// Mergers and acquisitions in reinsurance – a brave new world?

// SI Re is feeling the benefit of prudent expansion in new markets

// SI Re has appointed Dr. Robert Salzmann as new actuary

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STEPS 1/15

Mergers and acquisitions in reinsurance – a brave new world?

Editorial Bertrand R. Wollner, CEO

The global reinsurance industry has lately been gripped by a series of high-profile mergers and acquisitions. The ball was set rolling in the autumn of last year with RenaissanceRe's announcement of its intention to take over its competitor Platinum Underwriters for USD 1.9 billion.

Shortly thereafter, XL hit the headlines in December by taking over Catlin in a merger of the world's number 17 and number 23 reinsurance companies. The merger of Axis and PartnerRe, previously ranked globally at 20 and 10 respectively, created even bigger waves.

Further deals are widely anticipated and some managers and market pundits have even warned that reinsurers who ignore the «strategic imperative of size» and fail to recognise «which way the wind is blowing» are putting their very existence in jeopardy.

Far be it for us to deny that there may well be convincing – or even compelling – reasons for some of these deals, but we would suggest that small and medium-sized reinsurers should resist the temptation to jump on the consolidation bandwagon too precipitously. As in every other industry, the benefits of reinsurance mergers and acquisitions are inconclusive; a whole range of demand-side arguments suggest that it is wise to maintain critical distance from the notion of scale for scale's sake.

For a start, the micro-economic concept of economies of scale is of only limited relevance to the reinsurance industry. Market players offer similar products, i.e. contingent payment commitments backed by equity capital. The expected loss amount plus a volatility margin represents the lower price limit for even the largest and best-diversified reinsurers; thus, leeway for any economies of scale – achieving lower production costs for comparable products thanks to greater volume – is limited. The bulk of the production costs are actually determined by the market and this is indeed true given that, in saturated markets at least, demand for reinsurance cover is generally shrinking while overcapacity is being further aggravated by an inflow of alternative capital.

There are of course some outliers: certain scale advantages may accrue in respect of external costs (claims and acquisition costs) by dint of the unusual and privileged circumstances enjoyed by

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leading providers. However, such cases are, contrary to popular belief, the exception rather than the rule.

Larger providers are also at an advantage as far as administrative costs are concerned, since their fixed costs are spread across a larger volume of business. The massive rise in regulatory costs magnifies this effect still further. Larger reinsurers also benefit when it comes to the cost of capital, or more precisely, of third-party financing. However, given standard external financing ratios of around 25-35%, this effect should not be overstated.

Potential diseconomies of scale in the industry's all-important claims costs would seem more relevant: larger insurers can «afford» to continue writing business with lower-than-anticipated risk premiums for longer than small and medium-sized competitors.

Size is thus a double-edged sword in reinsurance, and quite how structural change on the market is to be overcome through increases in size alone (through acquisitions, for example) also remains to be seen. Cost reductions and/or additional capacity – especially if obtained at sky-high prices – fail to address the question of ongoing margin erosion and as such do not constitute a launchpad for innovative solutions that might prove a match for the current paradigm shift.

Given these circumstances, SI Re's objective remains the pursuit of a selective and disciplined underwriting policy with a view to consolidating an efficient alpha portfolio. A beta method, i.e. writing a market portfolio, is best avoided. The challenge for small and medium-sized reinsurers is to find a way of explaining to their clients that this is, as it were, the price to be paid for higher diversification of their cessions, longer-term availability of their reinsurers' equity capital as well as the circumscription of the larger providers' market power. Few cedents need to be reminded of their experiences in 2001 and 2002, when they had to bow to the superior market power of the five leading reinsurers. It was no coincidence that the industry's top segment lost market share over the ensuing years, both to successful start-ups in 2001 and, to a lesser degree, in 2005.

An appropriate dispersal of reinsurance cessions is also advisable from a solvency perspective and there are clear incentives for this in the form of low capital requirements under Solvency II. Given all this, solidly-positioned small and medium-sized providers do not need to be overly concerned about the periodic scaling-back of reinsurance panels.

This is especially relevant to SI Re, which is part of a leading German mutual primary insurance group with an exceptional reputation in terms of its willingness and ability to settle legitimate claims. We are convinced that there will always be clients who are prepared to pay a suitable premium for the special pedigree and provenance of such capital. Therefore, we see no reason why medium-sized and specialised primary insurers should not prosper and flourish on the market – this segment is looking for reinsurers like SI Re, who can meet them on an equal footing, genuinely understand their requirements, and stand out from the crowd by virtue of their flexibility and accessibility.

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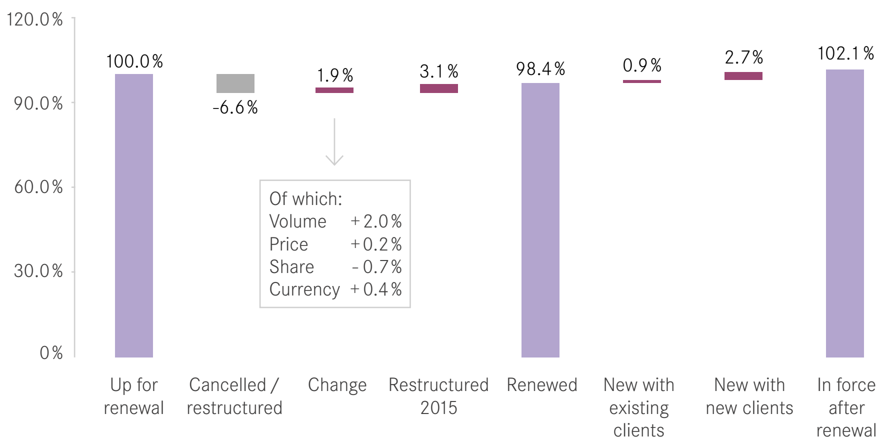
SI Re is feeling the benefit of prudent expansion in new markets

The reinsurance market continues to experience considerable overcapacity, with Aon Benfield's figures (January 2015) revealing that reinsurers' capitalisation has risen by a further USD 35 billion to USD 575 billion. Alternative capital, which now accounts for USD 62 billion, holds considerable sway over the property insurance market.

JANUARY 2015 RENEWALS



Capital market investors show no signs of curbing their investment in insurance markets, despite diminishing returns during the current climate of low interest rates. Reinsurers are using sidecars to pass on undesirable peak and accumulation risks to alternative investors while passing on any price advantages to their cedents, and this is only reinforcing the downward price trend.

Under current circumstances, reinsurers need to focus on identifying business that fits their own portfolio and meets their requirements. SI Re is thus making no changes to its prudent and selective underwriting policy while consistently diversifying its portfolio. As such, the company is increasingly benefiting from the recognition it has gained in the insurance market over the last decade as a reliable and skilled partner whose merit is a function not of its size but of its flexibility and proximity to its clients. As a result, SI Re has managed to increase its premiums earned by 2.1 % in the January 2015 renewals through a prudent increase of underwriting limits and geographical expansion in the Benelux countries, Finland, Iceland, Portugal and the Czech Republic. Increasing its share of business with existing and/or new clients has enabled the company to more than make up for the decline of 6.6 % (see chart).

SI Re has increased its volume of business with existing customers by 2 %, with prices remaining more or less unchanged and shares dipping slightly. Hard work by the underwriters in particular enabled SI Re to expand its client base by 13 % compared to the previous year, and the company wrote approximately 90 % of its premiums in the year-end renewals.

While SI Re is broadening the geographical mix of its portfolio, the breakdown by line of business has remained virtually unchanged, with the proportion of motor business dropping only slightly from 18.2 % to 17.5 % and liability following a similar trajectory from 24.1 % to 23.8 %, while marine has expanded its share from 0.7 % to 2.0 %.

SI Re has appointed Dr. Robert Salzmann as new actuary

New actuary Robert Salzmann brings fresh wind and solid expertise to SI Re.

The end of last year saw Robert Salzmann's move to SI Re from KPMG, where he had been working as Assistant Manager, Quantitative Finance Group, since 2012. Previous to this, he had earned his doctorate at the RiskLab Switzerland in ETH Zurich's mathematics department. His insights on mathematical insurance problems have been published in leading actuarial journals such as the ASTIN Bulletin. He is soon to qualify as a Certified Actuary and Member of the Swiss Association of Actuaries (SAA).

At SI Re, Robert Salzmann is responsible for the actuarial analysis of reinsurance treaties as well as the modelling of catastrophe risks. Furthermore, his experience will also contribute to achieving further refinements to SI Re's actuarial analysis and reservation tools along with the SI Re model for the Swiss Solvency Test (SST). Robert Salzmann reports to Andreas Gadmer, Head of Risk Management and Member of SI Re's Executive Team.

«We are delighted to have found such a skilled and qualified actuary in Robert Salzmann. He is an ideal addition to our team and his solid expertise and fund of new ideas will provide us with optimal support,» enthuses Andreas Gadmer.

Robert Salzmann appreciates the broad scope of his activities at SI Re and his proximity to the business, especially working closely with the financing team, underwriters and clients. He perceives SI Re's efficient communications and short decision paths as strengths that allow it to offer clients ideal solutions in a dynamic business environment.

«The actuarial challenges facing a reinsurer in dynamic and increasingly complex market conditions are always going to be exciting. As an actuary, it is my goal to reconcile the analysis and modelling of risks with regulatory requirements as well as the company's commercial profitability targets while never losing track of changes in the market and our clients' interests. I am looking forward to entering the reinsurance industry with SI Re and playing my part in the company's ongoing success,» explains Robert Salzmann.

Even though he has been living in Zurich for more than 10 years, he still feels very connected to his roots in the Canton of Valais, where he runs an apiary with his father – an extremely satisfying hobby

that nonetheless requires an immense amount of work. When the plants are in bloom during the summer months they take their hives up into the mountains with a view to harvesting some fine Alpine honey by late summer. As Robert Salzmann tells us: «Bee-keeping is a volatile business and susceptible to myriad external influences. It gives me a completely different perspective on our fragile global eco-system and on life in general – this enables me to see things from a different angle in my professional life as well.»

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