// Reinsurance after HIM – Existing business models put to the test

// SI Re reinforces its position in the January renewals

// Johannes Westhäuser, Junior Actuary at SI Re

SI Re

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Reinsurance after HIM – Existing business models put to the test

Despite continually eroding prices and persistently low returns on investment, the traditional reinsurance market managed to deliver satisfactory results up until September 2017. However, this was only possible as insured catastrophe losses since 2011 remained below the long-term average, while year after year reserves from prior underwriting periods could be released as profit. Global reinsurance capacity meanwhile continued to rise steadily, as did the share of alternative capital markets, which offered favourable refinancing opportunities to traditional reinsurers, thus further intensifying competition.

Only marginal capital erosion as a result of HIM – Overcapitalisation persists

In the third quarter of 2017, however, a virtually unprecedented series of natural catastrophes by the means of the tropical hurricanes Harvey, Irma and Maria (HIM) occured, which happened in quick succession and ravaged the USA and the Caribbean. Insured losses estimated at more than USD 130 billion confronted the reinsurance industry with its first acid test since 2011. However, the response of the market during the year-end renewals differed from that in previous catastrophe years: in light of the unchanged significant overcapitalisation of the sector as well as new capital inflows - particularly in the area of alternative collateralised capacity - in the fourth quarter, rate increases even for loss-affected programmes remained significantly below the expectations of reinsurers.

As illustrated JLT Re information in Figure 1, global reinsurance capital continues to exceed gross premiums considerably, namely by 17 % or USD 45 billion as of 31 December 2017, compared to USD 60 billion at 30 June 2017. This amount can be perceived as an indicator of the overcapitalisation of the market.

ILS continues to advance – despite HIM

The insurance-linked securities (ILS) market contributed significantly to holding back rate increases in the reinsurance markets following HIM. Although for the first time many investors suffered heavy losses in this asset class, they not only remained faithful to this investment class, but even increased their stake in order to participate in the anticipated (moderate) market hardening. According to Aon Securities, as of 30 June 2017 global alternative capital totalled USD 89 billion, as compared with USD 10 billion in 2005. At the end of the catastrophe-stricken third quarter, this amount had diminished by only USD 7 billion to a total of USD 82 billion, a figure nevertheless still slightly above the USD 81 billion recorded at 31 December 2016 (see Figure 2). Guy Carpenter estimates that, taking the fourth quarter into account, the total amount of alternative capital rose by 9 % in 2017.

The end of cyclicity?

The reliability demonstrated by the ILS market in light of the losses caused by HIM is remarkable and has exceeded the expectations of most market observers and players. Certainly, some participants question whether the moderate size of individual storms is really sufficient for reaching a conclusive verdict on the convergence market. But for many, the prudent response of the alternative market to this year's natural catastrophes constitutes evidence for the end of cyclicity in the worldwide reinsurance business. Whether this actually holds true remains to be seen, as similar assertions have been made repeatedly over the last two decades. It may still be too soon to speculate about the nature of a new equilibrium in the reinsurance market.

Doubts concerning the existing business model of the reinsurers

Be that as it may: HIM has triggered a fundamental review of existing business models in reinsurance. Numerous corporate executives seem to have come to the firm conclusion that the catastrophe reinsurance business – which over decades reliably delivered attractive returns – will remain structurally, and not just cyclically, under pressure. In the case of short-term peak risks, the alternative capital market has established itself as a permanent competitor for reinsurers. Large primary insurers will increasingly use those possibilities at the expense of the traditional reinsurance market. An exception to this trend will involve smaller primary insurers, who wish to maintain a close consulting and support relationship with their reinsurers and who shy away from both the complexity and the costs of alternative capital markets. But even here it seems to be only a question of time until innovative products and solutions will enable this market segment also to profit from the less costly alternative capital.

Moreover, it is not excluded that the ILS concept will also gain a foothold in other, less volatile lines of the reinsurance business. Although currently investors are not yet interested in risks with long settlement periods that are hard to model, financial innovations and technological breakthroughs (keyword: predictive analytics) could change that.

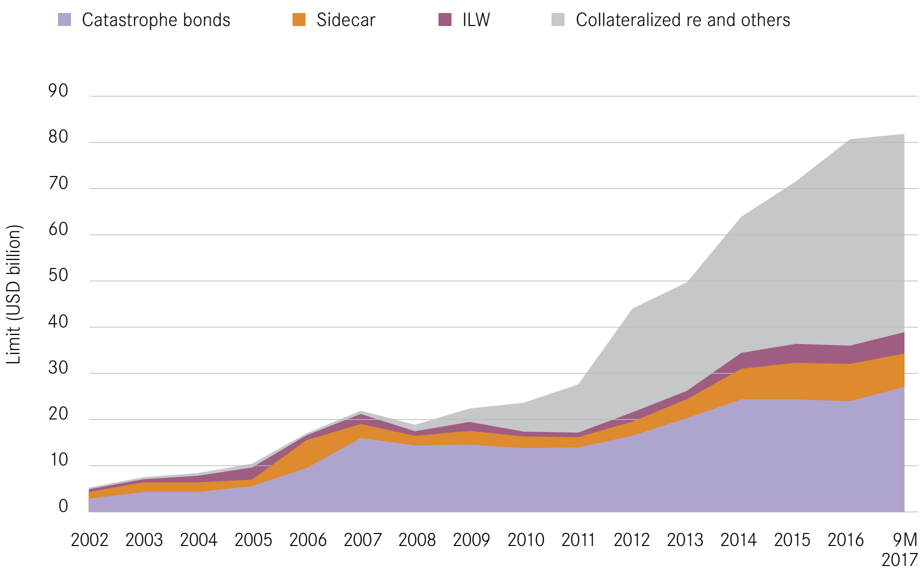
Cost efficient retrocession coverage and capacity transfer to other lines as responses

In reaction to this new market dynamic, various well-known companies have announced their intention to buy more retrocession coverage, in order to lower their own capital costs and to protect their balance sheet, in particular from ILS funds that make capital available

FIGURE 1: REINSURANCE CAPITAL AND PREMIUMS (WORLDWIDE, 1998-2017E)

Source: JLT Re

FIGURE 2: DEVELOPMENT AND COMPOSITION OF ALTERNATIVE REINSURANCE CAPITAL (2002-2017)



Source: Aon Securities Inc.

with relatively low return expectations. Furthermore, it can be expected that capacity restructurings will occur, away from the volatile catastrophe business and towards specialty and liability lines. Far-reaching changes should also be expected in the European reinsurance business as the result of a significant increase in competitive pressure, even if the triumphal march of ILS does not continue in this area.

Of course mergers and acquisitions (M&A) will be brought into play when discussing strategic responses. However, there is good reason to be sceptical , not only because of the sobering historical record of M&A in the reinsurance business, but also due to the fact that the increasingly flexible and efficient non-traditional capacity sources make sheer size less relevant as a success factor.

Global insurance gaps as a chance for «underutilized» capital

However, a balanced presentation of the current market situation must also include mentioning of the demand side. With growth of around 10% since 2008, reinsurance premiums have risen much more slowly than has primary insurance volume, thus additionally increasing pressure on rates. Naturally, this development is directly related to the increasing capital strength of cedants. On the other hand, reinsurers have not been – or rather are not yet – innovative and creative enough when it comes to covering large-scale social and economic risks.

It is a well-known fact that worldwide only about 30% of losses from natural catastrophes are insured, which most people associate first with developing and emerging countries. However, Western Europe itself includes striking examples of underinsurance, e.g. earthquake risks in Italy. According to Munich Re, not even 4% of the losses caused by the heavy earthquake of 2016 were insured.

But massive coverage gaps also exist in other areas, which are even more relevant from a macroeconomic standpoint, such as pension provisions and death benefits protection, where the shortfall for the EU is estimated in orders of magnitude that come very close to its total economic output (GDP). Reinsurers could, for example, collaborate in the development and marketing of simpler and less costly annuity policies or support direct insurers (including technology start-ups) who distribute death benefits policies with innovative product design and underwriting.

Uninsured cyber risks represent another great potential. The yearly economic costs of cyber incidents (whether of a criminal or non-criminal nature) are estimated globally at up to USD 500 billion. By comparison, worldwide cyber insurance premiums stand at approximately USD 3 billion, slightly more than one permille of total non-life premiums. It is obvious that at present cyber risks are almost completely uninsured. Doubts about the insurability of such risks are still great, predominantly due to a lack of historical data, the highly dynamic nature of the underlying risks and incalculable cumulative risks.

Development of new risk pools in the digital world

Another substantial possibility to develop new risk pools for reinsurers consists of partnerships with technology platforms. Already now in China technology companies such as Alibaba and Tencent offer insurance products that are based on their intimate knowledge of clients and superior brand strength, and which pass on their underwriting risks to licensed insurers. Such possibilities will also open up in Europe in the foreseeable future, and are already being cited as a reason for the possible participation of SoftBank in Swiss Re. It should certainly be decisive in this regard that it continues to be unattractive for technology firms from a return and risk perspective to take over the entire value chain of a fully capitalised and regulated insurer.

To summarize: The reinsurance industry must adapt to structural and fundamental changes on the supply side. The unbridled advance of alternative capital, possibly also in new lines, requires a reassessment of existing business models. Beyond defensive and reactive responses, however, countless opportunities are available on the demand side for reinsurers to expand market volume proactively and, in so doing, reduce the onerous surplus capital in the market or distance themselves from its influence.

SI Re reinforces its position in the January renewals

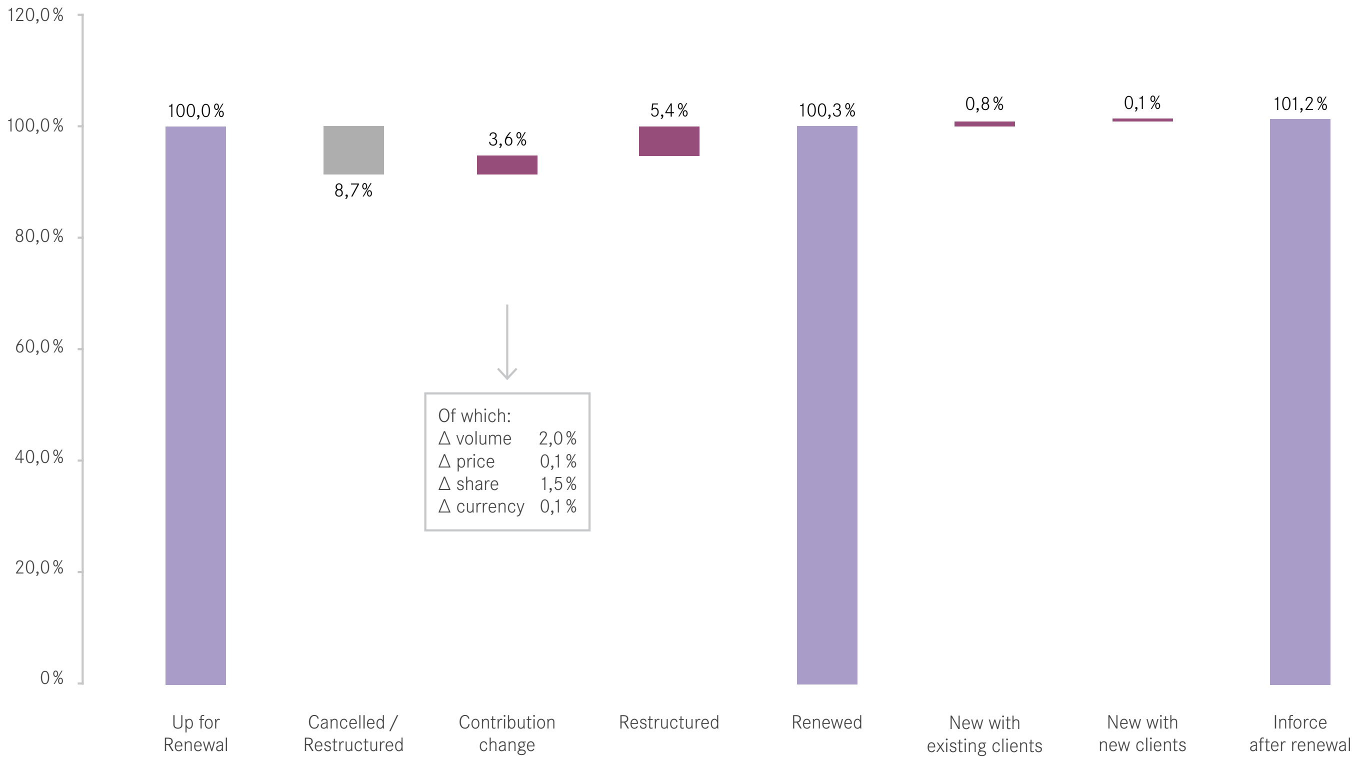
In the recent January renewals SI Re recorded a moderate premium growth of 1.2 %. Additional business with existing clients accounted for two thirds of this growth. The primary objective of the company was to consolidate the above-average volume and client growth of the previous year and, wherever possible, to strengthen its position in existing programmes. Although rates in the company's European core markets remained at a low level, SI Re succeeded in implementing price increases of 0.3 % in its third-party business.

Despite record losses from natural catastrophes in 2017, reinsurers were unable to impose significant rate increases across a broad front in the latest renewals. In most lines, prices remained largely unchanged. In light of the steady rate decline in recent years, however, this already should be considered a success. Capacity is still amply available. On an adjusted basis, only marginal rate increases were recorded, even in the European natural hazards business. The relatively low regional insured loss burden in 2017 dominated the renewals, whereas global factors did not play a decisive role. In other lines, such as property, motor and general liability, rate increases were limited to loss-affected contracts. Commissions in the proportional business also remained on the whole at the previous year's level.

Against this backdrop, SI Re focused in the January renewals on optimising its portfolio and reducing the occurrence probability of natural catastrophe events. The renewed portfolio grew by 1.2 %. Following the extraordinary premium growth of 12 % in the previous year's renewals and an increase of 17 % in the client base, a consolidation of the newly established client relationships as well as of the traditional cedant base was of paramount importance for SI Re in the portfolio renewal. In particular, SI Re was keen to adapt those of its own exposures that subjected it too closely to natural catastrophe risks by raising the attachment points.

SI Re renewed almost 100 % of its existing book at the turn of the year. This time premiums in the amount of EUR 132 million were up for renewal. 8.7 % of the

FIGURE 3: RENEWALS AS PER 1.1.2018 – OVERALL BUSINESS



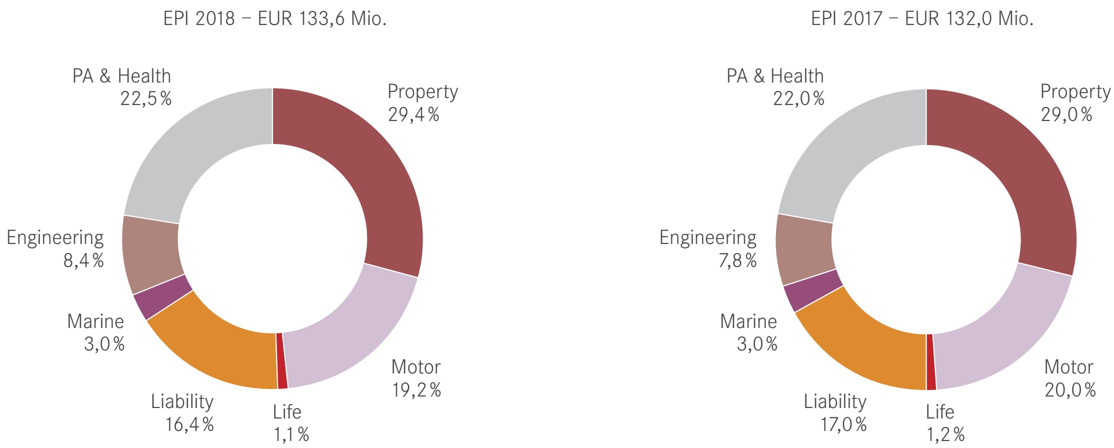
book was cancelled or restructured – 94 % of these cancellations were initiated by SI Re (see Figure 3). This reduction was compensated by volume and share increases as well as slight rate increases. While prices increased on average by 0.1 or by 0.3 % in third-party business, SI Re succeeded in expanding its shares by 1.5 %. The additional volume growth is attributable almost exclusively to new business with existing clients, whereas in the previous year the lion's share of portfolio expansion derived from new clients.

Against the backdrop of this stable development, the central indicators of the portfolio remained largely unchanged: As in the previous year, SI Re earned about 60 % of its premiums in the third-party business, i.e. with cedants outside of the SIGNAL IDUNA Group. More than 80 % of all clients are, like the parent company, mutual insurance associations with whom a close «natural» affinity exists. More than 70 % of the book is based on proportional reinsurance policies. All business in the renewals is written in Continental Europe. Germany, with 19 % (the portion of the total volume generated by external business) is the largest individual market, followed by France/Benelux and Austria.

The largest business lines include Property, with 29 %, Health with 22 %, Motor with 19 % and General Liability with 16 % (see Figure 4). Shifts in shares between the individual lines totalled less than one percentage point. With a share of over 60 % of total premiums, the long-tail business continues to constitute the central pillar of SI Re's business strategy.

SI Re remains committed to a disciplined underwriting policy. This principle is reflected in a refusal rate of 81 % in case of new business requests, compared with 56% in the previous year. 42% of offers were declined for price reasons, 49% on the grounds of strategic considerations and 9% due to their incompatibility with the underwriting guidelines of the company. In summary, SI Re used the January policy renewals to further pursue its business strategy by resolutely and successfully strengthening its well diversified book in Europe and in the traditional property and liability lines.

FIGURE 4: LINE SPLIT ON AN UNDERWRITING YEAR BASIS



Johannes Westhäuser, Junior Actuary at SI Re

For one and a half years Johannes Westhäuser has already been working as a Junior Actuary at SI Re. The German native joined the company while still finishing his studies of mathematics at the Julius-Maximilian University of Würzburg. His interest in the reinsurance industry was already awakened by one of his university professors, who incorporated questions related to reinsurance in lectures on extreme value theory, thereby opening the student's eyes to the «world beyond primary insurance».

Johannes Westhäuser's tasks at SI Re are manifold. He is an integral part of the three-member actuarial team of the company, which he supports on all questions concerning the pricing of reinsurance programs as well as setting-up of loss reserves. The first 18 months passed by in a flash. Most importantly during the two major January renewals he was busy assisting the team with the evaluation and pricing of policies and was thus able to quickly gain deeper insights into the most important aspects of the core business.

Johannes Westhäuser particularly appreciates the manageable size of his employer, the positive and friendly work atmosphere and the short decision paths, which greatly facilitate the every-day work. Particularly in the case of cross-team projects, for example for the evaluation of new policies, the close cooperation between the actuarial and underwriting teams is indispensable, although SI Re distinguishes very clearly the autonomous responsibility of both functions.

According to Johannes Westhäuser the insurance industry is confronted by its largest challenges in how it will be handling new trends and risks, for example the increasing digitalization, the emergence of alternative mobility concepts (telematics, autonomous mobility) as well as new statutory and regulatory provisions, such as the European Union General Data Protection Regulation. In addition, new market entrants and business models are among the challenges facing the industry in the future.

In addition to his job with SI Re, Johannes Westhäuser is completing his studies as an actuary (SAV) at the ETH Zurich in a program extending over several years and involving a total of ten different testing modules. Although the training is quite demanding, he nevertheless finds time to enjoy the Swiss Alps while hiking and skiing or to relax when playing a soccer match.

SIGNAL IDUNA
Reinsurance Ltd

A subsidiary of
SIGNAL IDUNA Group

Bundesplatz 1
Postfach 7737
CH-6302 Zug
Switzerland
Telephone +41 41 709 05 05
Fax +41 41 709 05 00
www.sire.ch