// A look at what's ahead for the insurance industry

// Renewals 2012: SI Re maintains steady growth trajectory despite unfavourable conditions

SI Re

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A look at what's ahead for the insurance industry

Editorial Bertrand R. Wollner, CEO

The gloomiest scenarios forecast for 2012 have failed to materialise. The Eurozone has been able to stabilise itself for the time being, the budget dispute in the USA (fiscal cliff) was largely defused with a series of compromises, and the Chinese economy has dodged a hard landing. Further shocks to the world's financial infrastructure – and subsequent setbacks for the global economy – were thus avoided, allowing the global insurance industry to catch its breath for a moment as well.

However, neither is any indication of any return to business as usual in the offing. The European debt crisis is as acute as ever; whereas the insurance industry is experiencing a massive inflow of non-traditional capital while having to adapt to rising loss trends and market changes in the natural catastrophe segment.

ACUTE SOVEREIGN DEBT AND STRUCTURAL CRISIS IN EUROPE

The sovereign debt crisis has piled further burdens upon the financial services industry, compounding to the disruptions that at times threatened its very existence in 2007 and 2008. While massive expansion of the money supply by the central banks of the USA, UK, Eurozone and Japan has brought some short-term relief to the financial markets, the structural problems that led to the current crisis have yet to be addressed. The continuous decline in industrial production and competitiveness in Southern Europe since the launch of the euro remain the greatest challenge. As a direct result of steep increases in unit labour costs, production indices in these countries have sunk below levels last seen in 1998. Thus, rather than bringing about economic convergence, the «euro project» has widened the rifts within Europe. These unsolved structural problems and the associated vulnerability of global financial markets as well as national economies alike are without doubt the major concerns (re)insurers are still facing.

The insurance industry also has to prepare itself for lower current income from their bond portfolios and faces the threat of high unrealised losses once interest-rate policy shifts. Given such a backdrop, numerous insurers feel they have no option but to invest their clients' pre-

miums in less creditworthy investments and take on greater risks, which, in turn, have to be backed up with greater amounts of equity capital. Since the outburst of the crisis, (re)insurers have substantially reduced the average maturities of their fixed-income portfolio to mitigate interest rate and inflation risk.

The central banks' expansionary monetary policy is accompanied with considerable risk. The danger that asset bubbles – such as those that famously unleashed the financial crisis of 2007 and 2008 – may form is still concurrent, thus fuelling fears of inflation. Wages and prices have yet to react to the increase in the money supply: Inflation expectations remain in check and the velocity of circulation in all monetary aggregates has flagged sharply. However, inflation is not just a monetary phenomenon, since it is often accompanied by social unrest, conflict over the distribution of resources, and political crises. Such developments are becoming ever more critical in Southern Europe. Wide divergences in incomes, dramatic youth unemployment, insecurity relating to state pensions and chronic fiscal inequality may throw entire economies off balance, thereby endangering European integration and, ultimately, globalisation.

INFLOW OF NON-TRADITIONAL CAPITAL

Low interest rates not only weigh on (re)insurers investments, but also stiffen competitive pressure in their core business. In the hunt for attractive returns and diversification opportunities in non-correlated investments, hedge funds, not to mention mutual funds and pension schemes, are increasingly turning to the (re)insurance sector. Their interest is focused on so-called «convergence markets» such as sidecars, «collateralised» (re)insurance, insurance-linked securities (ILS), industry loss warranties (ILWs) and special purpose vehicles (SPVs) rather than direct investments in (re)insurance companies. These structures can be dissolved at any time, thereby offering investors flexible access to specific target markets. Recent analysis by Willis suggests that some USD 35 billion in capital is currently available on the world's (re)insurance markets in this non-traditional form.

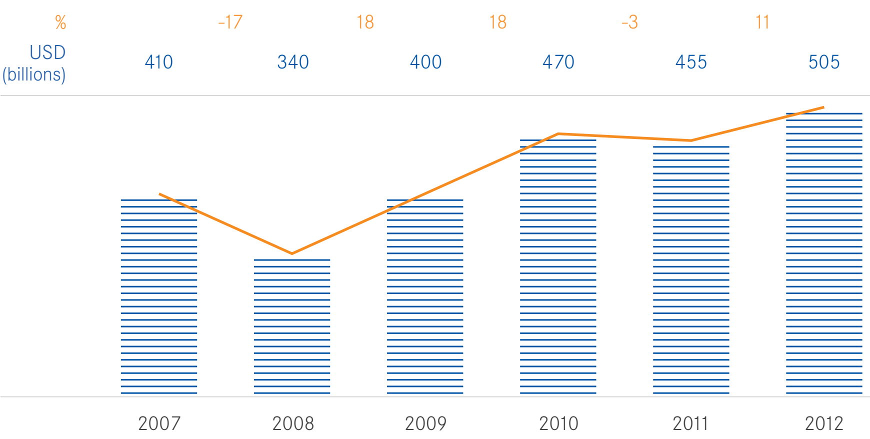
Price pressure, which was already substantial, is being further exacerbated by capital inflow. In 2012, the equity capital of the 31 (re)insurers in the «Aon Benfield Aggregate» rose to new record heights of USD 313 billion, exceeding pre-crisis levels in 2007 by USD 90 billion and prior-year levels by USD 33 billion. This effect is principally a result of the companies' net profits and unrealised capital gains, caused by the rising price of fixed-income securities. The increase of equity was accompanied by a stagnating demand for reinsurance. In some sectors demand even declined as larger cedants in particular centralised and bundled their reinsurance purchasing. The rationale behind was to reduce costs linked to the placement and administration of reinsurance cessions and to increase diversification effects at group level. These cedants have simultaneously adapted their group retentions to the new capital requirements with the result of a massive withdrawal of premiums from the market.

Against this backdrop of convergence, (re)insurers are also facing the fact that going forward it will be considerably more difficult to restore their capital base simply by raising prices after major loss events. The traditional reinsurance cycles have decreased in amplitude in recent years and, given the greater fungibility of reinsurance capacity, we may assume that - barring a wave of sovereign defaults or steep inflation - the underwriting cycle will cease to exist in its traditional form.

INCREASED NATURAL CATASTROPHES

Natural catastrophes remain an important driver of reinsurance rates. The annual intensity of natural catastrophes

EQUITY CAPITAL IN THE REINSURANCE SECTOR



Source: Aon Benfield Analytics

© Armin Strittmatter, detail of «Weg und Erlebnis»

worldwide has risen by 381 % over the last 25 years (from USD 8.1 billion to USD 35.2 billion). In particular, the years 2005, 2011 and 2012 were the three most expensive ones in the history of the global insurance industry. As a result of this abrupt increase in loss burden, the demand for catastrophe cover remains the deciding cost factor for cedants. In turn, for (re)insurers, it represents one of the central key elements of their success, subject to the precondition that pricing being aligned with this higher loss trend.

An atypical trend can currently be observed in this market segment: (Re)insurers are no longer reacting to major loss events with across-the-board price increases. Instead, they are tailoring their responses to clients, regions and individual results. This is predominantly due to the fact that the industry has further orientated its portfolio towards the short-term returns of property insurance in response to interest-rate developments. This turn of events, in conjunction with the growth of the convergence market, is undermining the relevance of the traditional (re)insurance cycle.

Renewals 2012: SI Re maintains steady growth trajectory despite unfavourable conditions

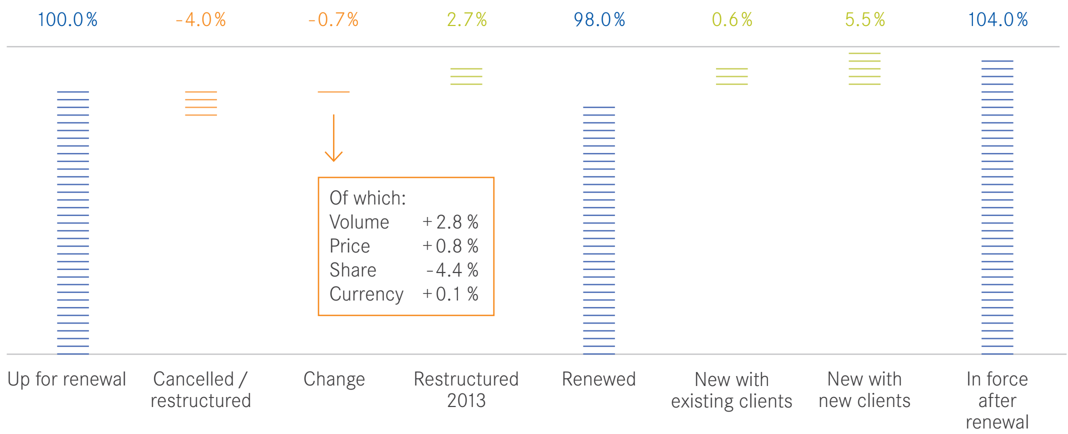
The (re)insurance industry is caught in a paradox: While the sector registered record levels of equity capital and aggregate net profits of more than USD 29 billion in 2012, as outlined in the editorial (source: Aon Benfield ABA Index, April 2013), these strong results are to a large extent due to one-off events caused by exogenous factors. Poor economic conditions combined with overcapacity are exerting downward pressure on prices, whereas investment returns remain sluggish due to the low interest-rate environment.

These challenging conditions left their mark on the 2013 renewals. Margins in short-tail business remained under pressure despite losses of USD 35 billion in the wake of Hurricane Sandy. On the other hand, we see more stable pricing in long-tail business. In addition, cedants are increasingly keen to further diversify their panel of reinsurance providers.

Certain (re)insurers and brokers have offered multi-line and / or multi-year covers in response to primary insurers' rising retentions. However, such bundling of risk across countries, companies and sectors comes at the expense of transparency. Model-driven approaches take centre stage while the knowledge of local circumstances and hazards is considered of secondary relevance. Combining such heterogeneous risks also gives rise to complex structures whose interdependencies are largely opaque.

The return of the leading (re)insurers to the European market has also been felt. The search for growth and diversification in recent years has led many of these players to scale up short-tail exposure in growth markets with high demand for reinsurance. Yet, the catastrophic events of 2011 revealed the risks and volatility

JANUARY 2013 RENEWALS



inherent in such regions. Consequently, the European market has again become an attractive proposition. We firmly believe that cedants will react cautiously to these recent developments and will continue to place their reinsurance programmes on many different shoulders. Despite this, the swelling ranks of globally operating (re)insurers has contributed to an intensified local competition.

SI Re nonetheless achieved very satisfactory results in the 2013 renewals. We managed to increase premiums by 4.2% on the portion of our portfolio that was up for renewal, of which newly acquired business amounted to 6.1%. Due to pricing, 71% of new enquiries were declined. Nonetheless, our total number of client relationships has grown by 23%.

SI Re has further improved its portfolio diversification in the most recent round of renewals. Of the specific lines of business underwritten, the proportion of property insurance rose slightly from 27.9% to 29.6%, while motor business decreased from 23.6% to 21.8%. Geographical distribution was subject to greater shifts. Total business in Scandinavia, Spain and Italy expanded while the contribution of Germany, Austria and France declined slightly.

SI Re is committed to long-term client relationships rooted in trust and personal contact. The majority of our business is linked to long-tail risks. SI Re consequently invests considerable time in each and every client relationship, thereby understanding our cedants' business model and supporting them with tailor-made (re)insurance solutions. This business model particularly suits the needs of our clients, who are typically from Western Europe and predominantly mutual insurance companies.

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