

Unfamiliar times displacing familiar strategies

*Seizing opportunities in
response to deep-rooted
change in the reinsurance
industry.*

November 2010

The financial crisis turned many conventional business models on their head. Traditional reinsurance models face substantial pressure from unprecedented turbulence and uncertainty – seizing success in a shifting reinsurance landscape will require innovation, courage and strategic repositioning.

Disappointing pricing fundamentals emerged as the chief concern for major industry stakeholders at this year's Monte Carlo reinsurance Rendez-vous. While the major rating agencies reported the global reinsurance outlook as 'stable', macroeconomic factors such as increased and prolonged economic growth volatility and the potential for a longer soft cycle put pressure on ROE targets and the reinsurance industry as whole.

'Adjusting to the new normal'¹ is a reinsurance industry theme that PwC has been discussing for some time, and this whitepaper explores whether the industry (and in particular the Bermuda reinsurance market) is now at an historic inflection point.

Is the industry at a stage where innovation, growth and strategic reform represent imperatives for long term survival, rather than optional levers for CEO's to pull?

To find out, PwC interviewed leading Bermuda reinsurance CEOs and asked them to comment on the threats, challenges and opportunities faced by the industry.

¹PwC Whitepaper: Top Insurance & Reinsurance Industry Issues in 2010 – Bermuda Focus: *Adjusting to the new normal*

Outlook: uncertainty/opportunity

'The biggest challenge to the industry is to earn a return in excess of cost of capital – most reinsurers are not doing this and this is clearly unsustainable' noted one reinsurance CEO. There is no doubt that the industry is making money, and indeed the Bermuda market's relatively unscathed emergence from the financial crisis points to its resilience.

However, with declining ROEs and most companies trading at a discount to book, the long-term attractiveness of the reinsurance value proposition demands proactive management.

Most CEOs we interviewed had not felt the need to change their business models following the financial crisis. But if you examine the issues that are crowding in on the industry, set against a desire to maximise future opportunity, it is clear that change is needed now.

1. Reinsurance rating drivers

Strong capacity compounds the pressure on reinsurance pricing with limited exception. Reinsurers are under pressure, with higher retentions among cedants and the use of non-traditional covers contributing to surplus supply in the marketplace. Commentators usually focus on what size of event would turn the market, the consensus being that without an event of \$40bn to \$50bn the market will continue to decline.

The reality, however, is that event magnitude is far less of a driver than buyers' perceptions of risk, their appetite for risk and their willingness to pay to manage that risk. An event that influences these factors will have a far bigger impact on pricing than another big cat. The success of Bermuda reinsurers can in large part be attributed to the emphasis they place on analytical and technical pricing. Maintaining a firm resolve towards sound underwriting fundamentals will be key through this soft phase.

2. Claims bill grows

Headline losses like the Deepwater Horizon oil spill transformed the offshore energy segment and pricing responded accordingly. Rate hardening also occurred in Latin American property cat following the Chile earthquake, albeit from an historic low, and questions persist around price adequacy in that region.

Of more concern for global reinsurers is the proliferation of single-digit billion dollar events that are occurring more frequently, eroding capital without a commensurate adjustment in pricing.

3. Capital management priorities

Returning capital to shareholders that has been hard to deploy at acceptable rates has been a common capital management technique in the Bermuda market since the spring of 2007. Despite this year's major and attritional events, an abundance of capital remains.

Further returns are attractive in providing temporary reprieve in meeting stated ROE targets and reward longer-term investors for their commitment to their investments. But the question, 'once capital has been returned, how easy is it to get it back?' is being raised.

We believe that companies with a robust track record of efficient and effective capital management usually succeed in attracting it back when needed – as evidenced by a substantial capital raise that was completed recently.

A more important question is whether now is the time to invest in securing longer-term growth and market share. In other words, in a period where underwriting discipline and cost management are essential to avoid future capital erosion, companies could also put excess capital to work by exploring alternative growth strategies. Given that reinsurance pricing could remain depressed for some time to come, coupled with signs that interest rates are unlikely to deliver significant investment income relief in the near to medium term, it is important to focus now on securing future positions.

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4. Deflation, inflation and interest rate uncertainty

Most CEOs we interviewed put inflation high up, if not top of their list of concerns. Indeed, while the industry has had (and continues) to deal with debt deflation and the downward spiral of asset prices, there is lively debate over whether the market is about to enter a period of inflation.

Although current consumer price indices remain low, concerns persist that governmental stimulus packages worldwide will result in a spike in inflation.

Inflation/deflation will determine the overall rating environment as well as future reserve adequacy. Added to the significant uncertainty around deflation versus inflation is the interest rate conundrum. Conservative investment portfolios helped Bermuda reinsurers weather the financial crisis; however, short term, high quality investments are now yielding between two and three percent. The longer the deflationary environment persists the tougher it will be to make investment returns.

5. Reserve redundancy

Companies have been afforded some relief from the bigger and more severe 2010 events (Chile, Deepwater) in their results through prior-year reserve releases. In a stage of the cycle often referred to as the 'cheating phase', such releases inevitably dry up. While the tail is relatively short on much of the business written within the Bermuda market, future events now have the potential to cause a more dramatic impact to quarterly earnings - as does future adverse development on prior-year reserves if releases go too far.

6. Regulation and equivalence

The reform of financial services supervision, and Solvency II in particular, presents a major challenge (but also an opportunity) for the reinsurance sector. The challenge results from regulators not creating sufficient distinction between sectors and specifically packaging rather than separating the banking industry from the insurance and reinsurance industries.

The clear challenge to the Bermuda market is Solvency II equivalence. Bermuda's opportunity lies in achieving equivalence in a way that preserves its jurisdictional advantage - namely a high-quality risk-based regulatory framework that is tailored to the wholesale reinsurance market.

Some of the obvious challenges that a lack of equivalence could present include:

- reinsurance collateral that is determined by individual EEA member states;
- Bermuda entities of EEA groups would be required to hold capital at Solvency II levels; and
- groups may be supervised by an EEA regulator rather than the BMA, potentially requiring Solvency II capital levels more broadly throughout the group.

We'll examine the opportunities that may exist for reinsurers as a result of Solvency II implementation later.

7. Alternative 'surge' capital

The ability of existing companies to increase premiums after a period of inadequate pricing or after a cat event is partially diminished by the relative ease of entry into the market by 'surge capital' e.g. side-cars, insurance-linked securities. Surge capital seizes the opportunity afforded by a hard market without having to absorb the costs of the trigger.

Surge capital can be a positive after an event, quickly filling capacity vacuums and allowing companies to maintain or grow

their positions in the market. This was a hot topic at the Rendez-vous meeting and there was growing support for the notion that new, longer-term entrants would be unlikely across the entire industry.

The cat-bond market had a near record second quarter in 2010, suggesting a resurgence towards the high levels of 2007. It appears that some of the structuring challenges are being addressed, with a far higher proportion of reinsurance brokers broking deals as opposed to investment banks. The upswing in ILS issuance suggests that capital market investors are renewing their interest in the sector, but again this emphasises a preference for short-term capital involvement. The extent to which reinsurers diversify into non-traditional products will determine how much of a threat, versus an opportunity, this change presents.

8. International tax reform

President Obama's measures appear less onerous than those tabled in a bill sponsored by US Congressman Neal (in respect of taxes on reinsurance premiums paid by US insurers to affiliated foreign reinsurers). However, protectionism remains a threat in varying degrees to the Bermuda reinsurance market and comes on top of the substantial collateral required for conducting business in the US.

A silver lining for Bermuda, however, is that neither measure includes a tax treaty carve-out and so other jurisdictions seeking to make domicile plays from a tax standpoint have had their advantage eroded.

Recent re-domiciliation activity has prompted much discussion but the advantages of Bermuda as a sophisticated and pre-eminent reinsurance marketplace are as compelling as ever. The choice of holding company domicile is more about capital flexibility and opportunism than anything else; market access is another matter. All the groups that have so far relocated their holding companies have retained their underwriting operations in Bermuda.

9. Valuations and the reinsurance value proposition

Putting together all the above issues against the current macroeconomic background it is easy to see why reinsurer valuations are low and why stock has been trading at, sometimes substantial, discounts to book. Discussing this with CEOs there was consensus that the sector is undervalued. One CEO commented that he 'believes there is significant underappreciated value in some quality reinsurers'.

The perception that the reinsurance industry is opaque is often downplayed. But when you consider the complexities of reinsurance business models and factor in the different challenges it faces, valuation and analysis can be challenging.

PwC's view is that more could be done to lift the veil through improved reporting and transparency. This view is supported by our research: 'I believe that gap is caused by a lack of information and credibility – if risk taking companies are to be rationally valued they need to improve the reporting and disclosure of risks being taken,' one CEO said.

This is a complex proposition, particularly as the financial reporting of insurance contracts changes. But it is clear that reinsurers who can plainly articulate the reinsurance value proposition to key stakeholders are less likely to be undervalued.

10. Operational performance and cost control

As margins shrink, the inevitable focus on operational performance and cost control sharpens. In Bermuda the recent changes to payroll tax certainly served as a counterpoint to expense management objectives.

Too many companies approach cost reduction in a 'slash and cut' way. To effectively and sustainably reduce costs, it is our view that organisations could use better demand management techniques, reorganise support functions more centrally, eliminate redundancies and shadow functions in business units, report in a standardised way, eliminate unnecessary duplication of tools and applications and leverage common solutions or platforms.

The reinsurance industry is no stranger to adversity and in the past has emerged stronger for it. The sector weathered the financial crisis and provided important lessons to others in financial services. In large part, this success was directly attributable to focussed and nimble strategic execution, effective and efficient capital management, robust and technically disciplined underwriting and tight cost management through soft cycles.

The down-cycle is the biggest test of reinsurance management - how it reacts to protect against downwards volatility and to manage ROE. The increased uncertainty and challenge in the industry that could produce a fundamentally different reinsurance environment in the future may mean, however, that a different response is necessary.

It could be argued that a lack of suitable investment into potential growth opportunities in the midst of this soft cycle could limit future success as the market turns. At the other end of the spectrum, a fundamental recalibration of the business model, with substantive investment now, could be the minimum required to stay competitive in an evolving risk landscape.

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Growth

There have been several cases in the reinsurance industry of acquisition, diversification and growth strategies delivering neutral or even adverse results to otherwise strong core reinsurance operations - so discipline and capital management through the down-cycle are critical.

It is our view, however, that strategic re-positioning and capital investment to drive future growth are complementary to capital management, even essential, given the 'new normal' to which the reinsurance market must adjust. But where could growth come from?

1. Innovation

During this year's Rendez-vous one large continental European and one Bermuda-based reinsurer launched coverages for offshore oil drilling liability risks following the Deepwater Horizon drilling disaster. These are examples of innovation in an ever-changing risk landscape.

At a time of reinsurance 'commoditisation' and when the industry is facing unanticipated and unprecedented risk, innovation is necessary to provide differentiation and to rapidly capitalise on shifting demand.

2. Distribution and risk transfer

Comparing the ROEs and profitability of leading insurers versus reinsurers is a sensitive point for the industry and, coupled with increasing commoditisation, the reinsurance industry has some work to do to improve its image to its ultimate customers. Reinsurers' knee-jerk responses in reducing cover and pushing up prices following major dislocations has made reinsurance buyers cautious about approaching the sector even in times where they really ought to be offloading risk.

By creating innovative risk transfer solutions that clients will purchase, rather than cutting back traditional capacity, reinsurers will create new opportunities. Fresh thinking about distribution, for example, could change buyers' 'commodity' perspective of reinsurance.

Reinsurers can benefit from providing clients with the support they need in times of risk adversity.

Furthermore, there are opportunities to improve the efficiency and effectiveness of risk transfer by investing in closer risk partnerships with clients than might be afforded through the traditional broker relationship.

As one reinsurance CEO put it: 'Reinsurers need to be more transparent and explain their business. Creating true partnerships between reinsurers and clients helps with this perception as well'.

3. Solvency II

In a recently issued report by Morgan Stanley and Oliver Wyman it was estimated that Solvency II could increase the demand for reinsurance in Europe by 10 to 20 percent. The report went on to say, however, that the substantial excess capacity already in the marketplace would be sufficient to mop up this demand.

It is unclear at this point what true growth potential might come from Solvency II and indeed who stands to benefit as insurance companies respond to demands for stronger capital bases by purchasing reinsurance. We see opportunity and growth for reinsurers coming from three main sources.

The first, as noted above, is a straight increase in demand for reinsurance. The second is likely to be through innovation and product development as a direct result of insurance companies seeking to manage capital positions in an effective way. The third is through mergers and acquisitions as smaller, specialty players find themselves unable to meet new capital or compliance hurdles. This could result in some 'fire sales' as the Solvency II deadline approaches, which presents opportunities for those companies able to unlock value quickly from these entities.

Bermuda stands to benefit directly from each of these three possible outcomes.

'There are always pockets of growth to be found, but the market is chasing those like fish chasing bread in a fish farm'

‘Reinsurers need to be more transparent and explain their business. Creating true partnerships between reinsurers and clients helps with this perception as well’

4. Emerging markets

China and Latin America are obvious candidates for growth. Many reinsurers are well poised to take advantage of the possibilities that these regions bring particularly as GDP per capita starts to edge towards the important inflection point. This is seen as a long game because many CEOs view these marketplaces as tough to crack. Investment now, in teams, infrastructure, marketing and strategic positioning is all important in securing share when the markets take-off.

There are also less obvious, but potentially lucrative regions, that again with some positioning and investment could provide substantial returns in the medium term. These include micro-insurance initiatives as well as reinsurance.

5. Market positioning

One of the strengths of Bermuda-based global reinsurance groups is the flexibility of their operating models. Every jurisdiction or marketplace has clear strengths as well as limitations. It could be argued that those groups that are able to exert the highest degree of leverage and outright power over a particular marketplace are those that can underwrite in markets from different access points. For example, in certain circumstances it may be advantageous to underwrite specific lines of business through a Lloyd’s syndicate; in others it may be less restrictive to work through a European platform. Determining which approach is worthy of strategic evaluation, if not investment, in advance of the next upturn in the cycle is crucial.

6. Non-traditional reinsurance

The 2005 storms sparked a substantial uptick in the use of non-traditional reinsurance with a spike in sidacar use (particularly in Bermuda) in 2006 and record use of catastrophe bonds in 2007. ILS deals have continued to flow this year despite the absence of major cat activity.

As discussed in Monte Carlo a high expectation of short term ‘surge capital’ through collateralised reinsurance agreements is expected to be the preferred capital markets response rather than long-term reinsurance investment should a market dislocation occur.

Notwithstanding this, as reinsurance companies manage the soft cycle, protection of market share could come through outwards cessions into such vehicles too.

The ILW market is strong and its potency as an alternative risk transfer tool has been proven in respect of certain recent events. However, traditional reinsurance groups have been slow to react to the potential demand in this area. Competition and diversification considerations may be behind this reluctance but such tools (including other forms of ILS) are here to stay. Making favourable alternative offerings available to clients will help reinsurers protect market share and/or grow, where ground has been lost.

7. Mergers & acquisitions

Organic growth of existing business will be extremely difficult in the near to medium term and in an environment where stock prices remain deflated continued M&A activity is likely. Following three substantial Bermuda consolidations in two years, expectations are high that more are on the table and with several billion dollar companies trading at discounts but trading profitably, those expectations are likely to be realised.

The US casualty market is a target for Bermuda-based groups looking to establish a diversified presence onshore - however the fundamentals are absent and look set to remain so for some years to come.

Penetration into continental Europe presents challenges and limited options other than those potential opportunities resulting from Solvency II. Given the strength of domestic reinsurance companies already in position, acquisition strategies need to take account of the substantive barriers to entry that include Solvency II.

While some of these approaches could create net growth to the global reinsurance market, others may only serve to increase an individual reinsurer's market share. Either way, the Bermuda market is a recognised centre of intellectual excellence and has the potential to reshape and lead the global reinsurance market.

Percentage of global reinsurance chief executives who spoke to PwC in the run-up to this year's Monte Carlo rendezvous said that they did not see potential growth in the reinsurance industry

78%

*The future of the Bermuda
reinsurance industry*

Seasoned reinsurance executives have experienced multiple cycles and periods of adversity in the past, but none like the current environment. It is our view that given the severity and extent of the challenges that the reinsurance industry now faces, it may be at the inflection point of a full-scale reinsurance landscape shift. This inflection point could represent a huge opportunity for reinsurers.

In this context, reinsurance leaders should consider the following:

Is the current structure of the risk transfer process still appropriate to respond to the new demand? Where and how can growth be secured, presently and in the future, through actions taken now?

How can the global reinsurance industry add value and be seen to be doing so? What value parameters need to be applied?

How should reinsurers address their diverse stakeholder community to enable a mutually sustainable, long term and value-adding relationship?

What risks will be significant in the future? How will products be (re) designed to provide efficient risk transfer solutions to address demand?

Which business model is best suited to adapt to emerging parameters? What investment decisions must be taken now to create optimal positioning to capitalise on these parameters?

How can the fundamental differentiators in risk management – intellectual capital, risk analytics, underwriting experience – be brought to the forefront again, developed further and leveraged strategically?

While it may be understandable that reinsurers are hunkering down, applying underwriting discipline and maximising hugely beneficial capital return mechanisms, they are, however, waiting for another major event to remove the excess capital and turn around another soft cycle.

Complementary strategies that address questions of capital investment and innovation do not have to undermine the strength of underlying businesses.

Indeed, given the landscape changes that we have discussed, decisive and well executed business model transformation strategies may be the only way to guarantee success when the cycle turns and markets harden.

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