Swiss Re: after the £500m loss

Issue 26-02-2009

Its chief executive has left and its credit ratings are tumbling. Angelique Ruzicka asks if a cash injection from Warren Buffett and a pledge to go 'back to basics' will be enough to persuade insurers and brokers to place business with the reinsurer

A year ago, it would have been unthinkable. Hot on the heels of AIG's nationalisation, Swiss Re, one of the giants of the reinsurance industry, has reported a loss of more than £500m. Its chief executive left last week and his replacement, Stefan Lippe, has asked the market for patience and pledged a 90-day review of the business.

So what does this mean for the UK general insurance market? Swiss Re is closer to your business than you think. Its woes could be the market-moving event everyone has been watching for, with analysts warning that the impact on reinsurance rates – and the knock-on effect on general rates – could be massive. ertisement

The reinsurer reported a net loss of CHF864m (£509.5m) for the full year of 2008, a shocking drop from its CHF4.2bn net profit of 2007. Earnings per share were down CHF2.61, from CHF11.95 in 2007. The losses came after the group – like others before it – ran into trouble underwriting asset-backed securities and credit default swaps.

The loss has left general insurers and the reinsurance brokers who act on their behalf unsure whether to place business with the company. Francois-Xavier Boisseau, chief executive of insurer Groupama, says: "As a purchaser of reinsurance I think there is a tendency to put all your business with just a few reinsurers. And I think putting your eggs in one basket, even if it is Swiss Re, can prove to be not a good risk management strategy. You might want to spread your bet."

Another chief executive of a leading insurer says: "AIG announced [a fourth-quarter loss of] $60bn. I don't expect Swiss Re to get into that territory. But now we need more transparency on the reality of their asset position and on their balance sheet."

Given its results, Swiss Re will be looking to increase its rates instead of undercutting competitors to win more business. Boisseau expects rates to rise significantly in 2010. "We haven't seen it go up in the UK in 2009," he says. "We saw a slight increase in liability and motor, but it was only in single digits. I think the reinsurer will have no choice but to increase their prices. I do think it will be a headache."

The market's confidence in Swiss Re could be tested even before 2010. One source says: "The Japanese renewal season on 1 April is an immediate test about its resilience. Swiss Re has a high profile and a good market share here, but the Japanese still appear to be deciding their stance. If you read that Japanese rates are appreciably hardening, this will imply a lessening of Swiss Re's position in that insurers will look for capacity elsewhere. The atmosphere of uncertainty cannot help, especially for longer-tail classes."

But the market environment could play out in Swiss Re's favour. Paul Oates, analyst at rating agency Moody's, says: "Rates have been going up and there is less capacity than there was. I think there is a pressure on supply so there is probably more demand from insurers who will look to reinsurers to help cover some of their risk as their capital has been depleted."

New man at the top

Some market commentators say that Lippe's promotion to the top job will restore credibility and propel the group back to its reinsurance roots; that the banking background of his predecessor Jacques Aigrain sent Swiss Re off course to focus too much on financial markets.

Oates feels Lippe fits in well with the reinsurers' current mantra: "In terms of [Lippe's] style I would say it's back to basics, which is consistent with Lippe's own background. At Swiss Re, he first headed the non-life underwriting department and then broadened to encompass life as well, so he has an insurance underwriting background."

Nicolas Michellod, senior analyst at Celent, feels Aigrain should have stayed, however. "What astonishes me is that [Warren] Buffett says he trusts the management of Swiss Re and now we have Jacques Aigrain leaving the company. When we are in a crisis, decisions should be made by strong people and managers. If Buffett thought Aigrain was a competent manager, he shouldn't have stepped down."

The world's richest man got involved earlier this month, when he made a CHF3bn investment through his company Berkshire Hathaway.

Swiss Re needed extra investment to boost its balance sheet. But raising money in the markets in the current climate was not feasible; neither was turning to the Swiss government.

Michellod says Switzerland already has huge problems with UBS so would have been loath to bail out Swiss Re. "Also, reinsurance is a specific business and I don't think taxpayers understand the need for such a company to be bailed out by the government."

The CHF3bn is in the form of a convertible perpetual capital instrument. No exact product has been issued like it before, but analysts describe it as similar to instruments Buffett has issued to Goldman Sachs and General Electric. "It's been tailored towards Swiss Re and their needs, and to make sure it fits in with the Swiss regulatory requirements," says Oates.

While analysts acknowledge that the reinsurer had little choice but to seek investment from Buffett, some still disapprove. "It's not something that any shareholders will view positively because it's an expensive transaction. But the company did need to do something after the fourth-quarter results. This is probably the least bad alternative," says one.

Others are encouraged by the expertise he brings to the table. "The good side of the coin is Warren Buffett entering the scene and powering up the capital of Swiss Re," says Michellod.

A proposal to raise additional capital has been dropped, however. At the start of February, Swiss Re announced plans for a CHF2bn rights issue but it has since made a U-turn, saying in a conference call last Thursday: "We have no plans for a rights issue. We believe we have adequate capital and plan to generate capital organically."

This switch has been poorly received by analysts. "You would have thought that some bolstering of capital under these circumstances would be useful but the issue has been shelved. The explanation that they had for it was that they gained some additional equity credit for the convertible note that's being sold to Berkshire Hathaway," says Mark Nicholson, equity analyst, S&P equity research.

All this has prompted a number of rating agencies to downgrade Swiss Re. Standard & Poor's has downgraded the company from AA- to A+, while Moody's has downgraded it twice in recent weeks: it now has an A1 rating. AM Best Co says it is reviewing its A+ (Superior) rating of Swiss Re and its similarly-rated subsidiaries.

If ratings worsen, Swiss Re's long-term business lines will be placed under particular pressure. A strong credit rating is a huge selling point as clients want assurances that backers can pay out on huge losses. "Brokers use ratings as part of their decision process when they recommend insurers on security listings," says Oates.

"Some businesses would historically need an AA rating in order to be written. In the life reinsurance business you may not be making claims for 10 to 20 years. It's tended to want AA ratings as that gives more assurance that the company is going to be around in 10 to 20 years to pay the claims."

Boisseau says if ratings fall further, Groupama will be forced to place business elsewhere.

“There won’t be another choice. But to be fair to Swiss Re, I would be surprised if it wasn’t a significant player in years to come.”

Another insurer chief executive says: “There is a minimum rating requirement. We have to change the goalposts, though, as the whole market is changing the way it analyses credit worthiness of businesses. We should not compare AA today with AA two years ago. But we must put weight to them because otherwise they don’t mean anything.”

Swiss Re, meanwhile, has admitted its errors. “You can’t be in the position we are in and say we didn’t make mistakes. Our biggest mistake was underwriting position on structured products, which cost us CHF3bn over 2007 and 2008,” said a spokesman for the board in the conference call last Thursday. But he pointed out that its peers were in a similar predicament. “We are not proud of our A+ rating. We would like to be back on the rating we like, but other players are on the same rating. The real issue is how our clients view it.”

Following the cash injection from Berkshire Hathaway, the board has said its main goal is to get “back to basics”, including restructuring the business, de-risking its investment portfolio, disbanding its financial markets division and focusing more on its core reinsurance activities.

Swiss Re could improve its situation through the hardening market, taking advantage of the limited capacity, sticking to what it does best, and redeeming Buffett’s investment. But it will be an uphill struggle.

There’s Lippe’s 90-day review – and then there’s Buffett’s three-year deadline. Nicholson explains: “It’s a rather ambitious target to buy back CHF3bn in capital at 20% premium to the existing price of the shares. It has three years to do so before the bonds convert into ordinary shares ... it would be a very severe dilution, so they’d want to avoid it.”