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SI Re

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Claims reserving practice in global reinsurance – time for a reality check

Editorial Bertrand R. Wollner, CEO

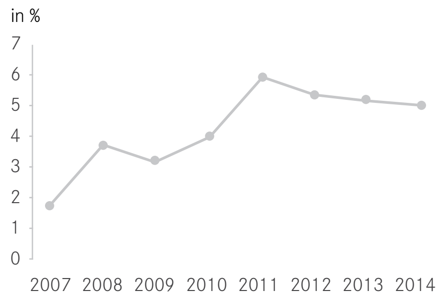
The persistent «softness» of the reinsurance market has dominated debates within the industry for years. However, on closer scrutiny, it turns out that for the last four financial years most reinsurers were able to earn double digit returns on capital, despite the continuous – and sometimes dramatic – collapse of prices.

There are two main reasons for this: First, for almost ten years, thus since the start of the current «soft» market phase, companies around the globe have been releasing claims reserves for previous underwriting years, with a corresponding impact on net income (see chart 1). Second, claims for insured natural perils have remained well below the long-term average since 2012 (see chart 2, which illustrates both effects).

Neither of these developments is sustainable. The next liability shock or the next major catastrophe of unexpected scale and character will most certainly occur. Therefore, at present, the industry is merely buying time to avoid already having to draw painful strategic conclusions from changes in the operating environment. These conclusions involve responses to the structural decline in demand for reinsurance, and to the constant inflow of alternative capital with expectations of returns below reinsurers' capital costs. These responses are being postponed, in particular, as global reinsurance markets continue to be highly competitive.

Aggressive reserving practices are not only unsustainable; they are also potentially very dangerous. There are numerous examples of this in the history of the reinsurance industry. We merely need to look back less than 20 years to find a similarly soft market environment in which reserving discipline was eroded. The sometimes catastrophic consequences became evident just a few years later, especially in the US liability business. Shareholders, regulators and cedents should pay close attention to these developments and should not lose sight of the «normalised» performance of individual reinsurers. In fact, such companies could soon find themselves forced to downsize their market presence substantially in order to maintain a minimum of profitability. This may apply even more so, since in today's zero interest-rate environment, investment income does not offer an effective buffer against the volatility of technical results. Furthermore, brash capital management with share buybacks at record levels has further reduced some players' ability to absorb fluctuations in results. Other reinsurers have undertaken acquisitions to deploy surplus capital – with the likelihood of success estimated at 50% on average.

CHART 1: RESERVE RELEASES IN GLOBAL REINSURANCE, IN % OF COMBINED RATIO



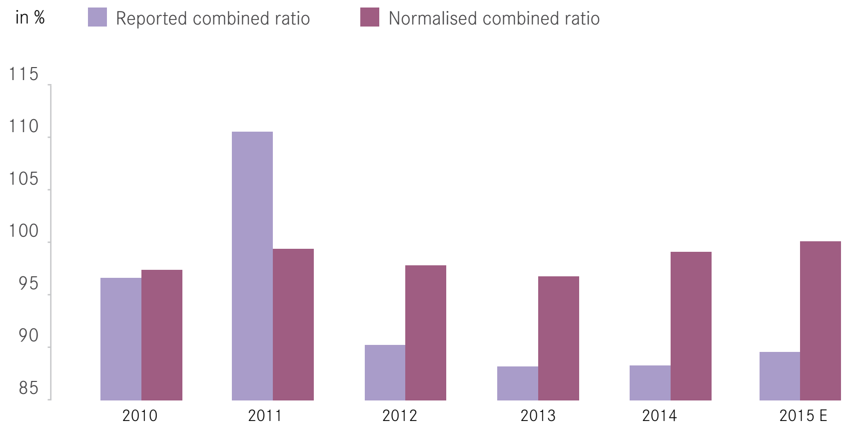
Source: Standard & Poor's, 2015

SI Re – Mutually yours

Sustainable, agile, committed

SI Re is committed to a conservative and sustainable reserving policy. Since the company was founded in 2004, the volume of its provisions has grown continuously – and at a faster rate than the underlying premium volume. A run-off loss was posted in only one single year to date. The pricing of all contracts is used to book a provision when premiums are received on each contract. If claims reserve notifications are higher, the provisions are revised. In the opposite case, they remain unchanged for several years after which they are not released, but are reposted to a higher, overarching reserve category according to specific criteria; alternatively, they are charged to a new accident year.

CHART 2: REPORTED COMBINED RATIOS OF GLOBAL REINSURANCE INDUSTRY ADJUSTED FOR FLUCTUATIONS IN PROVISIONS AND NATURAL PERILS CLAIMS



Source: Swiss Re, Global Insurance Review and Outlook, November 2015

The run-off results are assessed on an annual basis by both external and internal auditors, the regulatory authority (in connection with the annual Swiss Solvency Test), the rating agency as well as the responsible actuary. SI Re's reserving practice also undergoes a periodic actuarial review by external advisors. This approach allows us to strengthen the trust in our reserving practice on a continuous basis.

Analyses by Willis Re show that reported returns on equity in the reinsurance industry are substantially higher than the levels after adjustments for released reserves and below-average catastrophe losses. Assuming a normalised loss level and after eliminating the released reserves, reinsurers' return on equity in 2014 was only about 6 %, thus placing it well below capital costs – and thereby eroding value. This level of return is approximately equal to the return of a diversified and balanced ILS (insurance-linked securities) portfolio with moderate risk exposure.

Generally, reinsurers who act conservatively are in a better position to handle the challenges of this exceptionally long «soft» market rather than their more aggressive competitors, who weaken their reserve position year after year. This is all the more true as the pace of reserve releases has been slowing continuously since 2011 (see chart 1).

The last loss-intensive catastrophe years of 2010 and 2011 have largely «matured» and settlement is imminent. In view of the relatively low-margin years that followed, releases of reserves from short-tail business should very soon be an issue of the past. There is also less breathing space in the liability lines, as can be seen from isolated reserve corrections implemented recently by various market players, including some renowned names like AIG and Zurich Insurance Company.

These prospects exacerbate the challenges facing the industry: non-traditional capital with lower expectations of return, sluggish demand, falling rates, wider scope of cover – thus, ultimately more risk for less return. As a result, reinsurers will need to focus more on innovation, geographical expansion and cost efficiency in order to withstand the sustained, and potentially structural, pressure on returns.

The SI Re underwriting team

After more than ten years in the market, our company has matured into an established and solid European reinsurer with a reputation for consistency, stability and reliability. The core principles of our business approach are summed up in our corporate claim «sustainable, agile and committed». Our strong capital base is reflected in the «A-» financial strength rating awarded by Fitch.

«Our longstanding relationships are the best proof of the trust our clients place in us,» mutually agree the three Underwriting Managers Karine Wild, Nicolas Schmidhauser and Jürgen Hildebrand. They add: «When a client expands his commercial relationship with us and cedes more business, this is the ultimate sign of approval for us.»

Jürgen Hildebrand has been carrying responsibility for the German, Austrian, Nordic and Baltic markets for four years now. He has specialised in these markets as he was already familiar with them thanks to his previous underwriting experience at Converium. Equally, they are markets that require solid personal relationships in addition to technical knowhow. Jürgen also has a close affinity for the respective countries, their people and cultures outside of work. Business relationships, he says, naturally take time to develop, but if you sustain your interest in the cedents' business, you can develop and strengthen your position for the long-term.

From left to right: Jürgen Hildebrand, Karine Wild, Nicolas Schmidhauser

«In our markets, SI Re is respected for our stability, constancy and technical quality. Our cedents appreciate our relatively conservative and long-term approach to business relationships and to the risks we allow onto our balance sheet.»

Karine Wild is responsible for the markets France, Belgium and Luxembourg as well as her British clients. The French-Swiss dual national is a trained lawyer, who joined SI Re from SCOR in Paris in 2011. Karine has specialised in general and special liability coverage. She appreciates the company's short decision pathways, the considerable amount of personal responsibility, the manageable size of the team, as well as the holistic view of the markets.

Karine points out that the demanding markets in which she operates require many years of experience and good relationships to clients and brokers alike: «The attraction of liability business lies in

© Susanne Keller, detail of «Chicago Suite revisited»

supporting clients in a constantly changing legal environment. By the means of such a positioning in the long-tail business, SI Re has differentiated itself clearly from pure capacity providers.»

Nicolas Schmidhauser joined in 2009 from Converium, following the takeover by SCOR. In addition to his current responsibilities for the Swiss, Spanish, Portuguese and Italian markets, he looks after selected markets in Central and Eastern Europe. He manages a broad portfolio characterised by a mix of property/casualty and specialist insurers with differing legal norms.

«I liked the informal atmosphere, the distinctive business model and the opportunities for direct input at SI Re right from the very beginning, and these are the things I still appreciate today, seven years on.»

For Nicolas Schmidhauser, the biggest challenge is to meet the client's expectations in constantly changing market conditions while pursuing a consistent underwriting policy over time in order to ensure the committed and disciplined application of in-house guidelines.

When he is not in the office, you are most likely to find Jürgen Hildebrand at a football match, either enthusiastic in the stands or as an active player. He appreciates being on the go in everything he does and true to his motto, «sport unites». Karine Wild, on the other hand, is happiest when on a sailing boat, either on Lake Zurich or cruising the beautiful coasts of the Mediterranean. She also enjoys regular visits to Zurich's opera house. Nicolas Schmidhauser is a qualified tennis coach who loves to spend as much time with his family as possible and is often found with his nose buried in a volume of ancient history or science fiction literature.

SI Re further improves portfolio diversification

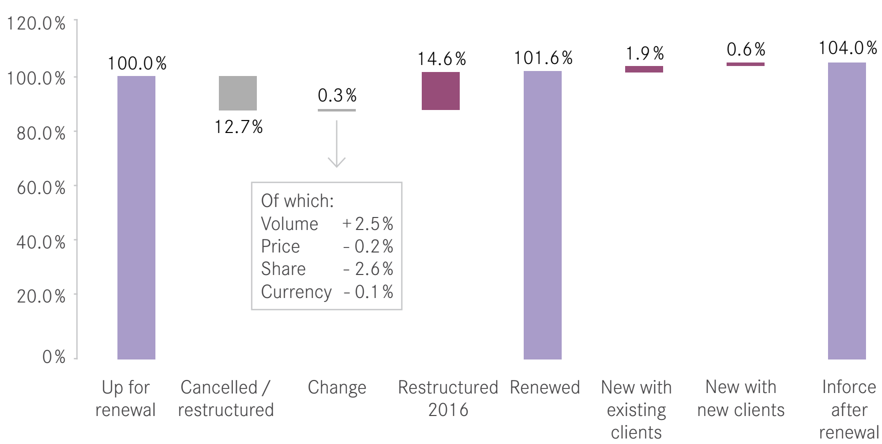
In the January 2016 renewals, SI Re continued its strategy of systematic portfolio diversification, thereby increasing its premium volume by 4 % and expanding its client base by 10 %.

According to Aon Benfield, global reinsurance capital remained unchanged at USD 565 billion year-on-year; however, the inflow of alternative capital has continued to climb and now stands at USD 69 billion. As alternative capital providers are willing to underwrite risks for lower return requirements than traditional reinsurers, rates are falling further. Thus, the influx of excess capacity – not just into natural catastrophe business, which now feels the impact by alternative capital providers, but also into other lines of business – is persisting. In the absence of more attractive investment opportunities, some reinsurers are merging or returning their risk capital to investors.

Notwithstanding these conditions, SI Re is continuing to deploy its dependable, prudent and selective business model to selectively underwrite contracts. SI Re writes 90 % of its premiums in the year-end renewal. We were able to increase our premium income by 4 %, to expand our client base by 10 % and to increase our number of contacts by 6 % for 2016. As can be seen on the graph below, we could grow the premium volume with the existing portfolio by 1.6 %. The decline of 13 % of premium volume due to retained or restructured business from our clients was more than offset by our efforts to increase our share of new and restructured business with existing clients, resulting in an 14.6 % premium increase. In addition, we generated additional premium of 2.5 % through new business with both new and existing clients. While SI Re further diversified its portfolio geographically, the mix of business lines remained virtually unchanged.

In the Nordic countries, SI Re took on moderate shares with several new clients, thereby improving its portfolio diversification. We also managed to expand our portfolio in Switzerland, Italy, the Iberian Peninsula and in Eastern Europe. Finally, new clients were acquired in Germany, France and Italy as well. In France and Benelux competition between reinsurers is currently very intense. We therefore decided to be more selective about how to deploy our capacity in these countries.

JANUARY 2016 RENEWALS



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