SI Re

# Size versus diversity in reinsurance

## An empirical study of the European market

SI Re – Mutually yours

Sustainable, agile, committed

# Foreword SI Re

Over the past decade SI Re has firmly established itself as a reliable reinsurance partner to its European clients. Our approach to reinsurance is well received. We focus on long-term relationships, financial security and advanced expertise in selected products and markets.

That said, we perceive attempts by global reinsurers, which are partially echoed by regulators and rating agencies, to promote size over diversification and diversity in reinsurance purchasing decisions.

To test the validity of this «big is beautiful» statement, we decided to conduct an in-depth survey of insurers and intermediaries on the fundamental criteria that drive their reinsurance purchasing and panel selection decisions. Dr. Schanz, Alms & Company, an independent specialised (re)insurance consultancy conducted the survey and authored the following report.

The results of the interviews speak for themselves. Size alone is of little relevance to the surveyed insurers. What matters most is the continuity and reliability of reinsurance relationships as well as the security afforded by a well-diversified reinsurance panel.

We are very much encouraged by these findings which we believe are of utmost relevance to the reinsurance market at large. We would like to thank all participating interviewees for their support and the insight they shared and hope you will find our survey an interesting read.

Yours sincerely,

Bertrand R. Wollner
Chief Executive Officer

# Foreword Dr. Schanz, Alms & Company

We are pleased to present this SI Re client survey on the relevance of size versus diversification in the European reinsurance market. Our research is dedicated to empirically assessing the key factors that drive reinsurance purchasing decisions and satisfaction of ceding insurers. In particular we focus on the determinants of the composition of reinsurance panels. Is the size on its own a decisive factor for the selection of a reinsurer, as claimed by some prominent market participants?

To address this question, we divide this research publication into two sections. First, we provide a brief summary of the main arguments put forward in the size versus diversification debate. Secondly, we share the results of 28 structured in-depth interviews with senior European non-life insurance and brokerage executives with responsibility for reinsurance purchasing, altogether representing gross written premiums of € 51 billion.

In a nutshell, the vast majority of interviewees say that a broadly diversified reinsurance panel, together with the continuity and longevity of their reinsurer relationships, are the most relevant considerations in the pursuit of risk protection strategies. Size in itself, and a subsequent limitation on a small number of top tier reinsurers, would appear insufficient to address the wide and differentiated spectrum of reinsurance needs in the European market place.

We hope that you will benefit from this publication and look forward to your feedback. Our most sincere thanks go to SI Re and the company's CEO Bertrand R. Wollner for commissioning this study. We would also like to express our gratitude to all interviewees who openly shared with us their insight, expectations and concerns about the composition of their reinsurance panel.

Yours sincerely,

Henner Alms
Partner,
Dr. Schanz, Alms & Company

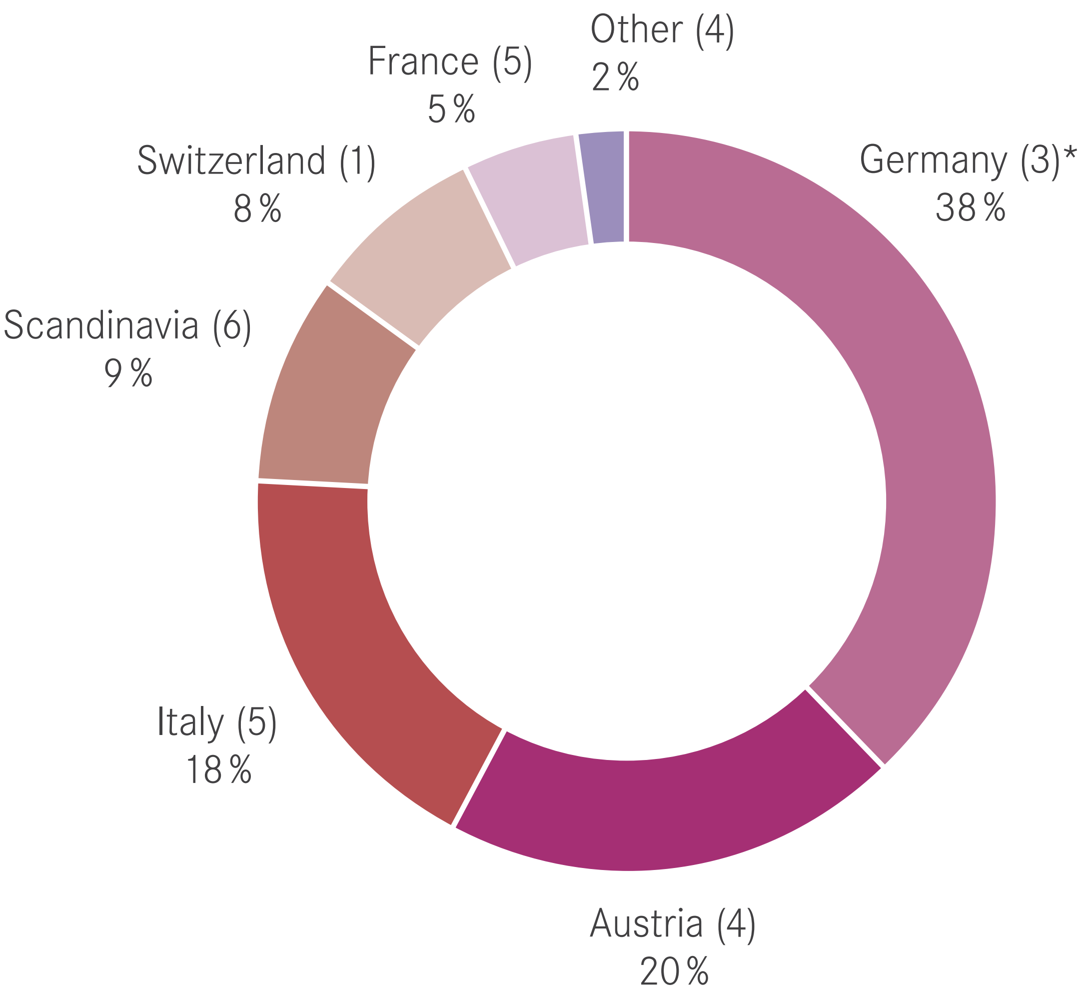
Dr. Kai-Uwe Schanz
Chairman and Partner,
Dr. Schanz, Alms & Company

# Methodology

The findings of this report are based on structured and in-depth interviews with senior executives responsible for reinsurance purchasing at 28 European insurance companies and brokers. The interviews were conducted from May to June 2017 by Dr. Schanz, Alms & Company, a Zurich-based research, communication and business development consultancy.

The companies participating in this research underwrote €51 billion of non-life gross written premiums (GWP) in 2016 (see exhibit 1).

Exhibit 1: Split of insurance companies interviewed by country according to their non-life GWP




Total: €51 billion in non-life GWP

* Number of interviewees per country

# Key findings

Protecting the balance sheet against volatility from large loss events is of paramount importance when making reinsurance purchasing decisions, according to the executives interviewed for this report. This priority is followed by the need to meet regulatory requirements and the desire to capitalise according to current market conditions. Of lesser importance for buyers is a reinsurer's ability to support innovation or the expansion into new territories.

Given the strategic relevance of reinsurance, cedants are keen to avoid surprises in their reinsurer relationships. Continuity, predictability and reliability are the main attributes they seek in their reinsurers of choice. In addition, the quality and amount of reinsurance capacity are important, in particular as cedants prefer to establish «complete relationships», working with their trusted reinsurers for as many risks, markets or products as possible. Timely claims payments, competitive pricing and expertise are relevant, too, though rarely regarded as key differentiators among reinsurers.

The insurers interviewed for this research work have panels that range from less than 10 to more than 25 reinsurers. The largest share of insurers maintains a panel of 10 to 15 reinsurers, but for short-tail risks in particular that number can easily exceed 30 reinsurers as these relationships are less personalised and often managed by brokers. Again, ensuring a maximum of security while minimising counter-party risks is the main reason for the broad diversification of panels. Smaller shares spread among many carriers help avoid dependencies, give access to a wide variety of expertise and offer the peace of mind that insurers expect from their panel. In fact, some panels have even increased in size over the past two years, predominantly to compensate for the larger shares that some reinsurers built up as a result of mergers and acquisitions (M&A).

Diversification is not just about a broad mix of reinsurers. Despite large panel sizes, many insurers want their reinsurers to write minimum shares to secure their commitment to, and interest in, the sustained prosperity of the cedant. They balance a small group of highly rated leaders against a wide range of followers with smaller shares to assure continuity. Tiering (the differentiation of reinsurers according to size) is in itself not a relevant concept to the insurers polled. Size only becomes meaningful in combination with high security, large available capacity and continuity. However, insurers view the inclusion of reinsurers of all sizes as equally important. A good mix of reinsurers provides the utmost security and the opportunity to forge long-term relationships.

Recent M&A activity in the reinsurance industry was viewed with mixed feelings, according to the interviewees. A reduction in capacity and choice is not in their interests. In response, many have replenished their panels to offset the effects of M&A. However, many insurers emphasise that the reinsurance market is working, with no evidence of oligopolistic structures.

Reinsurance remains a people business and the quality of personal relationships with their reinsurers is decisive for almost all the interviewees. Overall, the polled insurers are satisfied or very satisfied with the services they receive from their reinsurers. That assessment has been stable for the past two years. Continuity of support is the most relevant expectation vis-à-vis reinsurers, while flexibility in pricing and coverage ranks second.

The European insurers interviewed for this report are cautious reinsurance buyers. They prefer a traditional approach of following the fortunes rather than opportunistically maximising short-term benefits. They expect competitive pricing but not at the expense of the reliability and continuity of their relationships. To them security comes with diversification, not with reinsurer size, and they remain highly sensitive to imbalances in their panel, which they are keen to recalibrate immediately.

# Size versus diversity in reinsurance – Some theoretical considerations

The case for size in reinsurance, as promoted by some regulators, rating agencies, financial analysts and the media, is compelling. Larger carriers can achieve a better diversification by line of business and geography, are exposed to less volatility and will thus benefit from lower cost of capital. They can offer their cedants greater capacity and support them with more experience, expertise, resources and services. Furthermore, large reinsurers enjoy economies of scale with regards to administrative and acquisition costs. In addition, their assets are broader and potentially more diversified to generate sizeable income streams, even in times of low interest rates. Their historical reserves offer more scope for releases to bolster earnings as underwriting margins erode.

## The cyclicality of the debate

The categorisation of reinsurers into «leaders» and «followers» (in other words, core reinsurers and those of less strategic relevance) is probably as old as the notions of syndication and risk diversification. This debate is ultimately about «size versus diversity» and strongly influenced by economic and reinsurance pricing cycles. In the wake of the 2008 global financial crisis, brokers advocated larger panels to increase diversification and minimise counterparty risk. Previously, driven by the US liability crisis in the mid-1980s, «reinsurance clubs» had formed and exerted substantial influence on pricing. In the aftermath of the terrorist attacks of September 11, 2001, major reinsurers again imposed drastically tightened conditions on their clients.

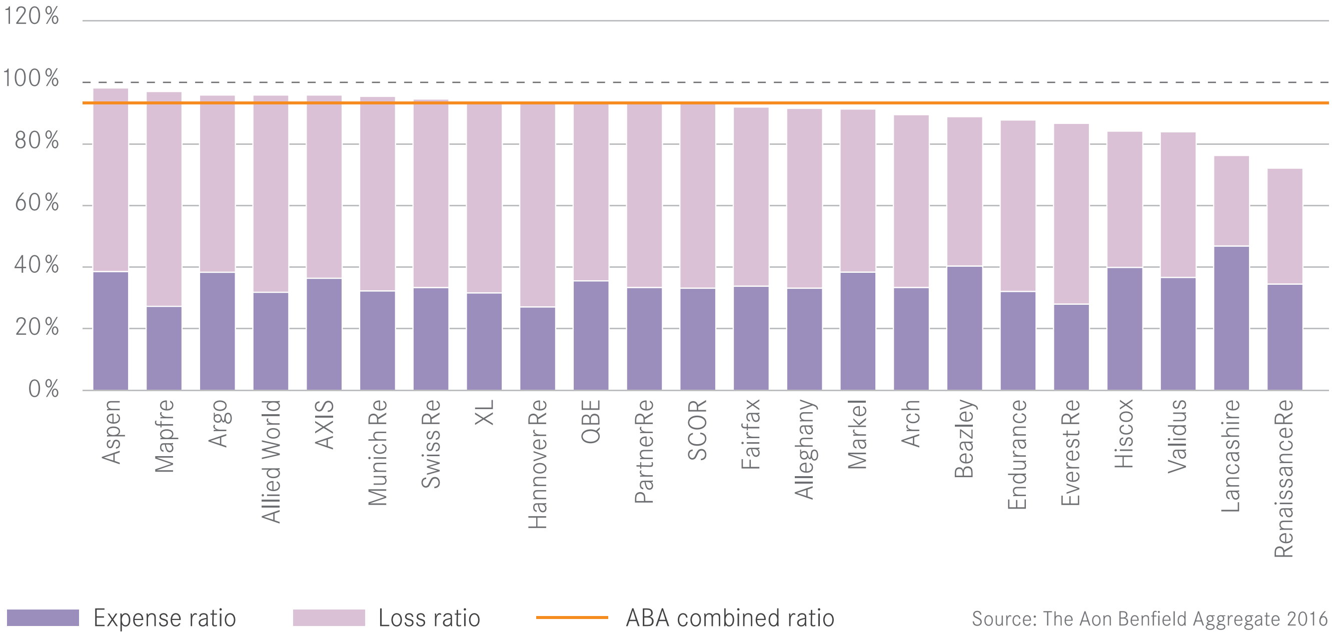
Nowadays, given the glut of capital and alternative sources of capacity, the traditional notion of reinsurance cyclicality is in question. Some pundits believe that it is sufficient for cedants to spread their risks among a small number of large reinsurers. Consequently, the argument goes, tier 2 and tier 3 reinsurers will eventually be squeezed out of the market.

In addition, the implementation of Solvency II favours the larger and higher rated players over the smaller ones which offer cedants fewer benefits from solvency relief. Furthermore, in times of scant top-line growth, massive technological change and the emergence of new and disruptive channels of distribution and product designs, cedants are thought to seek reinsurers that provide proven market and product expertise and the ability to partner with their clients to jointly innovate and expand into new areas.

## Smaller players may outperform larger counterparts

However, this apparent superiority of large reinsurers needs to be taken with a pinch of salt. While larger carriers indeed show lower expense ratios, the picture is more nuanced with regards to claims ratios where smaller and more focused competitors frequently have an edge. As exhibit 2 shows, smaller reinsurers can very well achieve an above-average underwriting performance in an average catastrophe year like 2016.

**Exhibit 2:** Combined ratios for fiscal year 2016



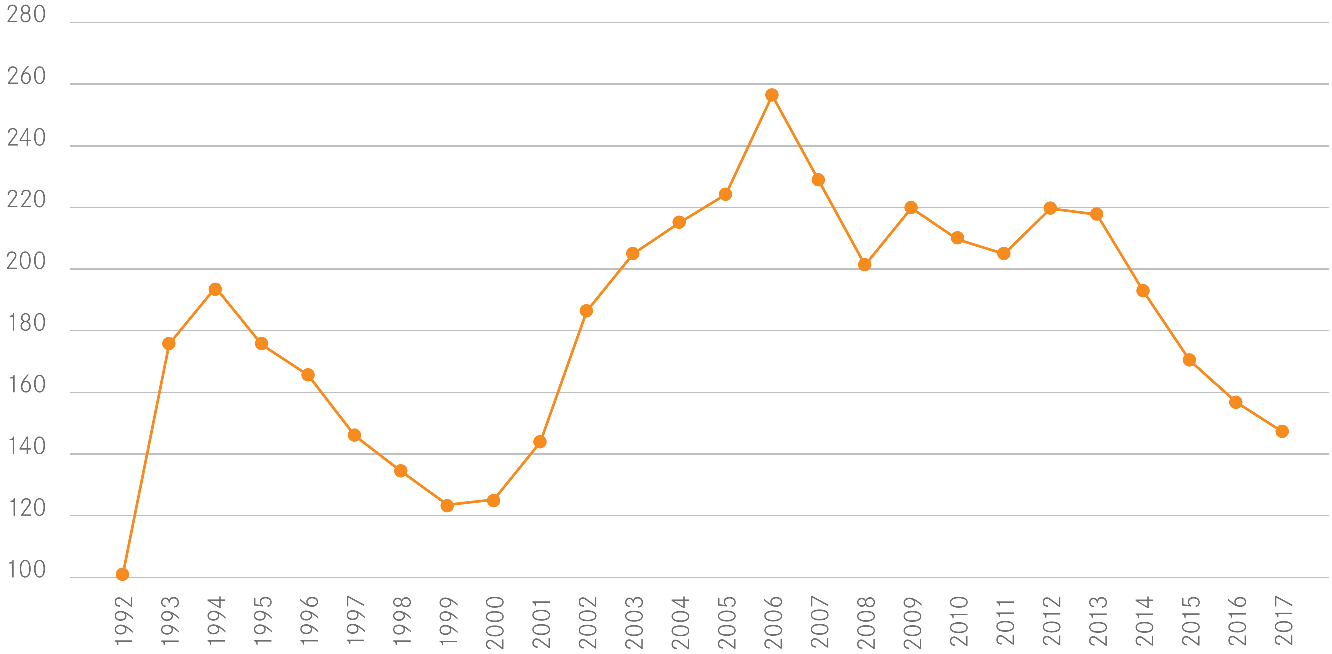

Source: The Aon Benfield Aggregate 2016

Crucially, cedants remain sceptical as to the supremacy of size over diversity. They remember times when a cataclysmic market-changing event led to a drastic depletion of capacity. In addition, as the financial crisis has shown, even large and top-rated market players can run into serious difficulties. In order to minimise counterparty credit risk cedants typically prefer to work with more than just a handful of reinsurers.

Besides default risk, cedants seek a healthy degree of diversity. A concentrated reinsurance panel may well result in a weaker negotiating position for cedants. They would sacrifice flexibility to enforce their own reinsurance conditions, thereby strengthening their risk management capabilities. Cedants generally allocate an exposed share of 10–15% to a limited number of lead reinsurers and supplement this allocation with smaller participants on the panel. This approach helps cedants retain flexibility and access to a variety of risk portfolio steering opinions.

In addition, reinsurers tend to be publicly listed. Driven by their shareholders' interests they tend to act in unison, particularly in the wake of major losses. As the rate levels for catastrophe reinsurance in exhibit 3 illustrate, massive surcharges occurred after events such as Hurricane Andrew in 1992 or the terrorist attacks of September 11, 2001. At this time the global market for catastrophe reinsurance was relatively concentrated. Subsequent to the large loss events, the market tightened significantly and cedants were confronted with rapid rate hikes which they could only cushion through a drastic increase of their retentions. Similarly, after the outbreak of the 2008 global financial crisis, rates surged and capacity contracted with respect to credit coverage. These reactions reflect the similarity of reinsurers' portfolios and their uniform approach to cycle management. Cedants can mitigate the repercussions of this by adequately diversifying the structure of their panels.

Exhibit 3: Global index of prices for non-proportional catastrophe reinsurance

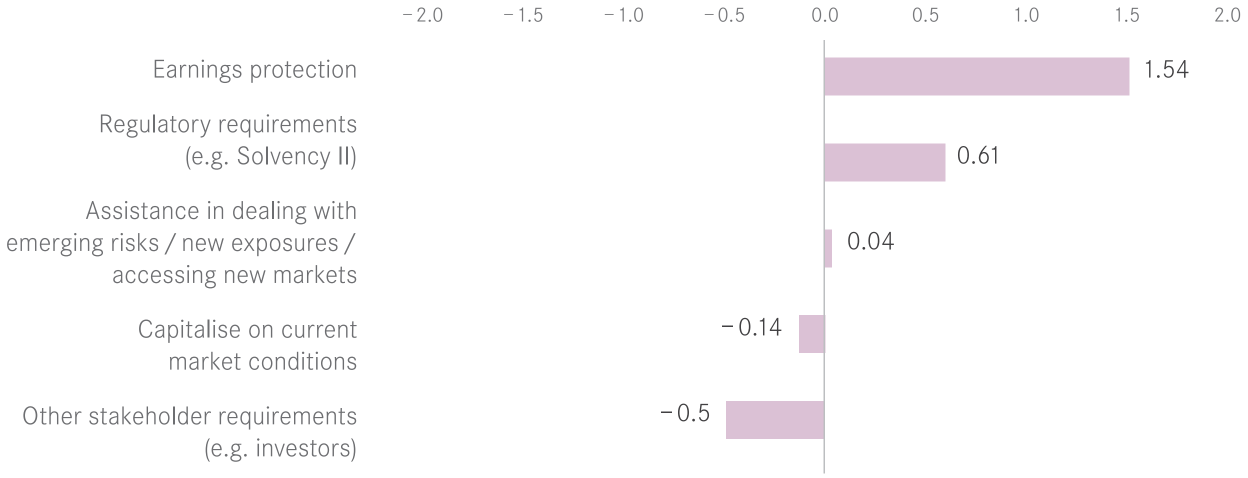



Source: JLT Re's Risk-Adjusted Global Property-Catastrophe Reinsurance Rate-on-Line (ROL) Index

Further to these quantifiable risk considerations, there are a number of qualitative reasons for promoting sufficient diversity in the reinsurance panel. In many cases, the most successful market innovations originate from specialised and entrepreneurial niche providers. Such capabilities make smaller reinsurers attractive to cedants and can offset competitive disadvantages in areas such as capital base and financial strength ratings. Moreover, specialised reinsurers may offer an alternative form of customer service and support, e.g. based on a higher degree of staff continuity.

# The empirical picture – Interviews with European reinsurance buyers

Exhibit 4: Strategic motivations for buying reinsurance




On a scale from – 2 (not relevant) to + 2 (very relevant)

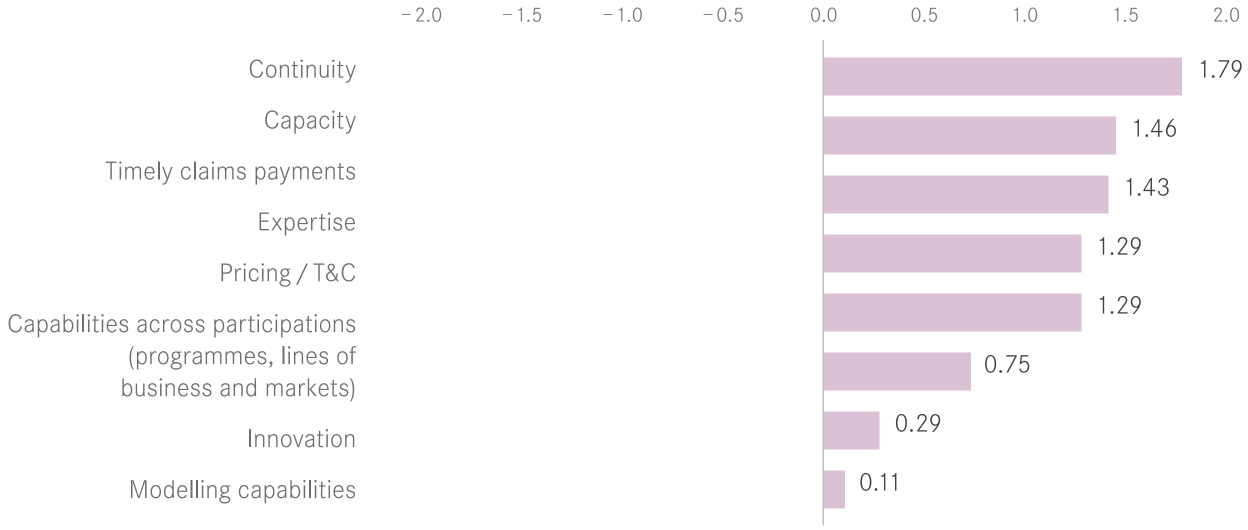
Earnings protection is the primary objective for the interviewees (see exhibit 4). On a scale from – 2 (not relevant) to + 2 (very relevant) the rating came in at 1.54, near the top of the range. Insurers aim to shelter their balance sheets against adverse shocks and the resultant earnings volatility. This is particularly true for those insurers with a predominantly national or even regional book of business and an exposure to large natural catastrophes, like some earthquake-exposed Italian insurers. In contrast, the larger and well capitalised national insurers seek to protect their equity or improve their capital efficiency by transferring risk to globally diversified reinsurers.

Regulatory requirements, especially from Solvency II, play an important role too, but are perceived as less relevant than earnings and balance sheet protection. Similarly, requirements from other stakeholders, such as investors, are not a decisive factor for purchasing reinsurance cover. For the insurers interviewed, the reinsurance protection they purchase is a strategic tool to steer the company and not a function of stakeholder pressure.

Given the current low cost of reinsurance it might be tempting for insurers to purchase more cover, retain less risk and use reinsurance as a cost-efficient alternative to equity or debt. However, virtually all insurers polled emphasised that they base their reinsurance purchasing decisions on fundamental strategic considerations rather than on short-lived market opportunities.

Finally, according to the insurance executives interviewed, the support that reinsurers might provide in assessing emerging risks or expanding into new business segments or markets, whilst welcome, is not a key motivation to purchase reinsurance.

Exhibit 5: Buyers expectations



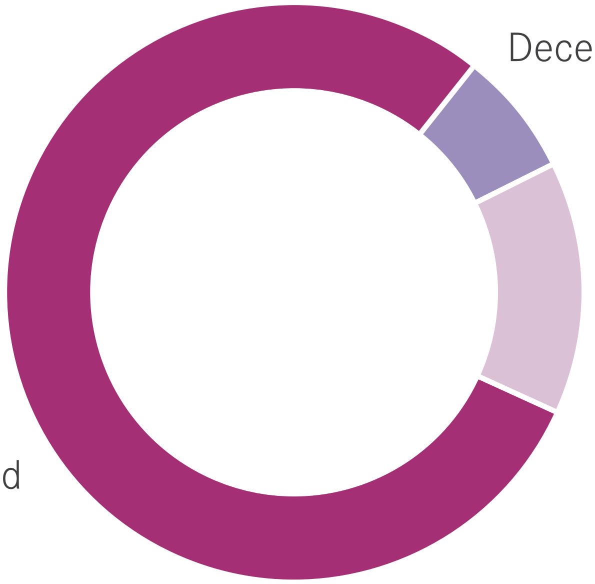

On a scale from – 2 (not relevant) to + 2 (very relevant)

Reinsurance is a business based on trust. The European insurers interviewed want to engage with their reinsurers in durable, long-term partnerships in which both parties invest and follow each other's fortune. With the exception of reinsurers concentrating on short-tail risks, it can take years to be accepted on a European insurer's panel of reinsurers. Some interviewees even mentioned that some of their reinsurance relationships are more than a century old. Continuity is therefore seen as paramount. Not only did continuity receive the highest rating (see exhibit 5), but it was also recurrently named as the most important attribute that a reinsurer brings to the table.

Sizeable capacity and timely claims payments are clearly important to cedants and largely taken for granted in the current competitive environment. Expertise is viewed as crucial too, but its relevance varies according to the size of the insurer. Those cedants with significant in-house expertise place less importance on this attribute. Specific expectations are also driven by the position of the reinsurer in the programme, namely whether they serve as a leader or a follower. Not surprisingly, competitive pricing and terms and conditions are necessities, too. Even those interviewees who consider themselves non-opportunistic buyers expect their reinsurers' pricing to reflect current market conditions.

Similar to the findings in exhibit 4 (emerging risks / business expansion), few interviewees expect their reinsurers to help them innovate. Most insurers emphasise that they know their markets and what works best. In fact, most players are comfortable with their in-house expertise. However, they are interested in innovative and efficient reinsurance solutions to cover new risks such as cyber. Modelling capabilities rank last among cedants' expectations. Those without in-house capabilities tend to rely on brokers for modelling support.

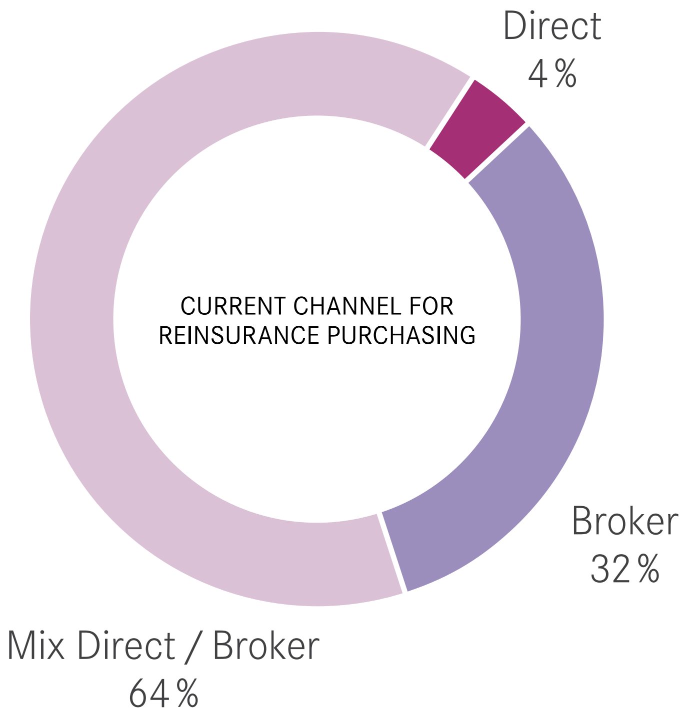
Exhibit 6: The organisation of reinsurance buying behaviour

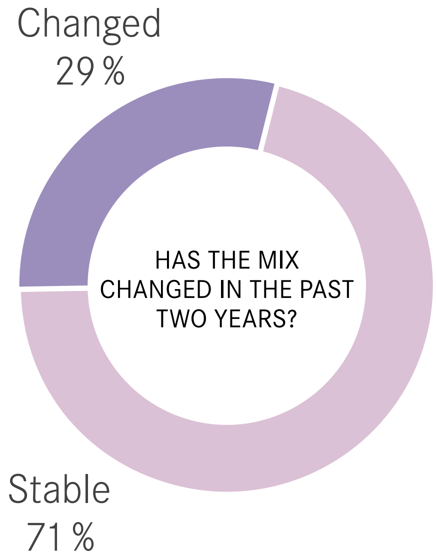



As shown by exhibit 6, reinsurance purchasing is conducted centrally by 79 % of interviewees. Typically the structure of reinsurance purchasing reflects the size of the organisation: Smaller national insurers with simple legal structures bundle their reinsurance purchasing decisions in one place or even with one person. In some cases, buyers differentiate according to the risk they cede. Larger, more complex programmes are dealt with centrally, while smaller excess-of-loss property or casualty covers (especially facultative) might be managed locally.

Whatever the preferred approach, the structure is not affected by current market conditions – another indication that European reinsurance buyers base their decisions on long-term considerations, rather than short-term opportunities.

Exhibit 7: Reinsurance purchasing channels



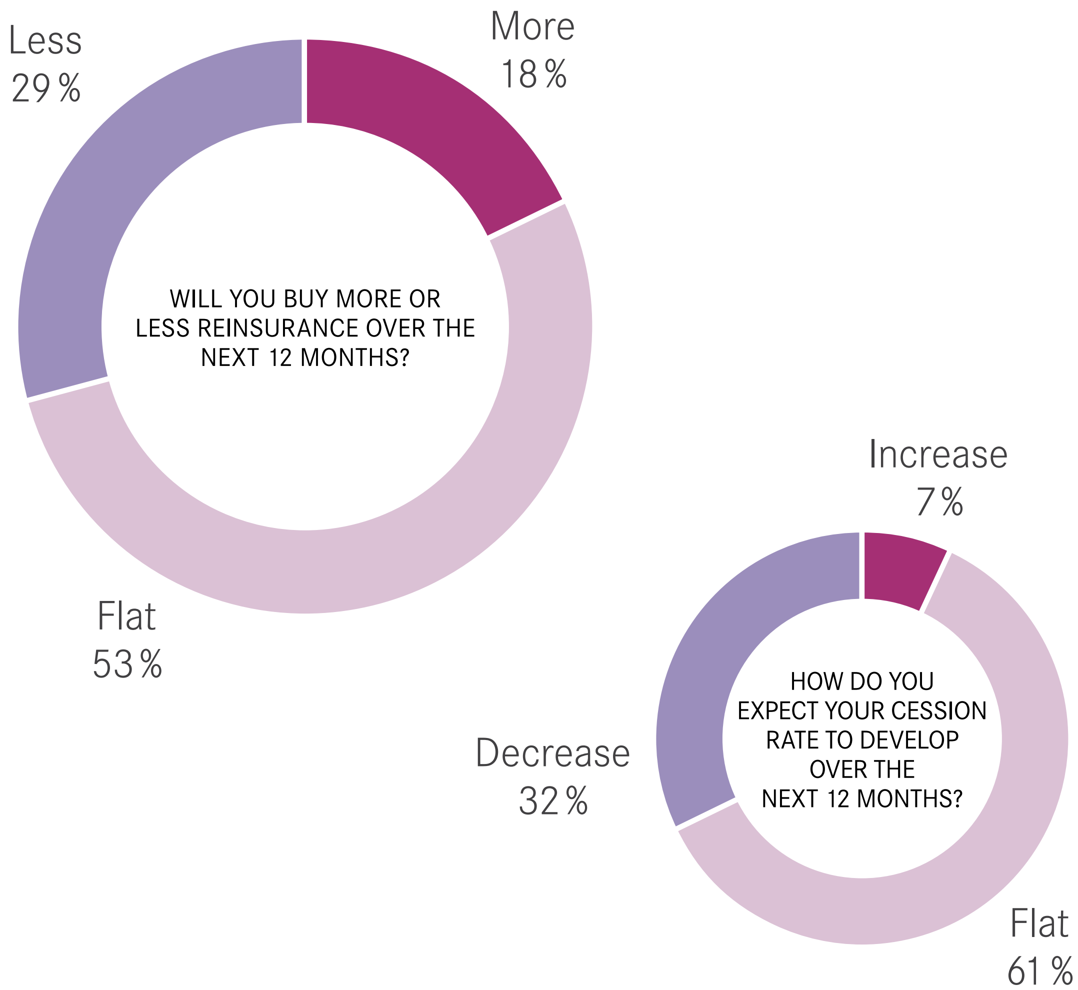





Brokers have firmly established themselves as an indispensable part of Europe's reinsurance purchasing landscape (see exhibit 7). The majority (64 %) of the insurers polled state that they buy reinsurance through a mix of direct and broker channels. One third transact all purchases through brokers. Insurers that pursue a mix typically differentiate according to the risks ceded to the reinsurance market. Long-tail casualty risks are frequently transferred directly to a relatively small number of tried and trusted reinsurance partners. In contrast, the more commoditised short-tail property and natural catastrophe risks are often ceded through brokers which manage the larger panels on their behalf.

Again, in respect of purchasing channels, insurers' approaches are fairly stable. For 71 % of interviewees, their preferred mix has not changed over the past two years, while 86 % do not expect the mix to change over the next 12 months. However, 29 % say that the relevance of the broker channel has increased as they broaden their panels (partially driven by the introduction of Solvency II), but also because brokers increasingly provide key services such as risk modelling.

Exhibit 8: Changes to the amount of reinsurance purchased



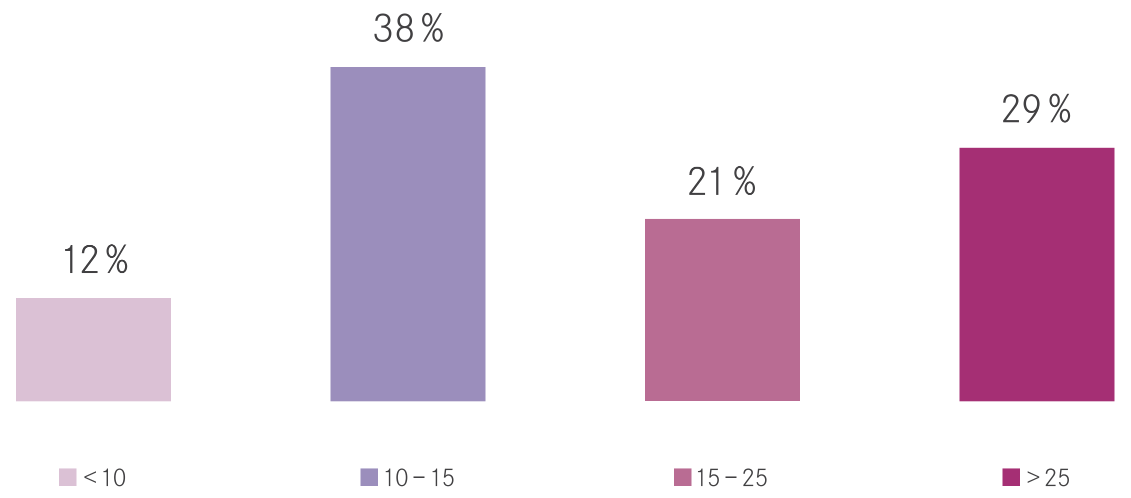

The majority of interviewees do not anticipate any changes to the amount of reinsurance purchased over the next 12 months or their overall cession rate (see exhibit 8).

However, a significant minority (29 %) expect to reduce the amount of reinsurance bought over the next 12 months. The shift from proportional to non-proportional covers continues and negatively impacts ceded premium volumes. The reasons for higher retentions are twofold: First, insurers retain more in order to boost their earnings. Secondly, many insurers have grown larger and financially stronger so that they can absorb more risk through their own balance sheets.

As a result, 32 % of polled insurers expect their cession rate to decline within the next 12 months.

Exhibit 9: The optimal panel size

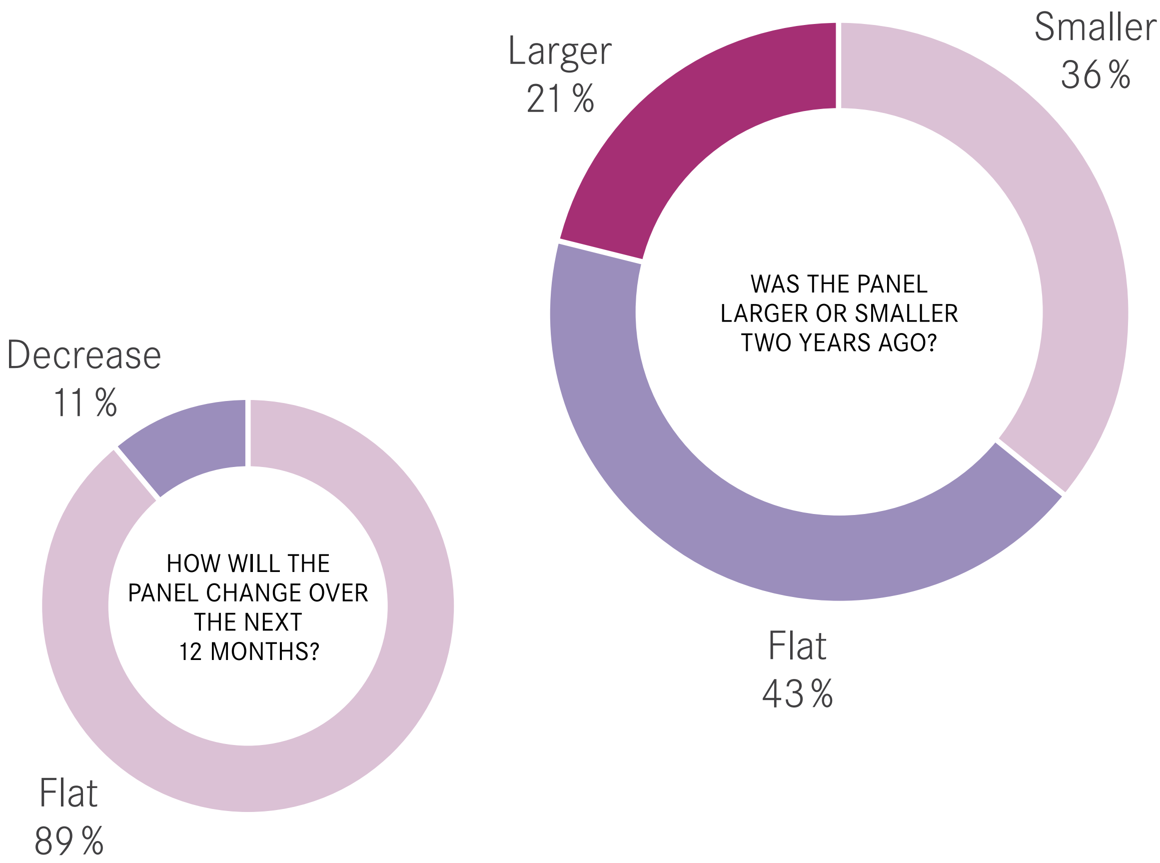
Optimal Size




European insurers operate with fairly large reinsurance panels (exhibit 9). Some 38 % of interviewees use 10 –15 reinsurers for most of their programmes. A further 50 % of the executives polled say that the number of reinsurer relationships is even larger, frequently exceeding 25 reinsurers. For most insurers a well-diversified panel is key because it assures stability, security and also access to a broad array of information and solutions, while mitigating the risk that the programme leaders develop a dominant position. Some interviewees expect reinsurers to take a minimum share as a proof of commitment and long-term engagement.

Naturally, the number of reinsurers on a panel depends on the specific programme. For short-tail risks the number of reinsurers can be larger. For long-tail risks, however, the number of reinsurers tends to be smaller, with higher individual shares. As mentioned before, insurers prefer to manage these (generally long-time) relationships directly, while they use brokers to deal with the larger and more diverse panels.

Exhibit 10: Trends in panel size

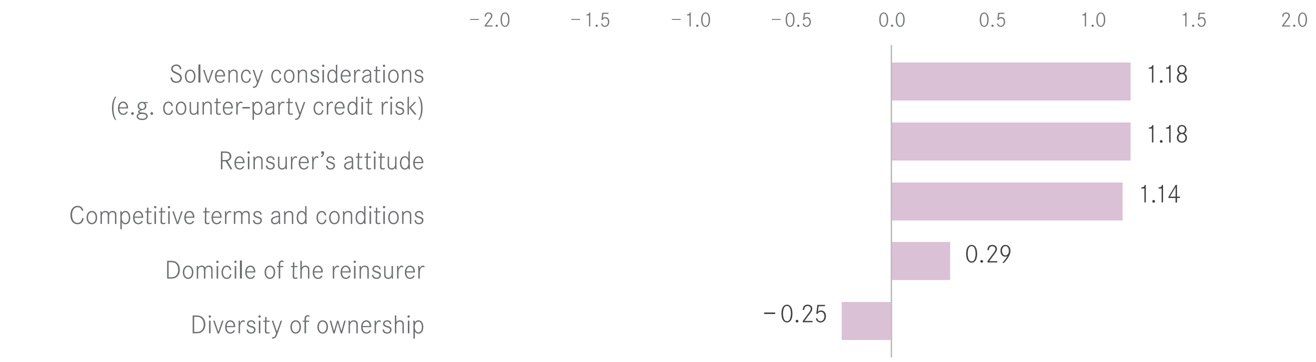



Over the past two years, reinsurance panels have remained largely unchanged or – contrary to popular belief – even increased in size (exhibit 10). Some 21 % of interviewees stated that their reinsurance panel reduced in the last two years, although surprisingly this was not of their own making, but predominantly due to mergers and acquisitions among reinsurers or because reinsurers retreated due to unfavourable pricing.

For 36 % of interviewees, the panel grew as insurers aimed to improve their diversification and reduce their dependency on larger reinsurers. Many interviewees also said that under the current soft market conditions they are interested in running larger panels and establishing new relationships, also as a precautionary measure against a potential hardening of the global reinsurance market which, as discussed before, tends to come with a shifting balance of power in favour of larger reinsurers.

Going forward, 89 % of insurers expect their panels to remain unchanged. The few that expect a shrinking panel size point to further reinsurer consolidation as the main reason.

Exhibit 11: The case for panel diversity

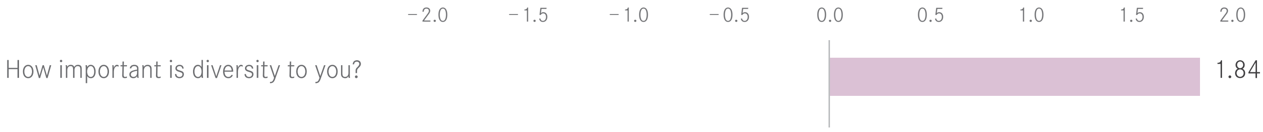



On a scale from – 2 (very unimportant) to + 2 (very important)

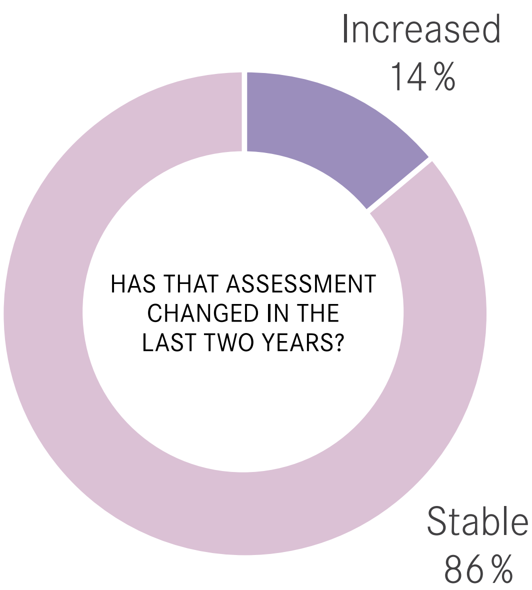
Solvency considerations, in particular the minimisation of counterparty credit risk, is the most important driver (see exhibit 11) for interviewees seeking diverse reinsurance panels. But of equal importance is the soft factor of having access to a diverse range of reinsurer attitudes and opinions, closely followed by competitive terms and conditions.

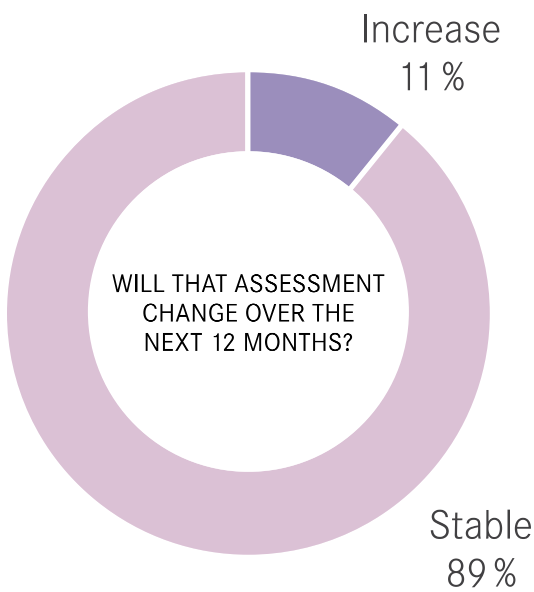
The diversity of reinsurer domicile is of less relevance, as reflected in the fact that many of the polled European cedants deal with (Continental) European reinsurers only. Similarly, the diversity of ownership plays less of a role, because third-party «alternative» capital or other sources of capital (such as state-owned reinsurers) have only a relatively small footprint among European cedants.

Exhibit 12: The relevance of diversity




From – 2 (not important) to + 2 (very important)



Diversity and the risk diversification afforded by it are of paramount importance to European insurers. Almost all interviewees stated that diversity is «very important» to them. They consciously diversify their panels among reinsurers' rating, available line sizes, product and market expertise, client relationship management approach and time horizon.

Close to 90 % of the insurers interviewed have neither changed their assessment of diversification in the past two years, nor do they intend to do so in the coming 12 months (see exhibit 12).

Reinsurers are frequently categorised into tiers – similar to the banks. For our interviews, we defined tier 1, 2 and 3 reinsurers as those with shareholders' funds of more than US $ 5 billion, between US $ 1 billion and US $ 5 billion and less than US $ 1 billion, respectively. Some pundits argue that the current soft-market conditions favour the tier 1 reinsurers, suggesting that a panel composed of these players would be sufficient to cover all cedants' needs in terms of security, rating, expertise and capacity.

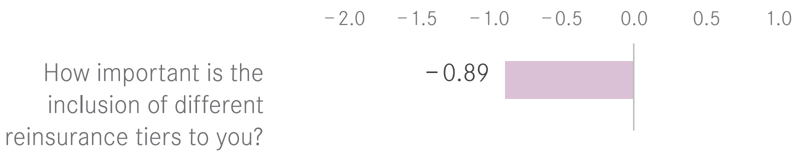
However, for the European insurers interviewed, tiering driven by size is hardly relevant (see exhibit 13). All interviewees stated that they include reinsurers from all three tiers on their panels in order to maintain a balanced mix between strong leaders and a larger group of followers. Clearly, in reinsurance size is closely linked to rating, capacity and know-how, but insurers are wary of and keen to mitigate the dominance that frequently comes with size. In addition, they value smaller players for their frequently superior record in areas such as continuity, reliability and responsiveness.

Again, long-term strategic considerations underpin the composition of the reinsurance panel, not current market conditions. Insurers' attitude to tiering has neither changed in the last two years, nor do the interviewees foresee major adjustments going forward. In fact, only market dislocations, such as a dramatic drop of capacity, rating actions or price upheavals could trigger a materially different weighting of the three tiers on panel. For most interviewees, this is a fairly speculative and unlikely scenario.

Exhibit 13: The relevance of tiering

| COMMENTS ON RELEVANCE | Number of mentions |
|---|---|
| Tiering not relevant | 10 |
| Diversity and mix of all sizes matter | 9 |
| Relationship and attitude matter | 5 |
| Size = Rating => rating matters | 4 |
| Avoid dominance | 3 |
| Size = Capacity => need large capacity | 1 |

| DRIVERS OF CHANGES TO TIERING | Number of mentions |
|---|---|
| No change, tiering not relevant | 11 |
| Reflection of market conditions, rating, capacity, pricing | 4 |
| Reinsurers' withdrawal | 4 |
| Soft vs. hard market conditions (reinsurers' loyalty) | 2 |




On a scale from – 2 (very unimportant) to + 2 (very important)

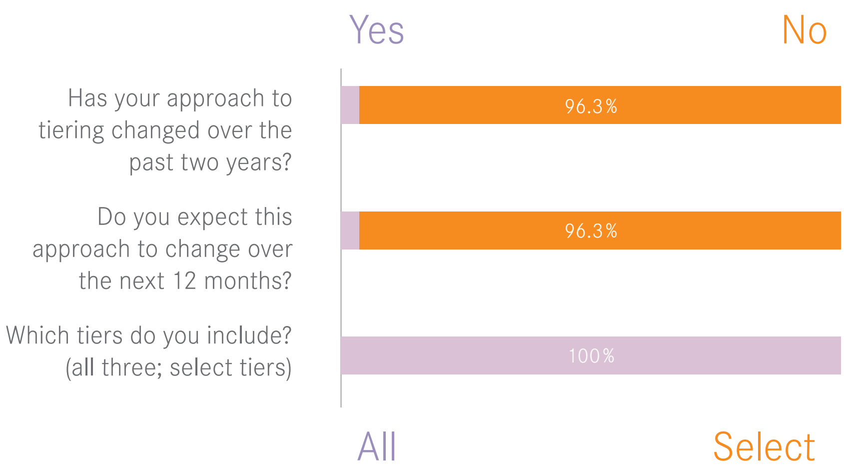
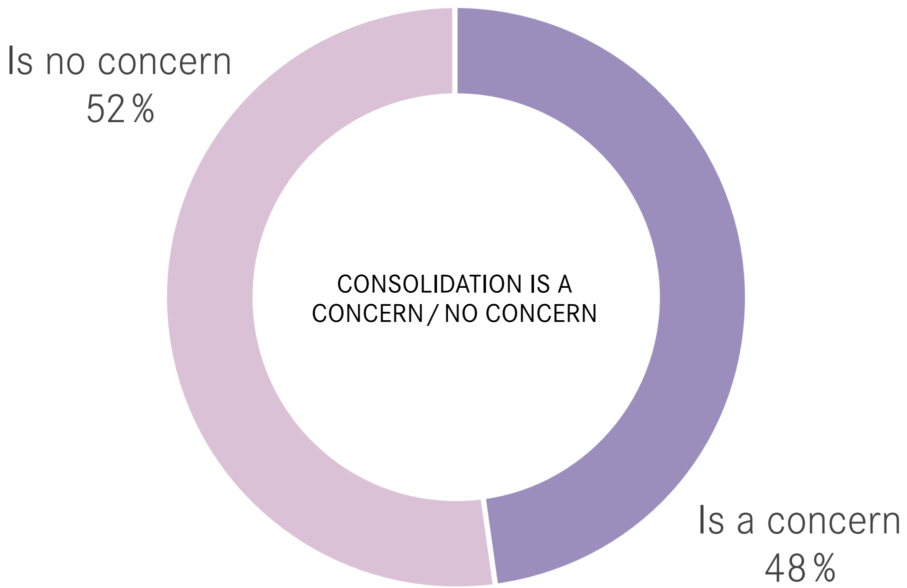


Exhibit 14: Consolidation in reinsurance

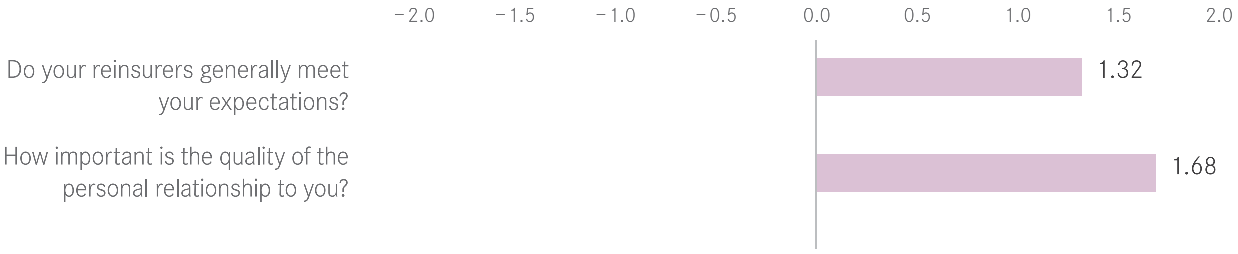
| STATEMENTS | Number of mentions |
|---|---|
| Concern – not in our interest | 4 |
| Avoid reinsurers build up too much share | 3 |
| Fewer reinsurers, less choice | 3 |
| Reduction in capacity not in our interest | 2 |
| Market is working – M&A not dramatic | 9 |
| Reflection of soft market conditions | 8 |



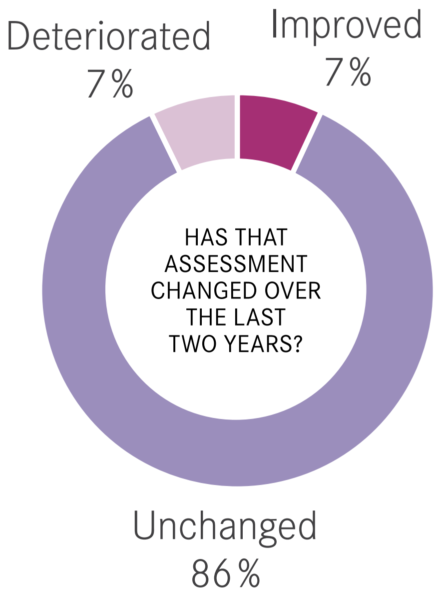
The reinsurance buyers polled are fairly relaxed about recent mergers and acquisitions in the reinsurance industry. For more than half of the interviewees, it is of no concern. Many dismiss the notion of an «M&A wave» and consider it hype. Interviewees believe that the market is working. Insurers say that, despite some recent M&A activity, they have no difficulty in obtaining the quality of service or the capacity that they seek. To them, the reinsurance industry is far from being an oligopoly dominated by a few players.

However, 48 % of interviewees stated that consolidation among reinsurers is not in their interest as it could lead to a loss of choice and a concentration in market power. But they do acknowledge that reinsurer consolidation is a natural phenomenon in a prolonged soft-market cycle.

Exhibit 15: General satisfaction with reinsurers




WHAT SHOULD REINSURERS DO TO IMPROVE YOUR SATISFACTION?
(Rank according to relevance: 4 = top, 0 = bottom)

As demonstrated in exhibit 15, the European insurance executives interviewed are generally satisfied or very satisfied with the services provided by their reinsurers. On a scale from – 2 (very dissatisfied) to + 2 (very satisfied) the average rating came in at 1.32. Not a single interviewee assigned a neutral or negative rating. The assessment is also very stable. Some 86% of all interviewees said that they have not altered the rating of their reinsurers in the past two years.

This favourable assessment is hardly surprising when one takes into account the rigorous vetting process that reinsurers have to go through before they are admitted to a European reinsurance panel. Changes to the panel composition are rare, not least because of the major role played by personal relationships.

Reinsurance is a business based on trust and confidence, especially so in Europe. Personal relationships matter greatly, as confirmed by an overwhelming majority of interviewees. On a scale from – 2 to + 2 the average rating was 1.68, i.e. in the very important range.

Of course, even though rated highly, reinsurers always have room for improvement. As shown in exhibit 15 this is particularly true for «continuity of support» and more flexibility in terms of pricing, terms & conditions and structure of cover. However, the perceived need and room for improvement is least pronounced in the area of innovation and market expansion support (see exhibit 15).

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