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SI Re

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Growing imbalances in the global reinsurance market

Editorial Bertrand R. Wollner, CEO

Supply and demand are increasingly drifting apart in the reinsurance markets, with cession volumes at best stagnating in the wake of rising retentions. The capital base of the world's 30 largest primary insurers continued to strengthen in 2013, with Swiss Re figures indicating that it has expanded by no less than 20%. However, increasing retentions also suggest structural changes in cedents' buying behaviour: centralising reinsurance purchases allows for the bundling of risks across countries, group companies and business lines, thus reducing aggregate reinsurance demand.

Cedents will benefit from this in the short term, but systemic risks may arise from unanticipated interdependencies and complexities over the long term, especially given many primary insurers' growing belief in and dependency on models. This particular approach could make them vulnerable to potentially serious underwriting errors.

Sluggish demand for reinsurance is not only a result of changes in purchasing behaviour, but also a reflection of limited growth in the original markets. Since the «Great Recession» of 2009, global non-life markets have been growing (even) more slowly than overall economic output. Cedents are thus more inclined to reduce their reinsurance cessions in an effort to at least achieve some net growth.

The considerable challenges facing traditional reinsurance markets did not begin with the financial crisis and the rise of market convergence only. Instead, business conditions for primary insurers – and hence reinsurance purchasing patterns – have changed radically over the course of the last three decades. Insurers today have much less room to «leverage» their equity capital to underwrite risk than they did 10 or 15 years ago, principally due to higher capital requirements imposed by regulators and rating agencies. Despite this, numerous – especially capital market-driven – insurers have raised their retentions, and thereby their risk tolerance, in order to generate attractive returns. This trend has been further reinforced by the erosion of investment income: interest rates have been in a tailspin since the 1980s and have currently sunk to an all-time low.

We are confronting a situation in which demand has stagnated but the supply of reinsurance capacity has expanded substantially. This reflects both a low-loss year in 2013 and an ongoing – albeit decreasing – running-down of technical reserves. On the other hand, global reinsurance markets are experiencing an unprecedented inflow of alternative capital. Pension funds, hedge funds and private equity investors are now providing some USD 50 billion of capacity, principally in the form of secured capacity or insurance-linked securities (ILS). At present, the share of ILS in global reinsurance provision has risen to more than 10%.

This increasing appetite on the part of capital market investors is not merely a result of near-record lows in returns on fixed-income investments. As the sector was spared major natural catastrophes in 2013, competitive pressure among reinsurers was increased by alternative risk carriers. The real test of long-term availability of alternative capital is therefore yet to come.

Given the current oversupply, reinsurance capacity becomes available at reduced price levels. In the most recent renewals, S&P indicates that worldwide natural catastrophe rates fell by 10–15%, and even by 15–25% in the USA. Likewise, in the special lines of aviation, credit & surety and US liability, premium rates dropped by 10–20%.

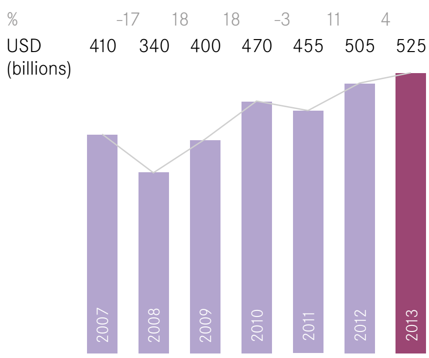
Market consolidation thus seems long overdue. As market pricing of reinsurers is again approaching their book values – and in numerous cases is already exceeding these – we anticipate an increase in mergers and acquisitions activity going forward.

SI Re is unconcerned by these developments, since we have underwritten traditional natural catastrophe property business only in exceptional cases. This CAT segment has always been data- and model-driven. The rise of the large modelling agencies has allowed recent arrivals for easy access to the history of catastrophe risks, thereby leading to an increasing standardisation of the business. This has knock-on effects for margins and the ability of market participants to negotiate for price increases after loss-affected years.

SI Re is instead concentrating on the ILS asset class; although this business is similarly under pressure, it is nevertheless possible to achieve attractive risk-adjusted returns. Given the European focus of our operations, ILS allow us to achieve a degree of global risk diversification that would otherwise not be possible. The ILS market further permits the writing of tranches of business that are much smaller than the minimum shares required in traditional natural catastrophe property reinsurance. In addition, by focusing on ILS, SI Re can avoid building up and maintaining expensive underwriting infrastructure, but instead can manage its exposure with existing actuarial resources.

Some 5% of SI Re's investment volume is currently devoted to the ILS asset class. We intend to further increase the proportion of ILS in our investment portfolio over the medium term, without exceeding the 10% threshold. SI Re is well positioned to scale up or scale down its ILS positions in response to varying market conditions, with no detriment to our relationships with our cedents. Our overall exposure is always nominally limited to investment volumes, broadly diversified and not dependent on the notoriously volatile retrocession market.

EQUITY CAPITAL IN THE REINSURANCE SECTOR



Source: Aon Benfield Analytics

With its ILS purchases, SI Re is prudently preparing for increased convergence between the insurance and capital markets. From a long-term strategic perspective, we are using this judicious ILS exposure to «keep a foot in the door» of the convergence market and demonstrate our appetite for innovation, without however jeopardising our core reinsurance business.

© Susanne Keller, detail of «Das Boot»

SI Re successfully negotiates choppy waters

SI Re has successfully positioned itself despite exceptionally challenging market conditions. We have once again managed to raise our premium volume while further diversifying our portfolio.

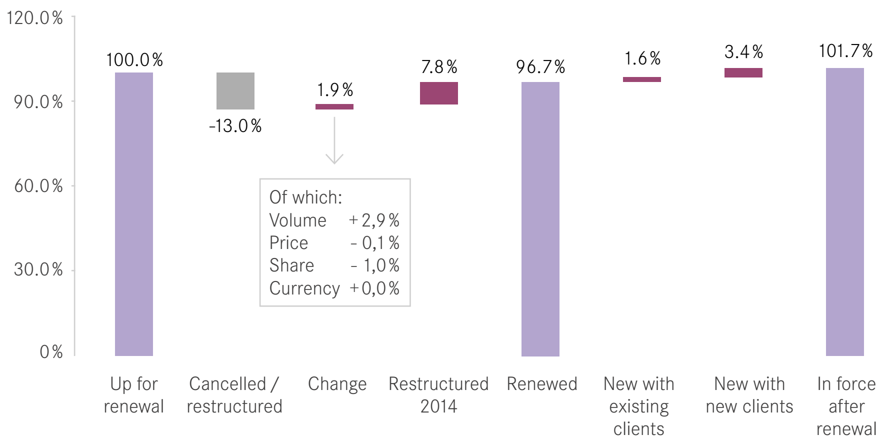
SI Re has been pursuing a prudent and cautious strategy for some ten years now by predominantly underwriting long-term, high-frequency risks for European cedents. A large proportion of our clients are mutual insurers with whom we enjoy long-term business relationships. A good two-thirds of our book consists of proportional business in standard lines, and we are considerably less exposed in special lines. The stable development of our premium volume demonstrates that our cedents appreciate this clear focus.

Renewals in our client segment exhibited lower rate volatility than was the case in business worldwide. Last year, Germany, Austria and the Czech Republic all faced substantial losses arising from the «second one-hundred-year-event flood» to occur within ten years. This was compounded by record claims in the wake of severe hailstorms at the height of summer. At least, price pressure was less in these markets compared to regions that once again experienced below-average natural catastrophe claims burden and ultimately benefited from that situation. Our client focus also worked to our advantage: mutual insurers are still enjoying a trust bonus from their policyholders for having eschewed capital market excesses during the preliminary stages of the financial crisis. Mutuals have successfully expanded their market share over the last few years and their additional premium growth has also benefited SI Re.

We increased our premium volume by 2% during the latest renewals round compared to last year, with growth being recorded particularly in new clients and new business with existing clients; elsewhere, our share of business remained stable. Within the context of the entire portfolio, SI Re maintained price levels compared to 2013. Thus, we fared considerably better than the majority of our competitors, who at times reported drastic price reductions. We received 17% more quotation enquiries than last year and the total number of our client relationships rose by 13%.

On December 31, 2013, our parent company increased our equity capital by CHF 25 million to CHF 160 million and, given these circumstances, we intend to write additional business in the current year. The relatively large number of insurance companies in Germany provides us with a potential for growth. However, we also intend to gain ground in Italy, Scandinavia and Spain as well as with British primary insurers. We will furthermore facilitate prudent expansion with a view to acquiring new clients in Central and Eastern Europe.

JANUARY 2014 RENEWALS



Beat Landtwing: client orientation from day one

After ten years of service, Beat Landtwing will be passing on the reigns as Chief Financial Officer of SI Re and will retire in autumn 2014. SI Re has developed to be a reliable and solid partner for its cedents during his tenure, and customer satisfaction has always been key for SI Re's experienced head of finance: «We offer our cedents first-class services on all levels and right away; that's the secret of SI Re's success.»

«The finance department's job is to provide the guarantees underwriters need when they are finalising contracts and to ensure that payments can be made at all times. This requires smooth operations in liquidity management in addition to efficient financial and technical accounting. At the same time, we also support management with transparent accounting and the compilation of informative annual reports that earn the trust of our clients and business partners alike.»

«All our undertakings at SI Re are intended to reinforce the company's position as a solid and dependable reinsurer,» explains Beat Landtwing. «When SI Re was founded, the first thing we did was to introduce the systems required for modern and transparent accounting; the next step was to mesh these with the requirements of our parent company. We began introducing the Swiss Solvency Test in 2005 and, as SI Re continued on its steady growth trajectory, we received our «A» rating from Fitch in 2008. The financial crisis struck later that same year. We adjusted our investment strategy and as even supposedly safe financial institutions were in precarious positions, we also switched our home bank. Looking back, I feel proud that in all those years, we never experienced a major negative surprise, neither on the underwriting nor the investment side.»

«I expect the increased pressure on reinsurers to continue as we move forward. SI Re nonetheless demonstrates that personal relationships remain crucially important in our industry. Our success is rooted in the stability and loyalty of our staff, both in management and underwriting. Our cedents know us, they know they can contact us directly, and they know the value of our bespoke solutions. So I am confident about SI Re's future. My personal plans? I am looking forward to having more time for travelling and going to the mountains.»

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