Dialogue: Having been through several shocks to the market in your career, how does this crisis compare to those?

Clement Booth: This is the most serious crisis by a long way. It’s a complete economic dislocation. If you look at the triggers for previous cycles, the World Trade Center was a single event, in the late 1980s you had the US liability crisis where reserves were inadequate, and there was Hurricane Andrew which triggered a property cycle, and then we’ve had of course certain economic events over the years which have had some impact on insurance, but we’ve not had an economic event this profound where effectively the role of the banks came into question.

Some commentators have been calling this a perfect storm with several events occurring at the same time.

Yes, in the last quarter of last year you had credit spreads widening, interest rates coming down, stock markets crashing, all of these happening in a perfect economic storm which most economists would have thought unlikely. The financial system at some point needed a major adjustment because it was driven by the extension of credit at unrealistic terms. This was made possible by a lack of transparency which was created by the banks and then passed down into a non-transparent system. Now we’ve got to deleverage that system, and we’re really no more than half way through. Getting that downward spiral back out of the system will be extremely difficult.

During your time as a reinsurer you stopped reinsuring certain kinds of investment reinsurance. Did you see this problem coming then?

That was around 2001. We did do some financial products, but we didn’t do large-scale derivative-type transactions or credit swaps. Although the transactions looked like they were priced properly, they did not envisage any catastrophe risk. The amount of capital that we were to allocate on a modelled basis was so small that it seemed to me that any major disruption would kill the portfolio. Here at Allianz, we do some financial products transactions through Allianz Risk Transfer, but only on the basis of their own balance sheet and on a much more conservative basis. That’s why I’m much more comfortable with where we are.

Insurance companies are not banks, so the understanding of risk is entirely different.

Yes, the business model is totally different. An insurance company takes in a dollar, and out of that dollar...
makes two or perhaps three dollars in terms of coverage and leverage. Banks took in a dollar and leveraged it to 40 or 50 in terms of exposure. The basis for that is a modelling system which in the case of 2008 turned out to be wrong, and we should not be surprised by that because if you look historically at this industry, unmodelled risk is always going to be a challenge.

If the current crisis is damaging to insurers who modelled incorrectly for it, does this mean that the downturn is going to cleanse the market of companies with poor fundamentals?

I doubt that any well run insurer will disappear. The problem AIG is having was caused by activities in the financial products division. Some other competitors may also have a financial products division which creates similar problems, but I think it’s not likely that any corporate and specialty insurer should fall because of normal activities of the business. However, I think that it should drive some consolidation. Revenues will be under pressure because the turnovers of customers themselves are under pressure. That will be a major impact in 2010.

How will this affect insurers’ performance?

Whether losses or loss trends will increase or not we don’t really know. During the Great Depression, P&C insurance did well and was the least affected of the financial services. But in 1929, we did not have a globalized world, so it’s a little more complex today. I think investment income will be down, and this means that companies’ earnings will be down. Shareholders will drive management to save, and you will need to consolidate. So I would expect to see some M&A activity in our markets.

This reduction of capacity would probably also harden market prices.

The market will harden for the next three years plus. There’s no doubt that the rate for risk will go up because the cost of capital has increased dramatically in the last 12 months. This is just a simple calculation. I say to corporate customers, look, you can talk to the people who calculate these things, and they’ll show you how the pricing engines work. There’s no doubt that the cost of providing insurance in this space has run up. Of course, it’s hard for customers who are under their own pressure. They also have to look at it differently and see that yes, their premiums may have gone up by 20% or more but what is the viability of the coverage? If you have any major loss, you’re not going to be worried about the premium.

And if there is a major loss, you have even less funds to cover your own risk retentions.

Yes, at the moment coverage is needed more than ever, but it is available only at an increasing price, and in a diminishing supply. Particularly risks like US hurricane will become more and more difficult to secure cover for – if at all. In some D&O areas, the prices will go up dramatically because the supply has been greatly reduced. And, of course, in aviation there will be dramatic price increases.

“This is the most serious crisis by a long way. It’s a complete economic dislocation.”

Clement Booth, Allianz Global Corporate & Specialty

Photo: Claus Uhlendorf
One answer to the market that you’ve referred to is “back to basics” for insurers. What does that really mean?

The insurance value proposition is a really simple one: If you stick to listening to what your customers need and responding to it, that’s a really good start. The fundamental model has been unchanged for 200 years since the days of the Lloyd’s coffee shop. This is also what underlies AGCS. It’s an underwriting-driven organization. It doesn’t lose sleep over the top line but rather concentrates on building excellent customer relationships and under-writing excellence.

If you’re a developer, and you’re building a bridge in some complicated place, or an underground railway system or a new stadium or an airport or whatever else, Allianz is a... techniques to bring down the cost or risk. And that’s what our people ultimately do: bring down the costs of risk.

AGCS itself was founded after a crisis: the 2005 hurricane season. Did that lead to this underwriting-driven focus?

The lack of transparency in the organization about which risks Allianz was writing in which regions was one issue. But there were several others as well. The discussion started before that hurricane season. The storms just made these problems much more obvious.

After 3 years, then, of building the globalized customer-focused model at AGCS, did this equip it to handle the current crisis, or was it just lucky?

If you get the basics right, you generally end up in the right place. We had to first create the right environment for sound underwriting through a lot of business restructuring. Then on the front end we have now developed a more successful customer interface. The combination of these two things puts AGCS exactly where I believe it should be in year four of its existence. Certainly no one expected a major dislocation like the one we just had, but what it really reconfirmed is that our insurance business model is sound.

Turning to other market factors, a year ago, market players were worried about the Bermudans. How do you see this development today?

They haven’t disappeared, but obviously the liquidity source and the preparedness to invest is really under some question. The excess capacity really has driven rates down. Allianz may not be the cheapest, but it’s a solid AA company in the midst of the worst financial crisis for 100 years.

And what role do you see reinsurers playing in the current climate?

Reinsurers may have overestimated the speed at which the market has been turning. They saw it hardening about a year too early. Certainly we’ll see the reinsurance market hardening now around peak risk scenarios like US hurricane, but I doubt we’ll see the change in pricing being led by them. Reinsurance is non-proportional these days – not following retail pricing.

But even if reinsurance prices harden, is this an issue for AGCS?

No. We have a very good reputation with reinsurers, so they feel comfortable accompanying our business, so the supply to us will not be interrupted.

Looking forward, then, where does AGCS go from here?

The next chapter for AGCS will be expansion. This doesn’t mean we’ve reintroduced top-line goals. Country by country, we’ve got a market cycle which again allows technical underwriting. AGCS will expand significantly in the next five years.

With all this restructuring, is the company prepared for the next phase in the market?

We are ready for the future with our powder dry. Our capital is intact, we’ve got a good team, and we’re increasingly seen as one of the leading players in the corporate and specialty market. There’s no doubt in my mind that in ten years we will be the market leader. That’s our stated goal, and we’re headed there. I’m very proud of what Axel Theis and his team are doing with the company.

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