SPECIAL REPORT/YEAR IN REVIEW

European Commission: the need to prepare for Solvency II will put pressure on insurers during next year

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ropean insurers and reinsurers are maintaining strong balance sheets on a risk-adjusted basis and this is reflected in the outlooks for AM Best-rated entities. As of November 30, 2014, 86% of companies had a stable outlook and 8% of ratings outlooks were positive (see graph 2). However, AM Best expects a period of uncertainty to continue in Europe as policymakers continue to work to resolve imbalances in the region. As lingering uncertainties in the eurozone remain, consequently 6% of rating outlooks were negative as of November 30, 2014.

AM Best highlighted in 2014 insurers cautiously shifted into riskier asset classes as chief investment officers sought alternative investments in response to the low-yield environment. This trend is likely to continue with insurers cautiously increasing their investments in alternative asset classes such as infrastructure debt, renewable energy and direct commercial loans.

Heightened supervision will continue to add pressure to western European re/insurers in 2015. Solvency II, the EU's harmonised regulatory insurance regime, takes effect across the 28 member states on January 1, 2016, after years fraught with delays. As companies prepare for Solvency II and regulators attempt to strengthen their oversight, re/insurers will need to maintain their focus on ensuring strong governance, internal controls and regulatory compliance.

AM Best expects higher levels of retention by direct insurers are likely to continue, as well as a move toward the centralisation of reinsurance purchasing and further restructuring. Insurers and reinsurers will continue to gradually expand internationally as they look for growth and profitability opportunities in less mature markets.

In competitive market conditions, the insurance industry needs to be vigilant in identifying emerging underwriting risks. Developments in science and technology create demand for risk transfer solutions that present an appealing opportunity for insurers, which can support new, exciting business ventures by developing cutting-edge products. However, innovators must be cautious and re/insurers must be careful not to underwrite business without fully understanding the potential for claims emergence. ■

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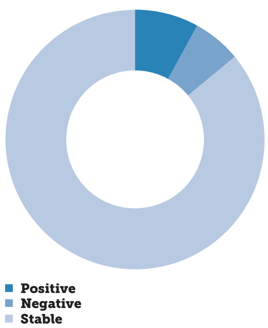
Graph 2: **Western Europe insurer and reinsurer issuer credit rating outlook summary, November 30, 2014**



Source: AM Best research

Flying over the war

This year was an unprecedented one for aviation disasters, but it is not just in the major loss arena where there have been significant developments

John Bayley and Gareth Jones
McLarens Aviation

This year's succession of high-profile losses – Malaysia Airlines suffered the loss of two planes in little more than five months, as well as other high-profile losses such as the Air Algerié crash in July – were tragic and hugely significant for the industry. While the aviation insurance market has long been highly competitive, with loss frequency reducing pretty much year-on-year, as well as increased underwriting capacity, it will be interesting to see if the losses of this year have an effect, at the very least in the war risk market. Recent figures from Lloyd's estimated this year's aviation hull war insurance losses at $600m, almost 10 times the amount generated by global premiums (roughly $65m).

Events modify what insurers will agree to cover and during renewals there will no doubt have been price considerations as well as a review the type of coverage provided. The fact is there are more places in the world that are politically unstable and risky, which is an interesting conundrum for insurers and service providers to offer the support required to their respective clients.

From a claims-management perspective this has presented a number of challenges. In the financially astute times we now all operate in, managing financial expectations and handling claims settlements is a huge task. Moreover, given there are a number of ongoing wars, the practicalities and logistics of dealing with such claims are much more difficult. We have had a number of our own surveyors flying out to various warzones, including Iraq, Libya, Afghanistan and Mali.

Of course, there are areas of the market that have not been affected by these tragic events and on the more general hull and liability side there have not been any major incidents of this kind this year. On the hull side there have been consistent reductions in the number of major losses for the last decade or so: an indication of how good the industry has been from a safety standpoint. Passenger safety continues to improve, with 2013 being the safest year on record and this year also impressive if you exclude those war risk losses.

Attritional loss

While major losses have been dominating the headlines, the number of attritional losses (typically in the $5m to $10m loss bracket) has, from our own claims data at least, held steady. Given equipment and technology values are increasing, such losses continue to be front of mind for insurers: this is an area over which the industry has much greater control. That such losses have been consistently high in recent years eats into the premium base and, as such, insurers are increasingly aware that costs (including claims management) need to be controlled. This is an area in which loss adjusters work closely with airlines, repairers and indeed the airlines' insurers to develop economic solutions to repairs all parties can live with.

The ground handling process is one from which a significant amount of attritional losses derive. Ground handling agreements, which define the obligations and accountabilities of the parties involved in the ground handling process, have been gradually changing over the past 20

Unmanned aircraft

Unmanned aircraft systems (UAS), commonly referred to as drones, have been one of the hot topics of 2014. Indeed, the media recently picked up on the fact an unidentified drone came close to hitting a plane as it landed at Heathrow, as confirmed by the Civil Aviation Authority (CAA). Usage is on the up: in the UK, for example (where anyone is operating a small unmanned aircraft of 20 kg or less and undertaking aerial work for which they will receive remuneration needs permission to operate from the CAA), the regulator has reportedly issued more than 200 permissions for unmanned aerial work since 2010. This year we even used a drone to obtain accident site data.

There are also some ongoing developments in terms of regulation. One study is being undertaken by the European Commission to look into the necessary liability and

zones

Australian and Dutch investigators examine pieces of Malaysia Airlines Flight 17 near the village of Hrabove, Donetsk, Ukraine

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systems

insurance requirements, with a view to developing a EU-wide regulatory framework.

As a result, we have been particularly busy this year briefing insurers on the operations of UAS. The relatively closed nature of the technology and its use means it is a topic in which the insurance industry is extremely interested. On the underwriting side there remain a lot of unknown factors. Insurers' appetite to cover this class varies widely and the insurance aspect is mainly related to liability. There are also some complications that arise with hull insurance, for example around values. On the one hand, the volume of production and regular software upgrades means values can decrease quickly. At the same time, the cheap production of vehicles at the lower end of the scale means some drones are almost disposable – a significant value being in the equipment they carry.

years or so. These have arguably moved largely in favour of the carriers (transferring more liabilities on to handling companies in the process) and it is fair to say in 2014 we are still seeing carriers looking to get more.

The corporate jet arena has also been busy in this respect. There has been a notable increase in the ownership and use of corporate jets and in our own caseload we have certainly seen more knocks and impacts in 2014 than there were two or three years ago. There is also a recognition in the business jet world that the safety culture and procedures need to keep pace with the increase in number of aircraft flying. ■

John Bayley is UK director of claims and Gareth Jones is head of aviation liability at McLarens Aviation

Learning to live with the new reality

While we have not seen any genuinely market-moving event during the year, there were several noteworthy developments

Graeme Rayner
Mitsui Sumitomo Insurance Group

The year gone by felt in many ways like more of the same – unremarkable from a catastrophe and large loss perspective and, for insurers, reserve releases continued to mask the difficulty of trading conditions. Like the year before, the market was characterised by ever-more intense competition, leading to rate reduction and a broadening of terms and conditions. A perpetual state of falling prices is, of course, ultimately unsustainable and will, at some point, come to an end. Prudent underwriters will now be taking the view a market-turning event or series of events might not come for some considerable time and the only hand of cards to be played is the one in front of you. This new realism will be informing underwriting in 2015.

While we have not seen any genuinely market-moving event during the year, there were several noteworthy developments. First, the extraordinary loss of the two Malaysia Airlines aircraft in utterly unrelated and unique circumstances highlighted the ability of reality to confound expected or modelled outcomes. However the industry's response to these losses was exemplary, with claims paid quietly, efficiently and competently. From an underwriting perspective, however, the muted market reaction to those events, together with the huge and violent damage caused at Tripoli airport, is interesting. Until very recently, these shocking losses would have been sufficient to trigger an immediate and significant uplift in rates; carriers this time opted instead to renew without increases, apparently to protect market share, irrespective of rate adequacy.

It is hard to see how a single event could change the status of the market. It is likely to involve a combination of an insured loss emanating from unmodelled events, fiscal and/or economic change and judicial and/or political change

However, arguments this is counterintuitive fail to consider these events in the context of benign environment in other areas and significant excess capacity.

In 2014 it became that much harder to imagine the set of circumstances required to change the market, perhaps partly because it is so unappetising to contemplate just how dreadful the confluence of circumstances must be to absorb such huge quantities of excess capital. It is hard to see how a single event could change the status. It is likely to involve a combination of an insured loss emanating from unmodelled events, fiscal and/or economic change and judicial and/or political change, which would ease market transformation rather than fling it from one extreme to another as was the pattern.

Collective focus

In terms of noteworthy moments in 2014, Steve Hearn and the London Market Group (LMG) deserve recognition for producing the LMG/Boston Consulting Group report on the competitive position of the London market. This delivered a clear message about the threats and opportunities facing the market and also emphasised the value of the insurance market to the UK economy.

It has served as a rallying call and brought a collective focus regarding the sustainability of business coming into London in light of the continued repatriation of premiums to local markets, and the necessity of our market structure to remain as globally competitive as possible. It also caught the ear of politicians, with a fairly immediate response from the chancellor of the Exchequer, George Osborne, in his budget speech. This has been an extremely valuable piece of work, which marked a defining moment in a market that is changing rapidly.

Differentiation

Drawing on the collective market experience of 2014, one vital consideration in 2015 will be the ability of individual organisations to identify their points of differentiation from competitors. If 2014 showed one thing it is that the market is going to become even tougher and companies therefore need to play to their strengths. This may be through claims expertise and the ability to manage claims situation efficiently and effectively, or breadth of product offering. But often overlooked factors such as service standards and immediacy of response will be points of differentiation.

At a time when the market is becoming tougher still, immediacy of underwriting response will become ever-more important in maintaining and increasing market share. Achieving what sometimes appear to be the service basics, such as being available when brokers and clients want to trade and ensuring underwriters with appropriate

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