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SI Re

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Why size does not always matter in reinsurance

In the wake of the most recent acquisition of Paris Re by Partner Re, some market observers expect a wave of consolidation in global reinsurance. M&A is clearly a topic in this year's renewal season.

The following recent statement from a leading rating agency is indicative of the reasoning of those who paint a consolidation scenario: «Recent consolidation activity has placed more pressure on smaller reinsurers (...) to increase scale to remain strongly positioned with brokers and clients (...) and to maintain strong credit fundamentals (...) Smaller reinsurers may also find accessing capital more challenging following recent market turmoil (...) Smaller reinsurers may have less opportunity to diversify their business, as buyers of long-tail reinsurance tend to be more sensitive to size» (Source: Aon Benfield, Reinsurance Market Outlook – Resilient Without Assistance, September 2009, p. 11).

We respectfully disagree and question the validity of this statement. The most recent instances of consolidation primarily reflect certain investors' opportunistic need to withdraw funds from their reinsurance investments - rather than a compelling case for size on the part of the buyer. In addition, one of the major lessons of the current financial crisis is that size as such is no quality in itself, certainly not a safeguard against severe balance sheet disruption and corporate turbulence. Large and complex financial institutions, including a number of insurers and reinsurers, have piled up toxic assets, pushed leverage beyond any prudent limits and taken on gigantic credit-related liabilities. Some of them were simply «betting the farm». The highly rated and commended Enterprise Risk Management frameworks of such institutions have not prevented such excesses from occurring and failed to recognize that the fungibility of capital in risk models should not be taken for granted under severe market stress.

We maintain that consolidation is not necessarily in the interest of reinsurance buyers. They want continuity and reliability to govern their reinsurance relationships. The sudden disappearance of players, particularly when driven by opportunistic investor decisions, runs counter this fundamental desire. Consolidation makes it more difficult for ceding companies to improve the diversification of their reinsurance placements – a major strategic objective of many clients given the fact that the financial crisis has not spared some larger reinsurers.

Bertrand R. Wollner, Chief Executive Officer

No doubt, size does matter in certain areas and circumstances. For example, in asset management cost and other synergies are much easier to capture as scale increases. As a wholly-owned subsidiary of SIGNAL IDUNA Group, one of Germany's largest insurers, SI Re's investment decisions are supported by a close cooperation with SIGNAL IDUNA Asset Management (SIAM) which manages proprietary and third-party assets for SIGNAL IDUNA Group. We benefit greatly from SIAM's proven know-how, expertise, well-developed commercial relationships with the transacting banks. This example illustrates that SI Re is very

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well able to reap economies of scale. In addition to asset management, size can be a distinct advantage if the client requires significant capacity, especially in large corporate and catastrophe lines of business.

Having said this, we believe that these advantages are not sufficient to offset the disadvantages consolidation presents to those clients who are keen to diversify their reinsurance placements and to build reliable and durable reinsurance relationships.

Clients should also keep in mind that even prior to the financial crisis the case for size and consolidation in reinsurance was far from compelling: Economies of scale, i.e. cost synergies, are largely irrelevant in the whole-sale business of reinsurance. The decisive competitive differentiators are cost of capital, financial strength and customer service.

Against this backdrop, insurers are taking a more active role in assessing the credit quality of their reinsurers. Mechanistic and purely quantitative factors such as size or scale are deemed insufficient. Instead, insurers aim at gaining a deeper understanding of the specific factors that govern their reinsurers' strategic decisions. Simply relying on financial strength ratings is clearly insufficient and potentially dangerous. From our perspective, clients need to thoroughly understand two specific factors:

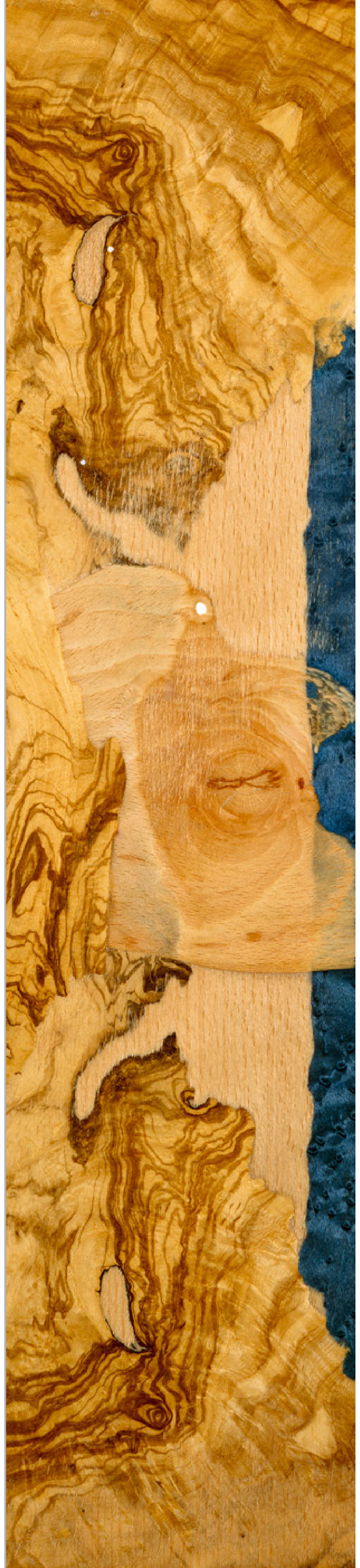
REINSURERS' SHAREHOLDER PROFILE

Clients should carefully explore the strategic focus and time horizon of their reinsurers' principal shareholders. Those reinsurers who display a high proportion of capital being held by hedge funds and private equity investors might be vulnerable to a sudden withdrawal of funds as evidenced by the financial crisis. Even under normal circumstances the time horizon of such investors is relatively short. Another factor to look at is the existence of large minority shareholders and their specific agenda, which in particular under circumstances of severe stress might run counter the interests of clients. Clients should be aware of the potential uncertainties arising from relationships with such reinsurers.

AGENCY RISKS

Typically, corporate decisions are not made by shareholders but by the board of directors and the management team who are supposed to act on their behalf. The interests of shareholders and their agents are not necessarily aligned, particularly as the latter typically enjoy information advantages. Also in reinsurance, a company's management could easily pursue objectives which run against the interests of clients. At SI Re, we believe to be genuinely different in that respect: Our clients have direct access to top management as well as to our only shareholder. There are no information asymmetries between SI Re's management, its board of directors and the parent company. This, we believe, offers our clients a particular level of comfort. In general, also as a lesson from the financial crisis, clients should establish personal relationships with their reinsurers' top management and – if possible at all – major shareholders in order to distinguish between those who pursue a short-term and opportunistic agenda and those who are committed to building and developing a long-term relationship.

In summary, we believe that the management of reinsurance relationships will place higher demands on clients going forward. A mere reliance on a reinsurer's size or financial strength rating is insufficient or even misleading. A more promising approach for clients is to obtain a much better understanding of the hard and soft factors which determine their reinsurers' actions and prospects. We believe that only on that basis an effective and sound diversification strategy can be implemented.



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Impressions from the current renewals season

The year-end renewals are in full swing. In Monte Carlo and Baden-Baden as well as in separate client meetings, SI Re made the following three major observations:

First, consolidation has reemerged as a discussion topic. Some market participants, however, including SI Re, attribute this talk primarily to the absence of other key topics such as major insured catastrophe losses, spectacular rating downgrades or shifts in reinsurance supply and/or demand. And there are conflicting views as to whether recent M&A activities reflect a strategic trend or merely opportunistic moves by investors.

A second major observation is a heightened interest of ceding companies in smaller reinsurers. We believe this reflects increasing desire to further enhance the diversification of reinsurance placements in order to limit counterparty risk. A company like SI Re is obviously very pleased with this development. We also observed a much higher involvement of insurers' CEOs in direct meetings with their reinsurers. In our view, they are keen to better understand their counterparties' corporate strategies and management philosophies and no longer view the placement of reinsurance as a purely technical matter determined by financial strengths ratings and quantitative indicators.

Third, a large reinsurer's withdrawal from credit & surety business gave rise to specific discussions. Some market participants were surprised by the move and expressed concerns over increasingly opportunistic behavior even on the part of large, relationship-driven players.

SI Re made use of these client meetings and interaction to confirm its objectives for the year-end renewals. We will continue to expand our geographical footprint in order to further improve diversification and capital efficiency. The Iberian Peninsula and our Swiss home market are two specific priority areas for future business development. In addition, we will continue to broaden and deepen our client base by forging new business relationships and acquiring higher shares with existing clients. We are confident that we will be able to successfully deliver on these objectives as clients recognize SI Re's expanding track record and are keen to do more business with reliable alternatives as they seek to improve diversification.

The SI Re team continues to grow

Daniel Burren, Actuary and Nicolas Schmidhauser, Regional Underwriting Director

SI Re continues to expand its team with the recruitment of Nicolas Schmidhauser as its Regional Underwriting Director for Iberia and Switzerland and Daniel Burren as actuary, in charge of reinsurance pricing. Nicolas Schmidhauser brings 20 years of experience in insurance and reinsurance to the table. He has acquired his expertise from Winterthur Re, Trans Re, AIG Europe and Zurich Re, Converium and SCOR Switzerland as Underwriter and Senior Client Relationship Manager. Daniel Burren, by contrast, joins SI Re directly from the University of Bern, where he graduated as a Master in mathematics and statistics. He also holds a PhD in econometrics.

STEPS spoke with the new members of the SI Re team and asked them about their expectations and ambitions for their new assignment. Despite a long career in insurance and reinsurance, Nicolas Schmidhauser, aged 46, is still fascinated with reinsurance as, according to him, it requires a thorough technical understanding of the risks one underwrites, human skills to build and foster relationships with clients and a flair for products and markets which are subject to permanent change. Not surprisingly, Nicolas Schmidhauser loves to broaden his horizon as he understands his profession as a «formation continue», a constant learning process.

It did not need much convincing when Mr. Schmidhauser was asked to join SI Re. The married father of two children, who lives in Hésingue, is thrilled by the opportunity the company offers for him: He is keen to expand his long-standing relationships with clients in Portugal, Spain and Switzerland. Another reason for joining SI Re was being able to participate in the transformational process that he sees coming for these markets as new solvency requirements are introduced. According to Mr. Schmidhauser, the structural and personal set-up of SI Re offers him an ideal environment to help shape these future developments: a small, agile and dedicated team whose key members he has been knowing for more than ten years from his prior assignments and a strong team approach which encourages every member to constantly and openly contribute his or her experience for the benefit of SI Re and its clients.

SI Re's explicit team approach also convinced Daniel Burren, aged 30, to join SI Re. Initially, the young mathematician who analysed in his PhD thesis economic fluctuations was not quite sure if the banking or the insurance sector would offer him the best career prospects. However, after having encountered SI Re's management team, it became quickly clear to him that within this small and open team of reinsurance experts he wanted to build his career. Being able to work closely with a team of a high calibre reinsurance experts he feels he can most quickly grasp the tricks in reinsurance while contributing to the company's success from day one by further enhancing its actuarial tools, models and processes. In addition, Mr. Burren is eager to participate in the growth process of SI Re while at the same time having the opportunity to familiarize with the different lines of business which the company is active in. He lives in Zürich and enjoys and practises sport in his spare time. As such he is not so different to Mr. Schmidhauser, who is an avid tennis player.

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