

Lubricating the wheels

It's time for change in the global reinsurance industry, argues **Dr Kai-Uwe Schanz**. Globalisation, deregulation, consolidation and new risk transfer options are challenging the industry's traditional way of doing business.

REINSURANCE IS A well-established "lender of last resort" to the insurance industry. It offers protection for the world's largest and most complex risks and provides insurance companies with capital relief as well as product development and risk expertise. Based on its diversification power, reinsurers help reduce the cost and boost the security of personal and commercial insurance policies. Without reinsurance, many risks would remain uninsured. The pace of economic and societal progress would slow and long-term welfare and prosperity would suffer.

There is no doubt that the reinsurance industry has an attractive story to tell. Unfortunately, the industry does not really excel at seizing this opportunity. Compared with other industries most reinsurers still seem to be unable or unwilling to convey their story to a broader audience, reflecting in part their traditionally low-key approach in what used to be a rather clubby business environment.

This conservatism is becoming increasingly problematic and, ultimately, costly. Reinsurers came under the spotlight following 9/11, spectacular natural catastrophe losses and financial market upheavals. An industry which fails to make its case runs the risk that its operating parameters will be shaped by people who do not fully understand it. Reinsurers are well advised to adopt a more proactive and self-confident approach to convey the benefits they bring to their stakeholders and society at large.

The core business of reinsurance is to provide insurance for insurers. As such it is a wholesale

“An industry which fails to make its case runs the risk that its operating parameters will be shaped by people who do not fully understand it”

business between professional corporate counterparties, which is why the industry has relatively little public profile. The industry really came of age in 1906, when the San Francisco earthquake (in inflation-adjusted terms still the costliest insurance event in modern times) proved that the peril faced by one small area could be effectively and efficiently supported by a network of global risk-bearers.

Without reinsurance, San Francisco would look very different. Two prominent reinsurers that

proved their mettle in the 1906 "baptism of fire" still lead the industry today: Munich Re and Swiss Re. Reinsurers typically assume the largest and most complex balance-sheet risks from insurers, such as an earthquake in Tokyo or a Katrina-type hurricane hitting down-town Miami.

CHALLENGING TIMES

The reinsurance industry faces a number of strategic challenges to its traditional way of doing business. These challenges also affect its crucial role of enabling economic and societal progress.

Globalisation has major ramifications for the reinsurance industry. Reinsurance has always been an international business as the imperative of diversification requires spreading risk beyond the home market. However, the increasing pace of globalisation brings significant new challenges in terms of complexity and exposure levels, arising from ever more integrated and vulnerable supply chains.

Deregulation continues to affect the insurance industry. In most of Europe, until the mid-1990s, insurers were heavily regulated with prices, terms and conditions determined by supervisory authorities. The radical deregulation that followed resulted in a massive increase in competition. Emerging insurance giants such as China and India are starting to face similar challenges, with a tremendous impact on domestic companies' capital, asset and product management strategies – and as such, on their reinsurance needs.

Consolidation also reshapes the client base of the reinsurance industry. With many clients growing larger and improving their diversification, reinsurance needs to change substantially. Clients require less traditional reinsurance products but more sophisticated solutions which optimise capital efficiency.

At the same time, the industry is witnessing an increasing frequency and severity of major catastrophe losses. The breathing space enjoyed in 2006 and 2007 does not alter the long-term pattern. As the potential for major losses goes up so does pressure from shareholders. The reinsurance business is extremely capital-intensive, but also very volatile, depending on how severely the wind blows or the earth shakes. The return record of the industry over the past 20 years has not been inspiring. The industry needs to come up with innovative approaches to reduce volatility and improve capital efficiency.

THE INDUSTRY'S RESPONSE

The response of the reinsurance industry to its radically altered business environment has been focused on three areas. First, the sector has been reviewing its traditional business model, which has remained virtually unchanged for one and half centuries. A combination of increasingly complex and large exposures, together with relatively poor returns, has prompted this review.

Traditionally, reinsurers assumed major risks on their own balance sheet and mitigated them by means of global diversification. Since the mid-1990s, however, a new concept has emerged: The transfer of insurance risks (eg earthquakes and hurricanes) to the capital markets via securitisation of premium flows. Even though this innovation has yet to really take off, the prospect of tapping global bond and equity markets worth far more than a hundred times the insurance industry's equity remains exciting. Reinsurers that transfer peak risks to the capital markets can significantly improve their capital efficiency, increasing return on equity and reducing volatility.

A less far-reaching industry response to the current challenges is to adjust its traditional relationship-based business model. Increasing competitive and shareholder pressures in both primary insurance and reinsurance have challenged the "gentlemen's" character of the business and its implicit pay-back rules. Market participants need to strike a new balance between relationship-oriented and opportunistic buying and selling strategies.

A third major change in the reinsurance industry is what may be called its slow emergence from obscurity. Traditionally, reinsurance has been a discreet "behind the scenes" type of business, conducted between sophisticated professional parties. The public hardly took notice of the industry's existence and regulators did not interfere with what were considered transactions among professionals. This has changed. The increasing frequency and severity of "headline" catastrophes has catapulted the ultimate absorbers of these losses, ie the reinsurers, to the front pages.

Reinsurers are under much closer public and regulatory scrutiny and pressure, especially when it comes to increasing prices and tightening coverage terms after severe catastrophe losses. In order to manage the risks associated with this trend, the leading reinsurers have started to engage in more regular dialogue with relevant constituencies, highlighting the industry's distinctive contributions to society at large and thereby effectively protecting its "licence to operate".

FIT FOR THE FUTURE

From a fundamental perspective the reinsurance sector enjoys excellent prospects. First, reinsurance is expected to continue to outgrow global GDP as insured asset values accumulate at a rapid rate. In the industrialised world, this is partly driven by more insured personal and commercial assets concentrated in regions which are exposed to natural catastrophes. In emerging markets such as China, India, Brazil and Russia there is the classic pattern of insurance demand expanding significantly faster than the overall economy.

“The prospect of tapping global bond and equity markets worth far more than a hundred times the insurance industry's equity remains exciting”

The rapid growth of fixed investments boosts demand for commercial property insurance. The accelerating integration of these countries into the global trading system fuels demand for marine and transport insurance. With the emergence of a middle class and their increasing purchasing power, demand for cars, homes and consumer goods is rising rapidly. These are all assets which require personal lines insurance.

Confidence in the reinsurance industry can be further drawn from its ability to adapt to a changing and more demanding environment. This adaptability has been demonstrated by wholesale changes to the current business model, such as an increasing reliance on securitising insurance risks. It also includes less visible changes such as rethinking the role of long-term business and stakeholder relationships.

The industry continues to offer a compelling value proposition to society at large. It has developed into more than a simple pass-on mechanism under which the unfortunate few who suffer losses are indemnified from the funds collected from a large number of policyholders. Insurers, and in particular reinsurers, can aid economic and societal development and progress in many ways.

They enable businesses to operate with less volatility and risk of failure, thus providing greater overall financial and social stability. The industry acts as a key facilitator of commerce and trade as it helps companies specialise on what they do best. Adequate insurance products help businesses absorb the risks which are usually attached to increased specialisation. The industry also encourages loss mitigation as it has an obvious interest in sponsoring loss control initiatives such as fire prevention and occupational health and safety. Society as a whole benefits from such activities.

What distinguishes the industry from many other financial institutions is its long-term view of investment. Insurers and reinsurers tend to have significant long-term liabilities on their books which need to be backed by assets of a long-term nature. As such they provide stability to the financial markets on the back of their strong risk-bearing capacity, long-term investment horizon and ability to accommodate short-term volatility.

Reinsurers certainly have a compelling story to tell. Going forward the industry must seek new and innovative business methods to maintain its place as one of the most important sectors of the global financial services industry.

Dr Kai-Uwe Schanz is principal partner at Dr Schanz, Alms & Company.

Search for the following stories on

>> **GLOBALREINSURANCE.COM**

>> Cat bond growth in 2008 "gradual"

>> Katrina rerun could be absorbed

>> Storm-insured volumes to "double by 2018"