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Standing out is in your hands

With growth stalling, low premium prices and share values under-performing, many wholesale insurers appear to be running out of options. How can wholesale insurers sharpen competitive differentiation, seek out untapped pockets of value and boost shareholder returns?

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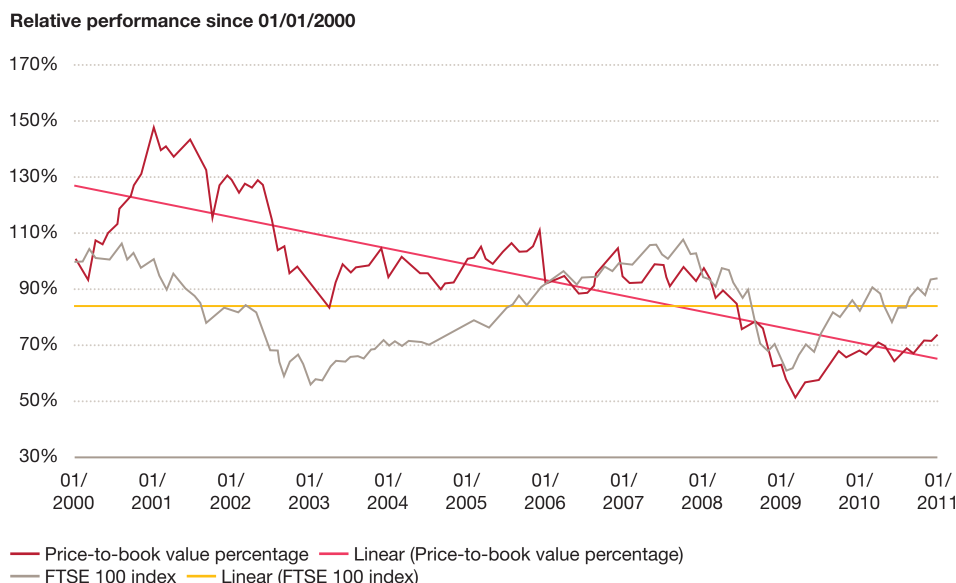
With limited growth potential in the traditional risk transfer market, wholesale insurers[1] must innovate to improve shareholder returns. Simply pursuing a diversification strategy has certainly not convinced the stakeholder community and has potentially been the primary value drainer in the industry. Evolving customer and investor demands provide opportunities to boost long-term growth and develop a genuinely differentiated strategy, both through enhanced risk analytics and whetting investor appetite for insurance opportunities – are you capitalising?

Although the 2010 returns in the wholesale insurance sector have been generally solid, most shares are trading at near to or even below book value (see Figure 1). What is the cause of the market's pessimism?

Rates remain soft across most wholesale classes despite the unfolding crisis in Japan. With relatively few major loss events in recent years prior to 2011, many wholesale insurers have built up a surplus of capital, which has put further downward pressure on rates. In a 2010 PwC report examining the state of the reinsurance market, several CEOs suggested that it would take a loss event akin to Hurricane Katrina to propel premium prices up again.[2] This is set to continue despite events in Japan, with insured losses as a result of the earthquake being disproportionately retained by domestic insurers due to the Japanese government's role in providing cover for residential earthquake losses. With only commercial and industrial risks directly ceded to the global insurance market, early estimates suggest that the catastrophe is unlikely to be capital depleting for global players (see Figure 2 overleaf). The very high frequency of cat events in the course of the past two quarters may however change buyers' perceptions of risk, their appetite for risk, understanding that risk retained on balance sheet attracts at least an economical capital charge and their willingness to pay an adequate risk adjusted price for that risk.

Figure 1: Relative performance of wholesale insurance price-to-book value and the FTSE all share index



Source: Datastream, PwC Analysis

NB: Companies are only covered where there are price-to-book ratios available

'The main scenarios against which I'm managing my business are low growth, soft rates and high inflation.'[3]

CEO

1 In this article, 'wholesale insurance' refers to insurance, reinsurance and retrocession cover transacted for and between professional counterparties. 'Wholesale insurers' include large corporate insurers, global and Bermudian reinsurers and London Market and other specialty insurance businesses. This article does not cover intermediaries.

2 'Way Forward: Innovation and differentiation in the reinsurance industry – the CEO perspective', PwC (September 2010).

3 All quotes in this report are drawn from interviews with reinsurance CEOs carried out as part of PwC's 2010 reinsurance survey.

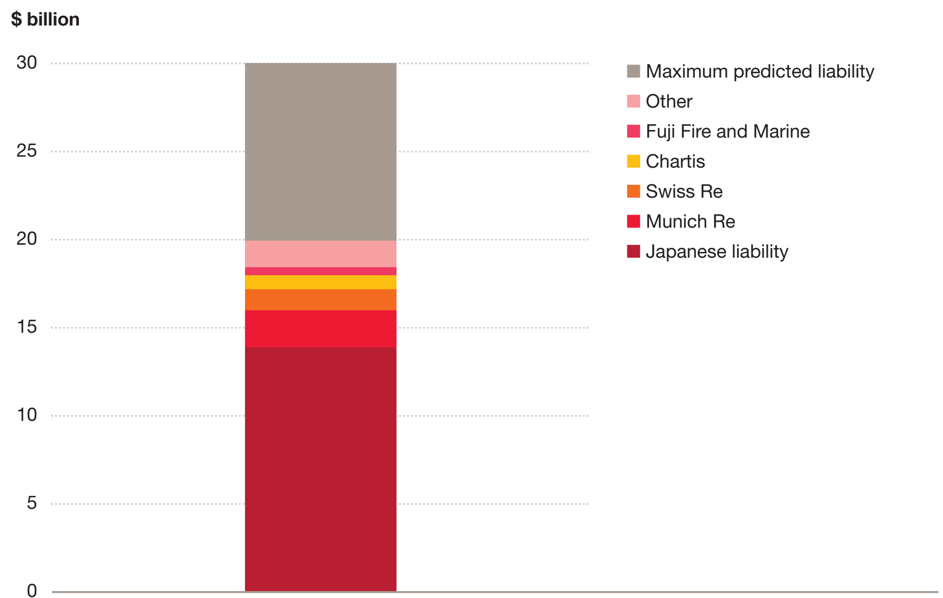
Are wholesale insurers doing enough to crystallize, demonstrate and communicate the value they can create?

14 **18**

14 out of 18 reinsurance CEOs interviewed by PwC do not see growth opportunities[4]

Source: PwC

Figure 2: Insurance losses as a result of the Japanese crisis per company



Source: PwC

The immediate dilemma is how best to use surplus funds when most CEOs see few opportunities for profitable growth within the current market. Returning capital to shareholders is one option, though this may prove short-sighted. As the findings from the latest Solvency II quantitative impact study (QIS 5) highlight, regulators are likely to force many non-life insurers to hold more, not less, capital. A volatile risk environment, as evidenced by events in Japan, Australia, New Zealand and Chile, also points to the need for higher reserves.

Ultimately, if more and more companies simply follow the pack by redistributing capital, it will confirm investors' belief that the growth prospects within the market are poor, deterring investment further (see Figure 3).

The issue that underpins the barren growth landscape is that there is growing disengagement within many wholesale insurers from both sides of the value equation: customer demand and capital supply.

Demand side

Corporate risk profiles have changed immeasurably as a result of the cost-cutting, operational overhaul and the shift in strategic focus to new and emerging markets emanating from the financial crisis. Yet many companies fail to appreciate the crucial value and importance of insurance within their overall risk management equation. Their insurance arrangements have not kept pace with the changes in their risk profile, resulting in inappropriate cover. The consequence is that most corporations see insurance as a cost to be minimised rather than a vital part of their strategic and balance sheet risk management. This is accelerating the commoditisation of the wholesale insurance product.[5] A similar picture is emerging within the reinsurance market as primary insurers seek to retain more risk in the hope of improved financial results.

Supply side

Wholesale insurers are also suffering from poor investor perception. Many analysts and investors regard the sector as opaque, with the perceptible rewards failing to justify the effort of trying to understand the value potential of the business. Thus it is difficult to compete

4 PwC 14th Annual Global CEO Survey 2011.

5 'Tackling the deficiencies in corporate insurance', PwC, March 2011.

for capital against industries that offer seemingly more transparent and easily discernible opportunities. The problem is compounded by the perceived lack of differentiation in the strategies pursued by most wholesale insurers and how they communicate these to the financial markets.

It is encouraging to note, however, that where sustainable value potential is identifiable, investors are prepared to buy into insurance companies. This includes renewed private equity interest in the sector, as was highlighted by the recent billion euro takeover of Brit Insurance by Achilles,[6] and Terra Firma's recent interest in Chaucer.[7] Investors are also seeking out targeted ways to invest in 'pure' insurance risk as a means of diversifying their portfolios, as is evident in the resurgent market for catastrophe bonds[8] with issuances of $1bn in the first quarter of 2011, relative to $650m in the same quarter last year.[9] Sidecars are coming back in fashion with the retrocession market looking to capitalise on insurers and reinsurers who cannot afford to take any more pain after the first quarter. An example is Alterra recently announcing the formation of a side car.

Insurers that fail to develop a differentiated strategy for growth will find themselves competing over increasingly commoditised low margin business, which can only heighten the disengagement from clients and investors. With little room to grow and enhance value, the only options left for such operations may be to seek a buyer consolidation or even enter into run off.

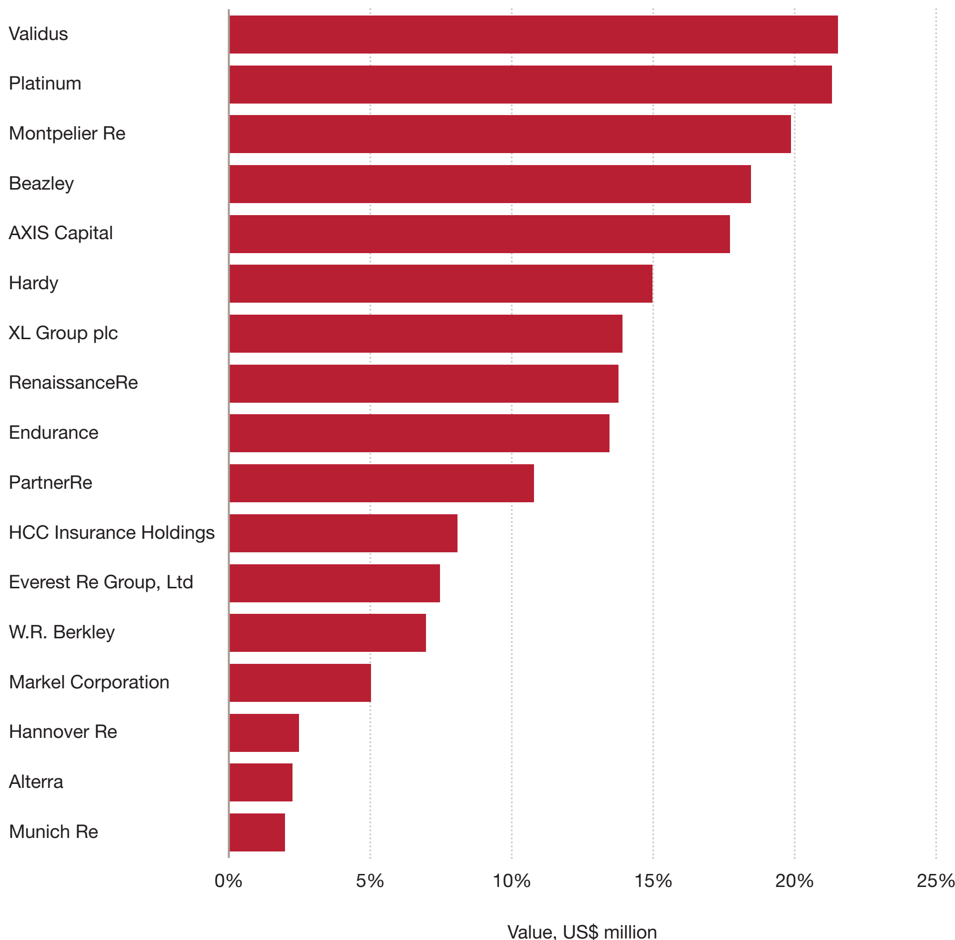
'The investor community seems to be valuing all reinsurance companies the same.'

CEO

'The absence of differentiation is an opportunity.'

CEO

Figure 3: Stake acquired through share buy-backs, Mar 2010–Mar 2011



Source: PwC

Are wholesale insurers searching hard enough for innovative ways both to encourage and to communicate long-term growth in existing markets?

6 Offer Document and Position Statement, published by Brit Insurance on 23.11.10.

7 *The Financial Times*, 07.02.11.

8 'Catastrophe bond market attracts new investors and further growth expected in 2011', Munich Re media release, 24.01.11.

9 'Strong Investor Demand Drives Catastrophe Bond Issuance of USD 1 Billion in the First Quarter of 2011', Willis media release, 12.04.11.

A key challenge to wholesale insurers will be helping to sustain superior financial performance despite the potentially higher capital charges under Solvency II.

Achieving differentiation

So how do wholesale insurers deliver stronger returns in the longer term? Emerging markets offer evident opportunities, though it will take a considerable amount of time to capitalise on them fully. While market expansion in the more mature developed markets is slower, changing stakeholder demands and an evolving risk transfer chain are opening up valuable new opportunities.

As such, this is an ideal time for far-sighted firms to develop more innovative and differentiated growth strategies. Capital is available to support value investments. The ability to create and execute a leading-edge strategy for the medium and long term would also help to convince analysts and investors that your company deserves fresh consideration.
We believe: first, that companies can deliver favourable and sustainable value despite the near-term challenges facing the sector as a whole; and, second, that companies will stand out from an otherwise undifferentiated and short-sighted pack and will therefore deserve to be valued on their individual merits.

This will mark a transition from wholesale insurers' tendency to be 'all things to all people', to a focus on differentiated and clearly stated strategies that are aligned with specific stakeholder needs.

Strategic opportunities

We have identified a framework incorporating four strategic directions for value growth from within the prevailing fast-moving commercial and risk landscape (see Figure 4):

I Skill

II Scale

III Risk partnership

IV Risk transformation

This strategic framework seeks to capitalise on and develop: superior risk analysis frameworks that facilitate pre-emptive exploitation of evolving risk opportunities; operational advantages in both cost and comprehensive service delivery to meet all client needs; closer liaison with customers to establish, communicate and effectively address their specific risk requirements; and, move along the

Figure 4: Strategies for differentiation

Scale

- Focus on operational simplicity and efficiency
- Globalise reach and expertise
- Provide full service risk management cover for clients efficiently

Skill

- Develop superior underwriting skill through training and incentivising staff
- Build agile business model and infrastructure
- Anticipate emerging risk transfer opportunities as a strategic imperative

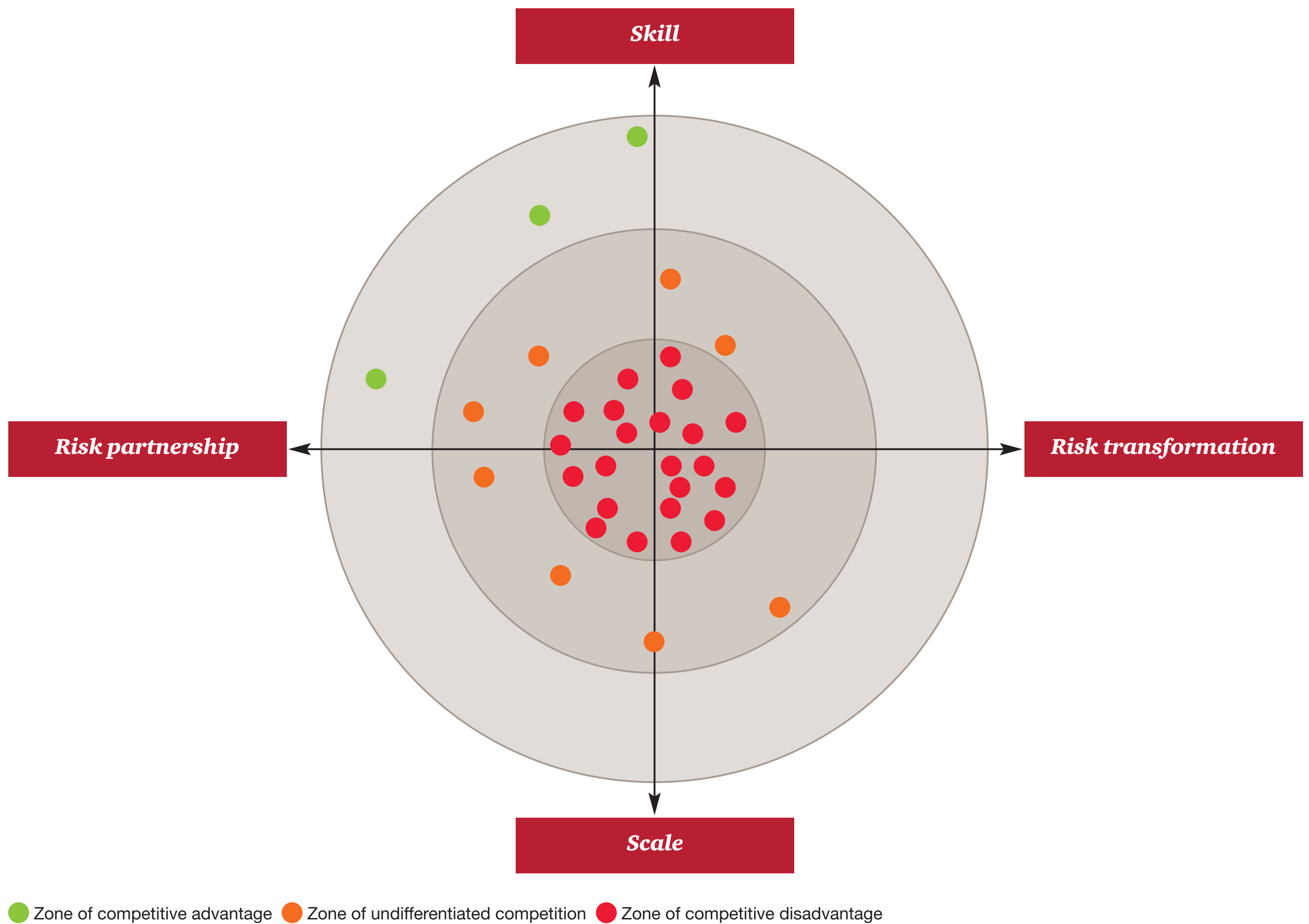
Risk partnership

- Client centricity: Focus on insight and alignment
- Focus on improved risk analytics
- Deliver bespoke risk management solutions

Risk transformation

- Improve market understanding
- Align with capital markets
- Package insurance risk into tradable securities

Figure 5: Assessment of strategies of select wholesale insurers



Zone of competitive advantage Zone of undifferentiated competition Zone of competitive disadvantage

Source: PwC review and analysis of the strategies of 33 insurers

value chain by sourcing and packaging insurance risk directly to satisfy specific capital market risk appetite.

Figure 5 demonstrates PwC's analysis and categorisation of the existing strategies of wholesale insurers in accordance with this framework, with the majority being placed in the zone of competitive disadvantage. The wholesale insurers that will emerge with renewed investor interest will be those that move away from the undifferentiated centre through developing further and utilising their superior risk insight, operational infrastructure, client relationships and understanding of investor risk appetite to promote their growth prospects.

'A superior cost ratio is the only way to generate adequate shareholder returns in the current environment.'

CEO

I) Skill

Specialty insurers have the advantage of superior expertise and risk analytics. Yet with today's specialty being tomorrow's commodity, they will need to seek out untapped niches and emerging trends if they're to sustain margins and utilise their competitive strengths. Success will derive from the anticipation of opportunities as a result of superior risk insights and market understanding, coupled with the operational agility to achieve first mover advantage. Successful companies will need to adopt a more transactional approach; taking on risks when they offer an attractive level of underwriting profit, withdrawing when returns begin to drop and swiftly switching resources to the next

opportunity. The ability to recruit, train and retain talent will be at the centre of such a strategy, and will therefore also require an innovative and competitive system of incentivisation.

II) Scale

With soft rates continuing, scale players are set to become more dominant as price competition intensifies, margins are squeezed still further and new solvency regulations drive up the capital costs of less well-diversified counterparts. Scale players will be able to offer a full suite of insurance services, across multiple geographies and multiple distribution platforms, and therefore provide comprehensive solutions for their clients. They will operate efficient global systems to achieve the economies of scale needed to keep costs low and to leverage tactical and strategic pricing flexibility, while still sustaining acceptable margins. In turn, scale players will be able to share expertise globally to pre-empt and develop effective responses to strategic challenges.

Wholesale insurers have an opportunity to reinvent their commercial offering as an informative, analytically rich and data-driven risk management service, with which bespoke risk transfer and management solutions can be tailored to mitigate the specific risk management requirements of the individual client.

III) Risk partnership

Risk management is now a key strategic priority within most corporations as a result of the financial crisis. Yet to mitigate these risks, corporations and insurers need to understand them. Insurers can develop and provide that understanding, having made huge strides forward in risk analytics in recent years, with Solvency II set to provide a further catalyst for improvement.

Indeed, the current approach to risk profiling and data communication by clients is inadequate, making it difficult for insurers to understand the insured's risk management needs. This is compounded by an unwillingness of the predominant part of the wholesale insurance industry to engage directly with companies and by ineffective articulation of the value of insurance in their overall risk and capital management framework. The resulting deficiencies in the risk placement and protection process mean that the cover being purchased may be wholly inadequate.[10] This is leaving clients exposed, creating avoidable claims disputes. Thus the relationship between the client and insurer is undermined as the value of the risk transfer process is called into question.

A closer tripartite partnership between client, broker and insurer built around more developed risk insight would allow insurers to construct more tailored risk management solutions. This would include a combination of more effective risk mitigation and, where necessary, risk transfer. For insurers, the advantages include a fundamental repositioning of the risk transfer proposition, leading to improved customer loyalty and a more informed basis for risk pricing and selection, along with a reduction in claims handling costs and potential disputes. The reward will be a more valued and valuable partnership with the policyholder.

IV) Risk transformation

There is an increasing demand for direct investment in pure insurance risk. This has the advantage of being largely uncorrelated with the market risks associated with many other forms of investment, notably equities (insurers included). This trend is driven by a new definition of risk premiums and poor yields in many other asset classes.

10 'Tackling the dangerous flaws in insurance protection', published by PwC on 14.03.11.

'The insurance-linked securities market increases the transparency of pricing and allows risks to be transferred to the capital markets and traded.'

CEO

By investing in pure insurance risks rather than an insurance company, investors can avoid some of the perceived uncertainties of buying into what they see as an opaque and homogenous sector. The growing appetite for direct risk transfer is already evident in the renewed growth in the catastrophe bond market, which includes increasing interest from pension funds, sovereign wealth funds and other mainstream institutional investors.[11] The direct risk transfer potential into capital markets stretches to all classes of business, including life and accident and health, and embraces sidecar structures as well as securitisations.

By holding insurance stocks, markets have demonstrated an appetite for indirect investment in insurance risk. A move along the value chain could transform this indirect investment via equities into a direct investment via insurance-linked securities. The real value potential of this model will come from getting closer to investors to gain a full understanding of their specific risk appetite and being able to translate this into transparent and marketable assets. Pioneering companies will be best placed to achieve first mover advantage.

Rethinking your vision

The value potential is there, but how can your firm make the most of it? Clear vision and determined execution will be vital in capitalising on these strategic opportunities and differentiating your business from your competitors. A number of key questions will need to be addressed in formulating, communicating and implementing this vision:

- What is your long-term strategy for value growth?
- Does your strategic positioning provide for genuine differentiation and true value growth in the eyes of investors and customers?
- What changes to your business model, your operational capabilities and your skill bases are needed to execute your strategy in the most effective way?
- How can you convey the strength and differentiation of your business in a clear, credible and compelling way?

Emphatic and decisive answers to these questions will ensure that your firm is on the right track to a differentiated and long-term growth strategy. The sooner changes are implemented, the sooner the value advantages will be realised. Standing out is in your hands.

11 'Catastrophe bond market attracts new investors and further growth expected in 2011', Munich Re media release, 24.01.11.

Giving you the edge

As part of our advice and support for wholesale insurance companies, we've been building up a wealth of data and analysis on why some firms are performing better than others and how organisations can maximise their value potential. If you'd like to discuss any of the issues raised in this paper or know more about how your business can develop a clearer and more differentiated strategy for value growth, please contact one of the authors listed here:

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