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SI Re

# STEPS 2/14

## The risks of alternative capital for primary insurers

Editorial Bertrand R. Wollner, CEO

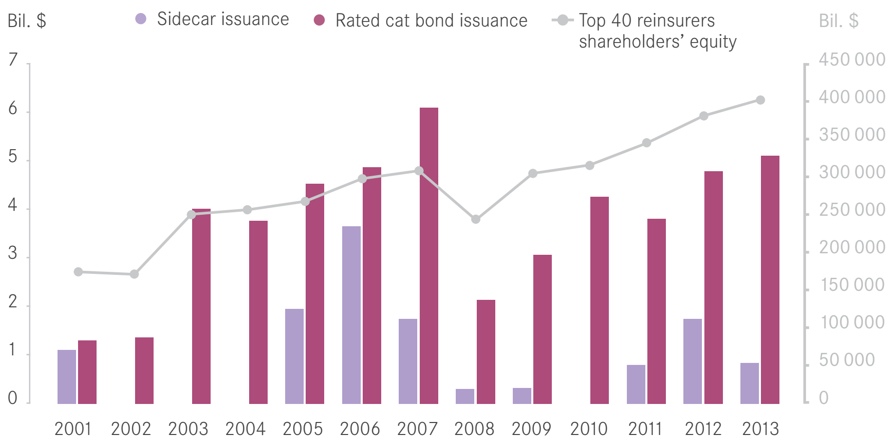
There has been an irresistible rise in the proportion of alternative capital in the reinsurance sector and it has now reached a market share of 20 % for Nat Cat covers on the global reinsurance market. The consequences are difficult to miss: reinsurance rates are falling, terms are softening, and profitability in the sector is on the slide. Beyond lower prices, however, this raises the question of what benefits – and indeed what risks – this development may have for primary insurers.

Aon Benfield announced in September 2014 that the share of alternative capital in the reinsurance sector had grown by 18 % in the first two quarters of 2014, reaching a current total of USD 59 billion. Over the same period, traditional capital had risen by 4 % to a current total of USD 511 billion. The unanimous opinion of the rating agencies is that alternative capital has now reached a critical mass and won an acceptance from cedants that will make it a «fixture» on the reinsurance market in future.

As the supply of reinsurance capacity is far outstripping demand, the competition between traditional and alternative capital is intensifying. There is increasing downward pressure on prices, and surplus capacity is spilling over into other insurance lines and regions. This is detrimental to the reinsurance sector's long-term profitability and creditworthiness; as a result, the rating agencies have already downgraded their outlook for the sector to negative.

The problems accompanying this development, which is a function of persistently low interest rates on the capital markets, have now even attracted the concern of the Bank of England. Mark Carney, the bank's governor, recently remarked: «Low rates are encouraging inflows of external capital into sectors like reinsurance. In effect, a ‹soft cycle› in financial markets is reinforcing a ‹soft cycle› in insurance – a particularly problematic combination.»

HISTORICAL INDUSTRY CAPITAL LEVELS

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# SI Re – Mutually yours

## Sustainable, agile, committed

### COMMUNITY OF INVESTORS CONTINUES TO EXPAND

Institutional investors, investment funds, pension schemes, hedge funds and reinsurers themselves are all buying into alternative investments such as insurance-linked securities (ILS), collateralised reinsurance, sidecars, insurance-linked warranties (ILW) and – most recently – hedge fund reinsurers as well. The fact that income from, and interest on, these investments has been dropping off since the beginning of 2013 seems to be having no effect on reinvestment – or indeed on the new money flowing into the sector – and the number and mix of investors has continued to grow over recent months.

Which investors are genuinely interested in and committed to the reinsurance sector over the long-term will only become clear when interest rates begin to rise again. However, it is impossible to tell at present, as every variant of alternative capital contains an exit strategy: for hedge fund reinsurers, this is the initial public offering (IPO). As long as capital market investors continue to commit only to a limited time horizon, caution is counselled for cedants.

### TRANSPARENCY IS A KEY FACTOR IN SUCCESS

Investors and fund managers have gained access to reinsurance expertise in record time, either by buying up historical data and modelling capacity or through partnerships with established reinsurers. The danger here is that this development may conceal the fact that risks are being incorrectly assessed or risk accumulations overlooked.

The reinsurance industry and rating agencies regard fiercer competition among funds – and what at times amounts to nothing less than inadequate underwriting discipline – with concern. In addition, as the appetite of alternative capital market investors for liability cover has grown, these players are now also exposed to pricing, underwriting, claims handling and model risks and/or are taking on risks that cannot be modelled at all.

Capital market funds thus cover risks that would not be expected in a traditional securitisation; however, very few are aware that practically all ILS funds are entitled to underwrite traditional reinsurance business and are doing this via the back route of more liquid instruments (e.g. swaps and private bonds) while often underestimating the concomitant risks. This involves clear conflicts of governance as soon as the funds fail to live up to their promised performance. Cedants and investors should proceed with caution and place their risks and/or assets in the hands of service providers who report their risks transparently.

### THE FUTURE OF HEDGE FUND REINSURERS

Alternative capital has recently also been invested in the liability – or even the multi-line – segment to build up so-called hedge fund reinsurers. As such, the investor is looking to generate an attractive return by investing premium income from long-tail risks; with liability risks, substantial reserves are typically accumulated long before any loss occurs or is settled.

Whether hedge fund reinsurers are indeed actually offering any added value over traditional reinsurers depends on whether they are providing their cedants with stable capacity over the long-term. Alternative capital investors tend to gear their business model less to technical results but more to maximising investment income. The reinsurance business they write must therefore generate a greater diversification effect in the asset mix on the investment side than is the case with traditional reinsurance. In addition, any fluctuations in the annual result must also be kept within a manageable range.

The risky investment strategies pursued by hedge funds, their high level of external capital and the hedging instruments with which they operate should all give cedants pause for thought. The financial crisis has shown that in times of stress, such instruments can create maturity mismatches as well as dependencies and guarantees that result in liquidity shortages. Furthermore, if hedge funds suffer losses on their non-insurance-linked investments, this may result in a sudden drop in their equity capital which, in turn, may impair their ability to settle claims.

### COLLATERALISED REINSURANCE HAS ITS QUIRKS

In the case of collateralised reinsurance, cedants often underestimate the inter-

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dependence between reinsurance treaties and their asset backing, the collateral agreements that cover the risk of counterparty default. Here, cedants should pay particular attention to restrictions relating to the area of jurisdiction, claims settlements («pay as paid»), the terms and conditions of the «special cancellation clause» in reinsurance treaties, the treatment of IBNR estimates in the event of contract termination, and the modalities of applicable insolvency law.

Primary insurers see counterparty risk as a significant obstacle to any further growth in alternative capital. In a recent reinsurance analysis, Keefe, Bruyette & Woods (an investment bank specialising in financial services) stressed that cedants set great store by the reliability of their relationship with their reinsurers and their «willingness to pay». Such circumstances lend particular weight to the observation that some 50% of claims involving alternative capital investors are currently under dispute.

### TRADITIONAL REINSURERS AT AN ADVANTAGE

You do not need look far for the advantages of traditional reinsurers over alternative providers: classic reinsurance offers its cedants what they desire most – security and reliability. Risks are speedily and cost-effectively assessed, structured, accepted as well as paid and settled when a claim occurs. Any capacity used up by a loss event is immediately restocked. There are also shared interests and complementary track records to consider: reinsurers and primary insurers enter strategic alliances and work together to develop new markets and segments, thus providing valuable knowledge transfer that transcends countries, sectors and products. All this is complemented by important ancillary services such as in facultative reinsurance and portfolio administration, for example, as well as in processing major loss events.

## The SIGNAL IDUNA Group enjoys pleasing growth

The SIGNAL IDUNA Group, SI Re's parent company, can look back on the 2013 financial year with satisfaction. Total premium income grew by 1.9% to EUR 5.56 billion. Both the Group's life insurance and property/casualty businesses grew faster than the market (+6.6% and +3.1% respectively). Premium income from the Group's health insurers remained stable.

The Group's investments (including financial subsidiaries) experienced growth of 4.6% to a current total of EUR 58.76 billion while the SIGNAL IDUNA Group as a whole reported a net profit of EUR 132 million. This translates to a contraction of 16.8% compared to the previous year, with 2013's natural catastrophe losses in particular proving a major cost factor.

The Group's life insurers enjoyed overall growth of 6.6% (from EUR 1.46 billion to EUR 1.55 billion) with regular premiums from own business rising by 2.0% to EUR 1.27 billion.

The SIGNAL IDUNA Group's two health insurers achieved gross income of EUR 2.74 billion, marginally less than last year. A total of no less than 2.61 million people are now covered by the Group's health insurance providers.

Although the 2013 financial year was dogged by major natural catastrophes of extraordinary frequency, the SIGNAL IDUNA Group's domestic property/casualty insurers recorded a 3.1% upturn in gross premiums written, which grew to EUR 1.16 billion.

# SI Re appoints Patrick Schumacher as Chief Financial Officer and Member of the Executive Team

**Patrick Schumacher has been appointed as SI Re's CFO and a Member of the Executive Team. He is taking up the reins from Beat Landwing, who retired on 30 September 2014.**

Patrick Schumacher is joining us from New Re, where, as Head of Accounting since 2009, he was responsible for their general ledger as well as both internal and external reporting. In addition, he was leading their Solvency II project. Prior to this, Patrick Schumacher had been Head of Portfolio Analysis and Head of Reporting at Swiss Re Germany in Munich, where he analysed claims, trends, cashflows and their potential gaps, hereby providing important decision-making resources for management. Patrick Schumacher has a fine track record, with many years' experience in designing and developing reporting instruments as well as researching and writing quarterly and annual reports. Patrick Schumacher is 50 years old and holds a degree in Business Administration from the Zurich University of Applied Sciences.

At SI Re, Patrick Schumacher will be in charge of financial accounting, investments, taxes, rating agencies, and IT. He will also be responsible for reporting, controlling and SI Re's quarterly and claims reporting.

«I am particularly impressed by SI Re's short decision paths and the close and direct interaction I enjoy with my colleagues. This ties me right into the decision-making process, and I am intimately involved with the firm's growth,» says Patrick Schumacher. «In the ten years since the firm was founded, SI Re has established itself as a reliable and solid partner for its cedants. I am looking forward to continuing this work by fully exploiting the firm's potential in finance and investments and helping my colleagues to promote the company's growth.»

«I started working at SI Re on 1 July this year and I have been using these first few months to learn the ropes. I feel entirely at home in my new role and have been impressed by the flexibility, transparency and efficiency that underpin SI Re's work,» Patrick Schumacher continues.

SI Re CEO Bertrand Wollner: «Patrick Schumacher is yet another strong addition to our team. The broad reinsurance experience he has gained will help us improve SI Re's positioning with clients, business partners and rating agencies alike.»

Our new CFO and sports enthusiast comes from the Rhine valley at Chur, but feels entirely at home in Zug. He is delighted by his new, short route to work – in the opposite direction to the daily hordes of commuters heading into Zurich. In his leisure time, he engages in a range of charitable work both within Switzerland and abroad.



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