// Reinsurance: Quo Vadis?

// SIGNAL IDUNA Group with double-digit growth in 2010

// SI Re says goodbye to Jean-Marie Bigot

SI Re

STEPS 2/11

Reinsurance: Quo Vadis?

From Bertrand R. Wollner, CEO

As the renewals season begins, reinsurers find themselves facing an ominous pincer movement: returns are at persistently low levels due to the financial and debt crises, while market volatility has soared. Stricter regulation and proliferating capital-market requirements are driving up capital costs. In addition, competitive pressure is heating up because increasing numbers of reinsurers are flocking to more and more markets in their attempts to diversify their portfolio.

The new supervisory rules stipulated by Solvency II and the Swiss Solvency Test (SST) have substantially increased the capital-backing requirements for investment risks. Since 2008 there has been a dramatic rise in the target capital for market and credit risks in the SST. With virtually no changes to the structure of capital investments in terms of creditworthiness and maturity, the amount of target capital has roughly doubled after diversification effects and adjustments for volume. Interest-rate risk has soared by 185% over the same period. Exchange rate and credit risks have increased by almost 200%, while equity risk has risen by more than 30% and spread risk is no less than eight times higher due to dwindling creditworthiness on the bond market.

These developments are leading to higher capital costs and interest on capital employed on the investment side. But as STEPS already reported a year ago in its 2/2010 issue, a «state of emergency» prevails on the investment front. Interest rates remain at historic lows, so one of the key sources of income for the insurance sector has dried up. At the same time, the notion of government bonds as risk-free investments has evaporated. In Europe, the reform debate now seems to focus solely on capital-adequacy requirements for the banks. But this will not suffice. The Basel III regulations should not only take account of the portfolio view within the banking sector, but should also simplify the structure of the financial markets. If the bulk of financial instruments were traded on public exchanges, they would become simpler, price transparency would be guaranteed, and confidence would be restored.

CAPITAL MARKETS EXPECT MORE OF REINSURERS

The reinsurance industry is attempting to adapt its business model in response to pressure from the capital markets – so far with only modest success. Due to income expectations and a focus on short-term returns, the industry geared its portfolio towards property insurance in recent years. Now, the major losses in the first three quarters of 2011 have exposed how vulnerable as a result the reinsurance industry has become to the forces of nature which, in turn, has increased earnings volatility. The consequence: higher risk premiums imposed by the capital markets.

The lack of earning power in the property and casualty segment was palliated in recent years by the release of technical provisions. Standard & Poor's estimates that changes to provisions accounted for approximately 20% of the loss ratios of «Class 1» reinsurers in the last few years. Without this effect, the reinsurance sector's combined ratios would have been 100% or more.

Moreover, according to Standard & Poor's, investors' return requirements have been increasing since 2009 and are heading towards 15% (see fig. 1).

These factors have increased risk aversion on the part of investors in the wake of the turmoil on the capital markets. It therefore comes as no surprise that the gap between the capital market's expectations and reinsurers' effective returns is continuing to widen, and most market players' equities are being traded at discounts averaging 20%. Some companies are responding to this situation with share-buyback programmes to increase

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the book value of their equities in the short term.

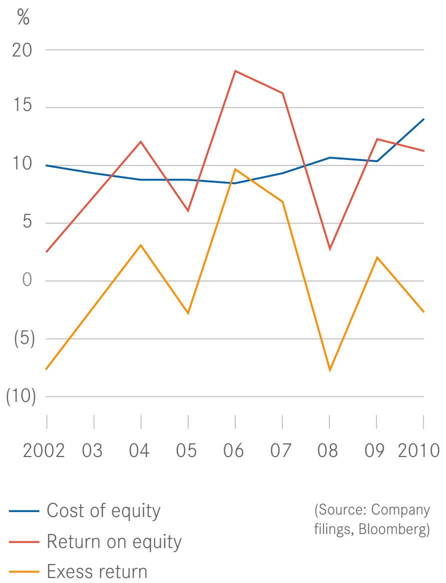
However, due to these developments the sector becomes more vulnerable to a potentially sharp increase in inflation triggered by the debt crisis: current claims reserves could soon prove to be inadequate, while additional negative effects on capital investments would also have to be overcome.

Returns on equity are likely to be in the single-digit range at best in 2011. Against this backdrop, investors are exerting enormous pressure on reinsurers to increase the value of their companies. In response, managers are stepping up their efforts to implement cost synergies while pushing ahead with mergers and acquisitions.

FOCUS ON TRANSPARENCY

Given the volatile environment, cedents are well advised to press their reinsurers for greater transparency regarding the composition of their portfolios during the forthcoming year-end renewal season, and to ask for disclosure of the dependencies in their risk structures. As a general rule, the risk-bearing capacity of smaller reinsurers such as SI Re is easier to assess, because such firms are more transparent and leaner. Another important factor to bear in mind in the case of SI Re is that the shareholder, the SIGNAL IDUNA Group, is a mutual insurance company which is not dependent on the mood swings of the capital market but – on the contrary – is committed to the principle of mutuality and to a long-term approach.

FIG. 1: GLOBAL MULTILINE REINSURER RETURNS



SIGNAL IDUNA Group with double-digit growth in 2010

At SIGNAL IDUNA's annual results press conference early this summer in Dortmund, Reinhold Schulte, Chief Executive Officer of our Group, announced: «SIGNAL IDUNA consistently expanded its competitive position in 2010 and grew at a rate significantly higher than the market average.»

In 2010, our Group recorded one of the most successful financial years in its history, which spans over a hundred years. We increased our premium revenue by 7%, bringing it to EUR 5.64 billion. The other business development indicators also showed positive trends: the sales result rose by 18%, gross expenditure for insurance claims decreased by 0.9%, and investment assets managed by the SIGNAL IDUNA Group (including its financial subsidiaries) grew by about 2% to EUR 51.5 billion. With a pre-tax operating result of EUR 757.7 million, the SIGNAL IDUNA Group came very close to equalling the previous year's record result.

The positive development of our Group's business is the outcome of a successful broadening of our business operations, combined with consistent integration work: last year, Deutscher Ring Krankenversicherungsverein was integrated into the insurance business, the Donner and Reuschel private banks were merged, and Deurag Deutsche Rechtsschutzversicherung, which SIGNAL IDUNA had recently acquired, was expanded by the Allrecht.

In the insurance sector, all three business areas – health, life and non-life – reported pleasing performance: the health insurers in the SIGNAL IDUNA Group posted an increase of 2.9% to EUR 2.65 billion. Deutscher Ring Krankenversicherungsverein, which had recently joined the Group, achieved growth of 7.9%, outperforming the market average. Our life insurers posted growth of 18.5% to reach EUR 1.8 billion, while booked gross premiums for the non-life insurance companies rose by 1.1% to EUR 1.05 billion. It is especially gratifying that for the first time in five years, the average premium for motor insurance rose, even though the number of insured vehicles remained virtually constant.

The performance of IDUNA Vereinigte Lebensversicherungs AG, our legal mother, is a key factor in determining SI Re's creditworthiness and our Fitch Rating. We are thus particularly pleased that our parent increased its premium revenue by 20.7% to EUR 1.7 billion, with new business premiums rising to EUR 636 million – an increase of almost 100%. Accordingly, Fitch paid tribute to the SI Re parent's 2010 business result as «resilient in the face of the current low interest-rate environment, and therefore above average.»

The previous year's trend appears to be holding up in 2011: during the first eight months, SIGNAL IDUNA was again able to increase its sales result by over 10% year-on-year. Reinhold Schulte comments: «The current financial year provides grounds for optimism. Thanks to an excellent sales performance, we are continuing on the successful course that we have charted in recent years.»

SI Re says goodbye to Jean-Marie Bigot

An era drew to an end at SI Re last month. After a career in reinsurance spanning 40 years, the last six of which were spent at SI Re, Jean-Marie Bigot went into retirement. In his capacity as Underwriting Manager for France, Jean-Marie Bigot was able to bring all his experience to bear and, as an employee from the very start, he played a key role in achieving the strong position that SI Re enjoys today.

Bertrand R. Wollner, CEO of SI Re, paid a highly appreciative tribute to his departing employee: «Jean-Marie's arrival at SI Re heralded the start of an huge success story. Our French portfolio now accounts for 22% of our external business. Thanks to Jean-Marie, we are well positioned as a reliable reinsurer in the French market. The Board of Directors and the management team express their sincere thanks to Jean-Marie.»

Looking back at his career in reinsurance, Jean-Marie Bigot says: «When I started out in reinsurance, my attention was caught by a cartoon showing a reinsurer with a golf club in one hand and a glass of champagne in the other. That was the industry's image of itself. A reinsurance treaty in the motor line of business amounted to barely ten pages. The list of exclusions was short, the termination clauses were rarely used, and the inflation clauses almost never mentioned. Prices and cumulative liabilities were usually determined on a very empirical basis. The conditions were quickly agreed, because income from the asset side remained high. In short, this was the era when people communicated via Telex, and reinsurance treaties were still put together with stencils.»

«Was it the golden age?» Jean Marie Bigot asks. «Certainly not! In my view, four developments have permanently turned reinsurance into a highly professional industry:

Major losses of unprecedented intensity like 9/11, Hurricane Katrina, the winter storms Lothar and Martin, and the recurrent floods that cost more because of the increasing density of urban centres, they all changed the insurance sector. Then there is the frequency and severity of man-made losses. One example is the motor insurance, where costs of physical injuries have soared due to changes to the economic, medical and legal environment. Thirdly, regulation has altered the sector substantially. The Badinter law and the ‹Rentes indemnitaires› decree (regarding court-structured compensation awards), both aimed at improving compensation for traffic-accident victims, led to massive cost increases for primary and reinsurers in the French motor market. Stricter solvency regulations, such as Solvency II, require an increase in equity capital. The growing complexity ushered in the era of the actuary: nowadays you need specialists in every area of direct insurance and reinsurance, ranging from modelling, analysis of (re)insurance products and estimates of technical provisions to contract quotations. This development has prompted improvements in the risk management, which in turn makes the sector more secure and resilient.»

Nevertheless, the key function remains that of the underwriter, whose personal relationships with clients allow him to understand the market's strengths and weaknesses. He is the face of his company and its underwriting policy and the champion of the cedent, on whose past, present and future he sheds light. This dual approach – with internal and external perspectives – makes this function exciting.

«I have appreciated the variety of my work and of the industry over the last 40 years,» Jean-Marie Bigot adds. «It's always about teamwork. This is why I would like to thank my colleagues, and I am now pleased to pass the baton on to my successor, Karine Wild, who will continue to expand our existing portfolio. I wish her success in this endeavour.»

Jean-Marie Bigot was also thanked by his successor, Karine Wild: «I'd like to highlight Jean-Marie's enormous personal commitment on behalf of SI Re and his colleagues. I have been impressed by Jean-Marie's openness as he familiarised me with his files, and also by his helpful attitude and the joy that he took in introducing me to Switzerland. I am looking forward to taking over his portfolio and to following his example of flexibility and commitment in the interests of SI Re.»

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