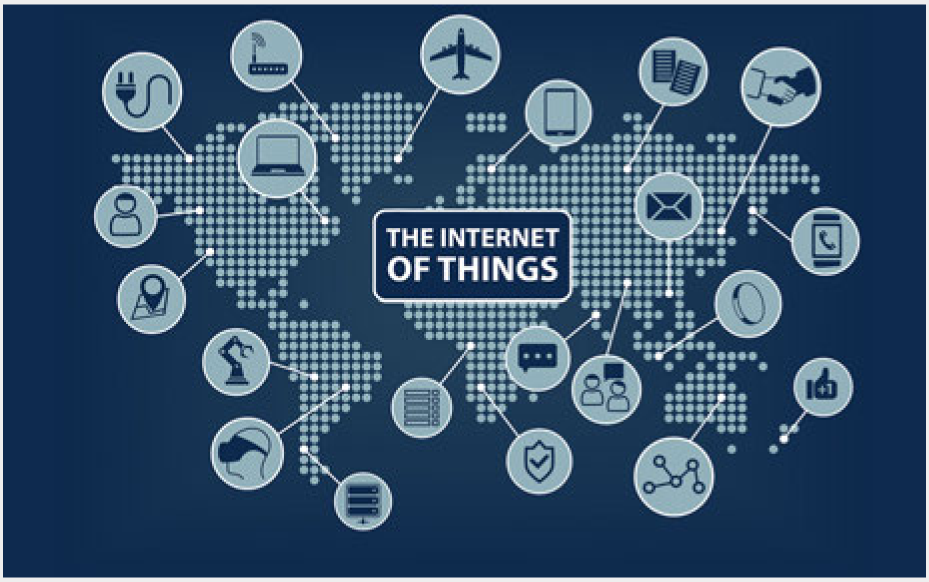
Consolidation, diversification of distribution and portfolio management will inform much of insurers' discussions in 2019.

Source: BankBazaar.sg

Insurers need to change their value proposition. So we need to provide more services to customers to reduce their risk. The insurance market and its clients require predictability in a world undergoing transformation.

One of the key Solvency II principles is that insurers' internal capital models must be embedded at the heart of risk and capital evaluation and they must be used as a key input to a wide range of business and strategic decisions. It is a challenge though to identify the capabilities insurers will need to support model uses that go beyond solvency calculations.

Lloyd's syndicates write different classes across different business lines, so it can be difficult to compare these on a like-for-like basis. The reason being that expenses and capital loadings can vary significantly between classes. But: "By setting a target return on capital, a consistent measure can be used across all classes to compare performance, taking into account the differences between classes. For example, a class like Political Risks is likely to have a lower target loss ratio than Motor, but without a return on capital approach it will be difficult to estimate what loss ratios are reasonable due to the significantly different expenses and capital charges for each."



Source: IT Pro

Global Interdependencies

There is an increasing awareness that global interdependencies fostered by corporate connectivity, the Internet of Things (IoT) and Industry 4.0 are moving re/insurance companies and the corporate clients into a new era of liability. What are corporates and their re/insurance counterparties' true underlying exposures and what solutions can be brought to bear on the issue of multi-class liability events?

For many years, the global re/insurance P/C market has been fixated with geo coding and a property-led debate. That is understandable to an extent because property is and will continue to be a valuable asset. Russell Group is convinced, however, that we are in a new era of liability, in which property damage will be a secondary consideration.

In this new corporate environment, emerging technology is causing a change in consumer engagement, while companies are revising their strategies to stay relevant to a younger internet-savvy consumer base. The on-demand economy and peer-to-peer market is young, but it is expanding fast. The likes of Uber and Deliveroo are breaking the mould of traditional bricks and mortar stores and look set to test the limits of liability exposures.

This new environment poses new risks. Uber offered up a test case a few years ago of the new era of liability that highlights insurance grey areas. Uber, for example, offers drivers insurance, but some uncertainty surrounds drivers' "contractor" status, and when this coverage is in effect.

According to reports, an example of the issues that can arise occurred when a San Francisco Uber driver killed a six-year-old girl because he was distracted while logging into his Uber app. Uber said that as there was no passenger in the vehicle, the car driver was not employed by Uber at the time, which meant that the company was not liable. Such cases are bound to rise significantly.

In this new era of liability therefore what are the big super events that people are most worried about? In Offshore Energy, we witnessed an event with no property damage, just a malfunctioning unit that resulted in a Business Interruption claim. Meanwhile, safety concerns resulted in the abandonment of the newly constructed Yme oil platform in the North Sea, which led to a reported claim against insurers of $1.3bn. What other casualty case studies are out there, which illustrate a growing trend of the flight to liability?

Houston Case Study

The cost of Hurricane Harvey had it hit the Houston shipping canal would have been devastating. Not just in terms of the property loss but the potential casualty exposure. This is because the 52-mile channel links up 130 of the USA's major refining and petrochemical companies (including ExxonMobil, Chevron and Shell) to the Gulf of Mexico and acts as a conduit for key products, such as plastics and pesticides to other areas across the USA.

What is less understood is the connected risk that links together the local geographies and industries in the region with insurers covering other specialty insurance classes such as marine, energy, and credit and telecommunications classes of business. The hurricane landed at the heart of oil and gas country and impacted production as many employees were evacuated and refineries closed. Many refineries escaped serious physical damage from storm winds but the real concern was that many facilities had never seen floodwaters this severe. The potential Business Interruption loss was vast. Meanwhile, Houston's supply chain risk is clearly of paramount concern in today's global world of "just in time" techniques.

Boeing Case Study

Supply Chains in today's aviation industry must also be more resilient to changes in demand or risk being

Source: Insurance Journal

Source: Nikkei Asian Review

"overtaken" by events such as the production crisis at Boeing and Airbus. Both manufacturers driven by a "vicious spiral" of rising demand, ramped up their production targets, without considering the impact on their aviation supply chains.

The Lion Air Flight 610 crash towards the end of 2018, was unusual for it involved a Boeing 737 Max 8 that had only just recently entered service. The aircraft had only 800 hours of recorded flight history before taking off on the 29th October.

Similarly, another crash in 2019 involving Ethiopian Airlines, led to all of Boeing's global fleet of the 737 Max 8 being grounded, pending further investigation. Both the Boeing 737 Max 8 and the Airbus A350 were heavily reliant on engines produced by CFM International, a joint venture between General Electric and Safran Aircraft Engines. Heavy delays in the delivery of parts, last summer, led to both Boeing and Airbus falling behind in production.

In the case of the Boeing 737 Max 8, the new Leap 1-B engine, produced by CFM International, led to Boeing introducing the controversial Manoeuvring Characteristics Augmentation System (MACS). The same system which is now under investigation.

Johnson and Johnson Case Study

Johnson & Johnson's most famous product is baby powder. The product is a bestseller that contains 99.85% talc, a mineral that sparked a flurry of claims that not only threatens Johnson & Johnson's reputation as a leading consumer organisation but also the many U.S. insurers that underwrite the company. Talc is mined near asbestos, a well-known cancer-causing agent. Asbestos is the many-headed hydra that nearly brought the Lloyd's market to its knees in the early 90's and threatens to do so once again. It is this link between Talc and cancer that led to Johnson & Johnson being ordered to pay $550 million in compensation along with $4.1 billion in 'punitive damages' in July 2018 - the sixth largest product defect award in US corporate history. From an insurance perspective, the most pressing issue is the loss of control of liability as risk moves throughout the insurance value chain. The knock-on effect of this case is quite significant for U.S. based insurers. According to Reuters, analysts in the U.S. cite litigation as the largest financial risk for Travelers, Chubb, Hartford Financial Services and W.R. Berkeley, the U.S. based insurers insuring the company.

Hyper Connectivity

We are entering an era of hyper connectivity with new rules, opportunities and risks for (re) insurers and corporate risk managers. As Russell Group has mentioned in previous papers, the connected cyber risk is also a mounting concern and one that is being fuelled by today's increased geo-political tensions that some reports attribute to state sponsored cyber hacks. The risk affects everyone in the insurance value chain – major corporates, their insurers and their reinsurers. We are witnessing the growth of systemic or network risk, which has been created because of vulnerabilities in the underlying connectivity between business. This is what we have been calling connected risk, and which has the exposure potential to be far greater than its predecessor the LMX spiral which the insurance market and Russell Group experienced in the 90's

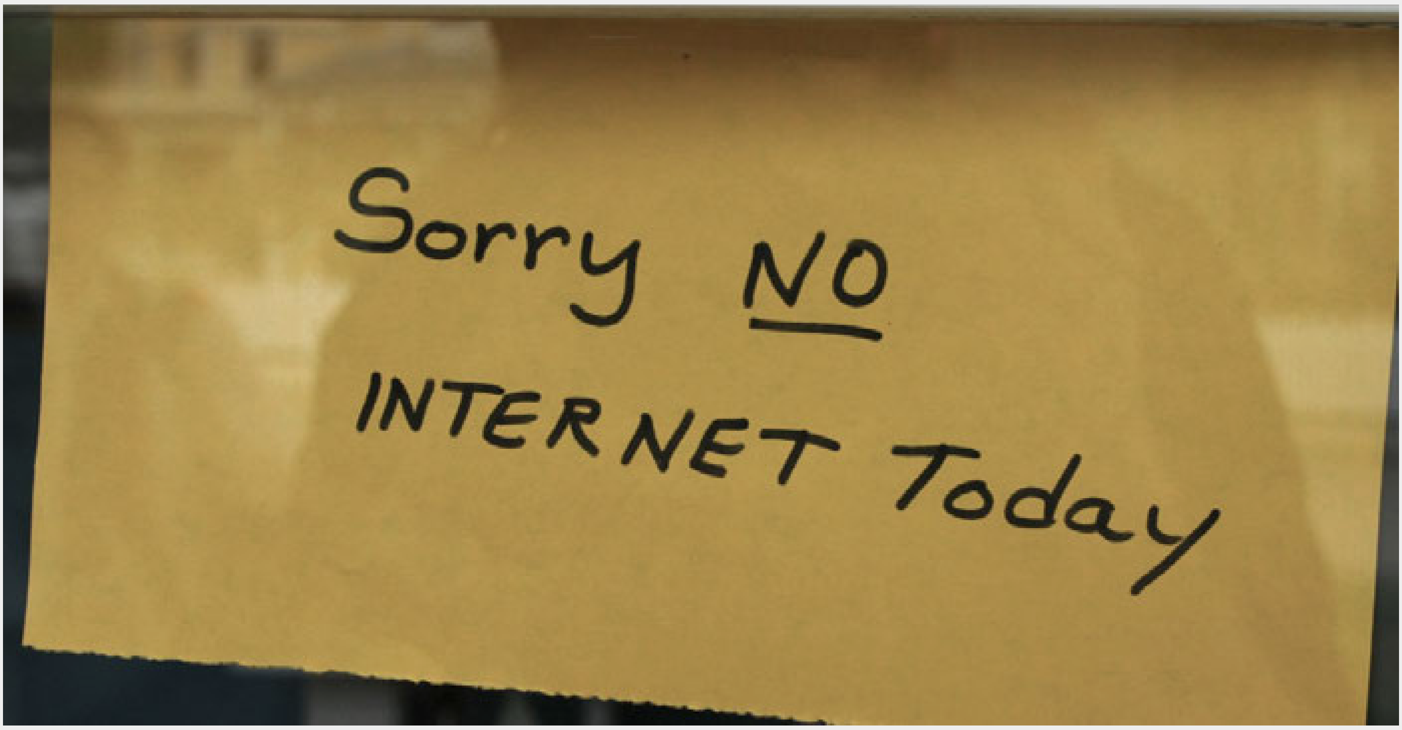
According to Adriano Bastiani, Head of Casualty Fac at Munich Re: "I have been asked before is cyber cat the new NatCat? Well the answer is yes and no. One of the hottest topics in cyber at the moment is failure of external networks, which is not covered in treaties - for good reasons. This would be the worst-case scenario for the market. Just imagine the Internet being out of service for 12 hours due to a cyber-attack. For the Internet, you have a number of US, European and Asian nodes. If you can hack one of these nodes you can probably turn off the Internet worldwide. This would be a cat scenario but you can't insure it because you cannot limit it to a certain amount. Every policy would be concerned."

Connected Liabilities

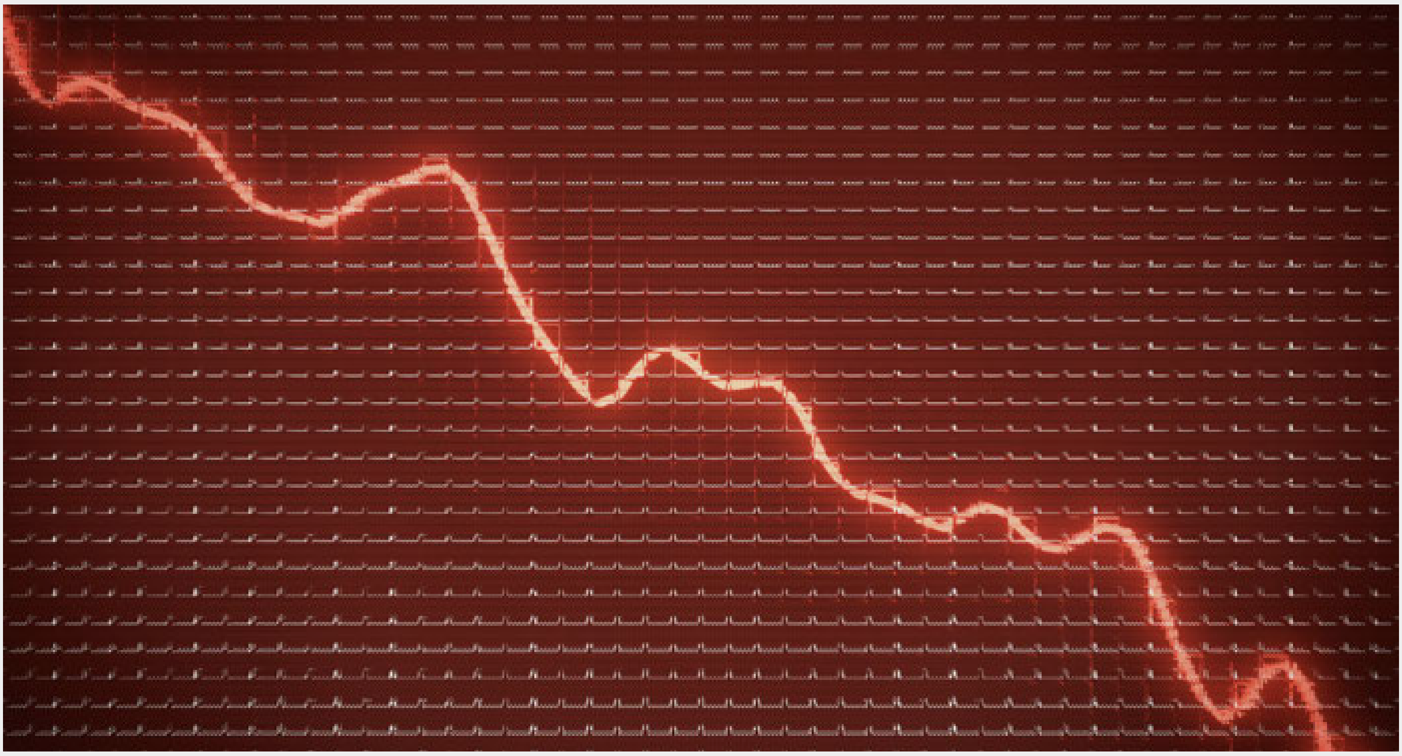
"The same applies to power grids. If you have a power outage in Germany there is a big likelihood this will extend across Europe but the footprint of such an event cannot be defined. For NatCat scenarios, however, we have a footprint for how such events emerge; it is not always the same but it always follows a certain pattern that you can model. If you have Internet outage it is not limited to a footprint – all potential policies are in place."

Connected liabilities from the same event are rising in today's new era of liability, whilst liabilities that are currently uninsured are also on the rise. Corporate risk managers are complaining that their insurers don't offer products that address their growing liability need. Meanwhile the insurance carriers are saying we can offer these products but the risk managers are not outlining the requirement.

There is disconnect, which needs to be addressed and which means there is a role to play connecting insurers with their clients as well as understanding the regulatory requirements. It is also evident that the re/insurance market needs to change to address disconnect between insurers and reinsurers and even disconnects within single insurance entities that have a global footprint.



Source: Auvik


Source: Gray Reed & McGraw

Distressing News

Market consolation against the backdrop of today soft market and low interest rate environment is another potential casualty risk. According to Clyde & Co. – Insurance Growth Report 2019 - distress is driving disposals. Following years of pricing pressure some insurers are running out of road. Companies at the fringes of the market will be looking at their long-term solvency and although some are releasing reserves, this option has pretty much run its course.

Clyde & Co. says: "We expect to see distressed businesses put up for sale. The Lloyd's market could provide rich pickings – with around 20 syndicates exiting different classes there is a substantial quantity of discontinued business which will either be closed naturally or sold to another syndicate, presenting the potential for billions of dollars' worth of legacy deals."

M&A activity and restructuring is another form of distraction from the main question of profitability. Just like in the late 1980s and early 1990s when the distraction was very high interest rates, the end result was the start of the Casualty disaster that ended up contributing to Reconstruction and Renewal and the formation of Equitas.

The PRA states in its Letter to CEOs: "In some cases, firms involved in corporate restructuring activity in recent years appear to have suffered losses, which may be traced in part to insufficient oversight during the period of transition. Examples include gaps in oversight caused by changes in underwriting management or broader management responsibilities, delays in being able to produce consistent financial information across a wider set of activities, and overall senior management distraction during such a period."

Robust Risk Management Framework

Modern liability insurance is expanding at a rapid pace. The risks and range of related liability products and requirement are also evolving at remarkable speed. Through the process of developing white papers on this topic, we believe that the key to addressing such a fast-moving risk is constant collaboration among key re/insurer stakeholders and their direct corporate clients. We need to build a more robust risk management framework that can be extended to insurance underwriting for new forms of liability risk. In this report, we've been able to identify several scenarios of organizations that might be impacted in our new era of liability.

With these insights, we believe that a marriage of C-suite sponsored investment in new forms of liability modelling and data-led bottom up underwriting inputs can benefit companies and help them identify vulnerabilities in their organization whether that is a FTSE 350 corporate or its re/insurance partners.

Source: Bloomberg

In addition, as best practices become shared and companies become more familiar with the risk modelling process, we would hope that greater preparedness would lead to more favourable insurance pricing, better control of peak accumulations and re/insurance aggregate management.

Conclusion

To summarise this report, Russell Group believes that regulators are becoming wise to fundamental flaws in the way that some insurers conduct their business. There will always be a tension between the ability of underwriters to underwrite with flair and flexibility and the regulator's remit, which is oversee a stable and sustainable insurance market. There is an enormous opportunity, however, for forward thinking carriers to make use of the latest risk modelling techniques to understand their underlying exposures while proving their credibility to the regulator.

Connect with Russell

Russell is the leading risk management company that provides a truly integrated business platform which enables clients to explore, evaluate and understand connected business exposure in a connected world.

The Russell business platform combines analytics software, universal data, consulting services and thought leadership to deliver value to clients.

Our approach empowers clients to better understand connected business exposure throughout the business trading network, gain deeper business intelligence and achieve superior return on equity.

If you would like to learn more about Russell Group Limited and the Russell business platform, please contact rborg@russell.co.uk or visit www.russell.co.uk/contactus