

How reinsurers respond to increasing economic and regulatory uncertainty



Dr Kai-Uwe Schanz from **Dr. Schanz, Alms & Company, Zurich** reports on the 5th International Reinsurance Summit which was held in Zurich on 27-28 June 2011, where delegates hear and discuss about growing complexity, excess capacity, risk selection, inflation and many other issues.

EUROFORUM's annual Reinsurance Summit has become a prominent item on Zurich's reinsurance agenda, helped by the fact that the city has developed into the most rapidly growing reinsurance domicile in the developed world.

Reinsurance sector reinventing itself

In his introduction, conference chairman Mr Herbert Fromme, Insurance Correspondent, Financial Times, summarised the challenging environment insurers and reinsurers are currently faced with: the reinsurance industry in particular struggles to 'reinvent' itself following the ill-fated vision of converging insurance and capital markets.

Stubbornly, low interest rates continue to erode a key pillar of industry earnings. The European debt crisis conjures up the spectre of another financial meltdown and a subsequent Great Recession 2.0. And, last but not least, Solvency II is looming large in terms of significantly increased capital, risk governance and disclosure requirements.

Excess capacity the biggest challenge

The first speaker, Mr. Chris Klein, Managing Director, Director of Reinsurance Market Management, Guy Carpenter, stressed that reinsurance fared pretty well throughout the crisis.

"Cover was provided, claims were paid," he said. All capital lost in 2008 was replenished by the end of 2009. In Mr. Klein's view, reinsurers' resilience is attributable to the fact that the industry's "structural problems" were effectively addressed pre-crisis: Reserve deficiencies were dealt with, equity ratios came down massively and accumulation controls were improved markedly. Going forward, Mr. Klein considers 'what to do with excess capacity as growth remains elusive' as the biggest challenge ahead of the industry.

Good premium growth in GCC fuelled by infrastructure

Mr Shashank Srivastava, CEO, Qatar Financial Centre Authority (QFCA), presented a view from a part of the world where growth is all but breathtaking.

Qatar, the world's largest provider of Liquefied Natural Gas (LNG), continues to post double-digit inflation-adjusted GDP growth. Insurers and reinsurers will benefit greatly from this momentum as insurance penetration is still at

very low levels of around 1% (premiums as a share of GDP), as compared with the global average of 7%.

"GCC premiums are expected to more than double to US\$27 billion by 2014. Available reinsurance premiums could exceed \$10 billion by then," he said.

A major driver of this growth is spending on infrastructure. In Qatar, more than \$75 billion were awarded to infrastructure projects between 2004 and 2010. By early 2011, over \$85 billion worth of projects were underway in the country with a further \$130 billion in the pipeline for the next three years.

"Respect growing complexity"

Opening the session "Between regulations and return – current strategies for success", Mr Hans-Joachim Guenther, CUO and Head of Reinsurance (Europe & Asia), Endurance Specialty Holdings Ltd, addressed the risks for reinsurers operating in a global market.

In his view, companies have to carefully weigh the benefits such as economies of scale, enhanced diversification and access to new business against pitfalls such as increasing organisational complexity, cultural differences and adverse selection.

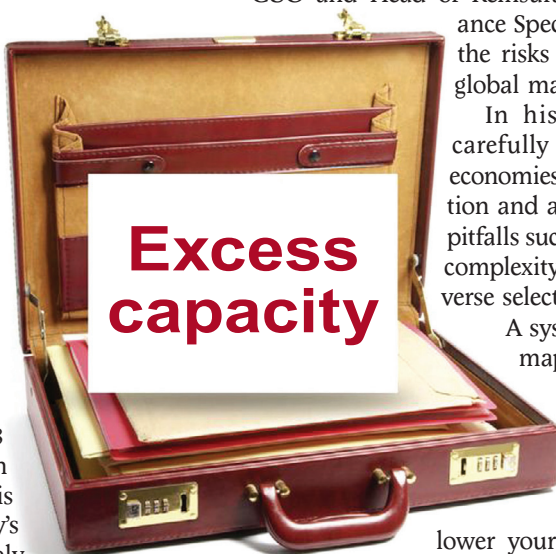
A systematic approach to business mapping and risk identification, combined with a matrix-type of underwriting setup (market versus product expertise) help avoid these pitfalls. "Do what you understand. Never

lower your standards. Respect growing complexity," he concluded vividly.

Value proposition of mid-sized reinsurers

Mr Peter Schmidt, CEO, Catlin Re Switzerland, elaborated on the value proposition of mid-sized reinsurers. He presented empirical evidence for the resilience of the mid-segment in both European insurance and global reinsurance, with the Top 6-20 holding their own against the behemoths such as Munich Re, Swiss Re, Allianz or Axa.

The mid-sized players increasingly rely on their reinsurers when it comes to meeting challenges such as subdued growth, a volatile investment environment and tightening regulation. They find this support with mid-sized reinsurance companies who, such as his own company, value continuity and long-term partnerships and, at the same



time, offer value-added services, an outstanding environment for talent, multi-line underwriting capabilities and superior financial strength ratings. “We have a market, face distinct challenges and offer a response,” he concluded.

Risk selection crucial

Mr Tom Hulst, CEO, Ariel Re, emphasized the essential role of risk selection when navigating challenging market conditions.

“Risk selection is the primary source of differentiation in performance and achieving a margin over time”, he said, pointing to the industry’s shortcomings in that respect and underperformance from a shareholders’ perspective. More specifically, he mentioned as winning strategies: a focus on those lines of business where the ratio of expected return to risk meets or exceeds an acceptable level, the selection of economically superior transactions within the chosen lines and the willingness to grow or shrink volume depending on market conditions.

Traditional reinsurance more in demand in emerging markets

Mr Clive Tobin, CEO, Torus Insurance Holdings, observed an increasing focus of reinsurers on direct commercial insurance. “Traditional reinsurance seems to be increasingly confined to the catastrophe area, at least in developed markets”, he said.

In emerging insurance markets, however, Mr. Tobin sees significant potential for traditional reinsurance, for example in the areas of energy, infrastructure and agriculture: “They need reinsurance across the board.”

Reinsurers need to be in touch with insureds

Kicking off the session “When global meets local – The industry’s view on reinsurance”, Mr. Henri Lebossé, Head of Risk and Insurance Department, Bouygues Construction, summarised the French giant’s view on reinsurance as “an excuse not to insure”.

He also noted that more often than not reinsurers are “too global and not enough in relation with the insured”. As to his company’s expectations vis-à-vis reinsurers, he highlighted the management of “IBNI” (Identified But Not Incurred) losses, a better knowledge of major corporate clients and the ability and willingness to offer tailor-made solutions.

RI markets remain overcapitalised

Mr James Vickers, Chairman, Willis Re, pointed out that global reinsurance markets appear to remain overcapitalised, with shareholders’ funds at first quarter up 20% compared to year end 2008 but 12% down compared to year end 2010.

For most reinsurers, the Nat CAT losses incurred since the beginning of this year present earnings rather than capital issues. However, he wondered how robust the overcapitalisation argument is in light of major share buybacks, declining investment income and capital uncertainty in connection with Solvency II.

He concluded by calling upon all market participants “to adjust to the new reality that outsized underwriting returns

will only be available on a localised basis for very short durations”, attributable, inter alia, to significantly improved actuarial and modeling techniques.

Reinsurers urged to look at “non-insurable” exposures

Mr Gregor Koehler, CEO of Pallas, the German chemical giant’s Bayer captive insurer, addressed today’s market reality in commercial insurance.

“Many traditional and valuable risk transfer products are available but coverage gaps do exist, for example in Nat Cat, Business Interruption, product and environmental liability. Risk transfer options are very limited in the areas of reputation and intellectual property”, he said. Mr Koehler encouraged reinsurers “to go direct” and drive innovative approaches to so-called “non-insurable” exposures.

Beware of claims inflation

Mr Gilles Meyer, CEO, SCOR Global Life SE, addressed the final session “Solvency II and regulatory challenges” from the perspective of a leading global life reinsurer.

He encouraged fellow life reinsurers to continue focusing on biometric risk only, ie to refrain from assuming investment risk from life insurers. This approach to life reinsurance has served the industry well, evidenced by a relatively steady pattern of profitability driven by mortality developments and lapse rates rather than financial market volatility.

He warned that whilst low interest rates currently dominate the list of industry concerns the spectre of inflation needs to be taken seriously in an environment where “FED liabilities have tripled over the past two years”. This vigilance is particularly warranted as consumer price inflation tends to be outpaced by claims inflation, placing a major burden on insurers with a heavy exposure to long-tail business.

Against the same backdrop, Mr Jacopo D’Antonio, President & chief underwriting officer, Aspen Re Europe, explained how reinsurers deal with “the headache of pricing under inflation uncertainty”, a particularly virulent issue following the financial crisis which led to a massive increase in liquidity in combination with a sluggish real economy.

As far as claims inflation is concerned “mainly long-tail business is affected”, a challenge dealt with through indexation clauses. On the other hand, short-tail business is more subject to “demand surge”, eg an abrupt increase in prices for construction materials following a major natural disaster.

Reinsurance contracts offer clients protection against these risks and, therefore, can be viewed as a “real option with claims cost as underlying”. Mr D’Antonio concluded by wondering whether current reinsurance rates adequately reflect the implicit increase in reinsurance cover in the wake of heightened economic and inflation uncertainty.▲

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