Confronting the new market realities

Getting to grips with a rapidly changing global risk and commercial landscape

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Introduction

In a tough financial services marketplace, reinsurers have some of the greatest reasons to be positive. Losses are down and profits are up. While price to book ratios remain at low levels, reinsurers' share prices have comfortably outperformed the insurance sector, as well as the benchmarks for financial stocks as a whole. Reinsurers' ability to absorb recent losses underlines both their resilience and the value of the protection they provide in an increasingly complex and uncertain global risk landscape. The nagging doubt remains how to secure profitable growth in a new and very different global marketplace.

With limited growth in demand for reinsurance in Europe and the US, the rapidly expanding markets of South America, Asia, Africa and the Middle East (together, these regions make up what PwC terms as 'SAAAME') offer greater potential for expansion. But many reinsurers are following the same path. As a result, the most attractive SAAAME markets are overcrowded and fiercely competitive. Changes in patterns of trade and risk in SAAME markets may also be exposing reinsurers to unforeseen losses.

A further challenge is how to be in the right place and attract the best business when an ever increasing amount of manufacturing and commerce now flows between SAAAME markets and misses out the West. In this environment, investors are questioning whether reinsurers are pursuing growth ambitions for the right reasons – and whether their interests are sufficiently aligned with those of management.

As we examine in this paper, the key to sustaining growth and meeting investor expectations is looking beyond what everyone else is doing to focus on what the business can offer that competitors cannot. Successful reinsurers are also striving to develop the scale, skill and market understanding to make the most of these capabilities. For some this will mean developing and strengthening their presence in SAAAME markets. But others could prove just as successful by making the most of core competencies in developed markets.

One important consideration is how to make the most of the developments in risk analytics and convergence between reinsurance and capital markets to provide a more efficient way to manage and transfer routine risks. Smart reinsurers can then focus their expertise and resources on the new frontiers of risk and the kinds of business that offer a more attractive balance between risk and return. They will also be looking at how to keep pace with the accelerating changes in the global risk and commercial landscape and the interconnectivity of the manufacturing patterns and trade flows within it.

The reinsurers that emerge stronger from this shake-up will have been able to marry up the new market realities with the distinctive strengths of their businesses. Failure to forge a clear path through this new landscape could leave other companies in an undifferentiated and uncomfortable middle ground.

The fact that SAAAME markets are likely to continue to expand much faster than developed markets is a fact of life. But the consequences of these trends are complex and far-reaching.

Winning over investors

Many investors remain sceptical about whether their interests are sufficiently aligned with those of the management teams running companies they invest in. How can reinsurers convince the markets that they're on the right track?

Questions for the board

- What can you offer in target markets that local and international competitors cannot?
- When do you expect to see a return on your investment in SAAAME markets above the cost of equity?
- Are you sufficiently aware of investor expectations?
- To what extent are your interests aligned with investors?
- How can you best explain the rationale of your growth plans and your ability to meet them to analysts and investors?

The focus of global investment and growth is shifting to the SAAAME markets. Many reinsurers are following suit. But investors are raising questions about whether these growth strategies will enhance returns.

Making money in markets where volumes are still often quite thin is a challenge, especially as many companies are following similar expansion strategies. In addition, prospective entrants may face restrictions on foreign operations or entrenched competition from dominant local players able to take advantage of guaranteed quotas for reinsurance placement. Further questions centre on whether these growth strategies are taking reinsurers beyond their 'core competencies'.

These questions go to the heart of the low price-to-book ratios at which many reinsurers' share prices trade. While there is obviously a host of factors behind this, the impact of low bond yields on reinsurance profitability can be overstated, not least because this should lead to a corresponding decline in the cost of equity. As a hedge fund manager recently quoted in the Financial Times said: 'Pensions and endowments place a higher priority on preserving assets than reaching for extraordinary returns and taking extraordinary risks to do so. We are experiencing that positive uncorrelated returns are more important for institutional investors than large returns.'[1] This is precisely the factor that is driving interest in insurance-linked securities (ILS), and while this may also be a source of support to the quoted reinsurance sector, the reality is that investors are not fully convinced. In this respect, a key concern is whether the interests of shareholders and management teams are as aligned as they could be.

Clearly, management teams need to take investment decisions that will build the business over the long-term rather than simply focusing on the next few quarters. However, many reinsurers may need to do more to articulate where the best opportunities for their particular business lie, what they are doing to capitalise on them and what qualifies them to deliver. This in turn demands a clear vision of where and how the business is going to compete. It also demands a credible execution plan that reflects the challenges outlined in this report, and which can be translated into financial performance metrics. The upside here is tangible and significant, with investors more than willing to back a strategy that really does create a clear alignment of interests.

1 Financial Times, 30.08.12

The risk of unforeseen losses created by rising SAAAME liability values and global economic interdependence were highlighted by the $12 billion of losses from the Thai floods of 2011.

$12bn

Keeping pace with a rapidly changing global risk landscape

As the risk landscape evolves, how can you make sure that risk selection, risk pricing and your presence on the ground are keeping pace?

Growth in production and demand in the SAAAME markets is leading to a rapid rise in liability values. The value of insurable plant and infrastructure in China, India and Brazil has surged since 2005 on the back of nearly $20 trillion of investment.[2] During this period, the combined manufacturing output of these three superpowers more than doubled to reach $2,310 billion in 2010 (adjusted to current USD values).[3] While premium volumes have risen significantly, they may need to grow even more quickly to keep up with the value of what is being insured.

But it is the increasing interconnectivity and interdependence of the SAAAME markets that creates the greatest challenges for reinsurers. Trade within SAAAME is growing much faster than the flows between developed-to-developed and developed-to-emerging markets. The associated risk transfer flows may not find their way into traditional reinsurance hubs such as Bermuda, London or Zurich. While many reinsurers are developing their presence in established regional hubs within SAAAME, they may need to go further afield to some of the emerging centres in places such as Labuan, Shanghai or Sao Paulo to make sure they have access to the evolving trade and risk transfer flows. The implications of this interconnectivity were summed up by Vikram Pandit, CEO of Citigroup, in a recent interview with the Financial Times: 'When you see a Brazilian company wanting to buy orange groves in India, it doesn't touch New York, it doesn't touch London, it goes directly. The south to south flows are literally bypassing the centres.'[4]

Unforeseen losses

As the supply and production chains of global companies become more geographically scattered and inventories of key components become smaller, the potential for business interruption losses is also escalating. There is therefore a danger in over-reliance on single risk models that may fail to take full account of the indirect and knock-on exposures this creates.

The risk of unforeseen losses created by rising SAAAME liability values and global economic interdependence was highlighted by the $12 billion of losses from the Thai floods of 2011. Thailand's industrial all-risk insurance premiums, which covered most of the losses, were only $370 million in 2011, resulting in a loss ratio of more than 3,000%.[5] The losses were not only telling in their overall scale, but also because of the significant impact of supply chain and business interruption claims coming from other countries, notably Japan. Having already transferred a considerable amount of manufacturing to Thailand, Japanese corporations increased this still further in the aftermath of the 2011 earthquake.

Looking ahead, the developments in the global risk landscape and the challenges this creates are going to accelerate. As pay in many of the more developed SAAAME markets such as Brazil and China rises, workers' employee rights are likely to increase (which drive compensation liabilities). A considerable amount of the world's production capacity is also going to be shifting to lower cost destinations and nearer to the centres of consumer market growth. This includes Africa, where available risk data and analysis may be even more limited than the previous wave of frontier markets such as Thailand and Indonesia.

The developed market catastrophe risk clusters of US and Japanese earthquakes and US and European wind storm damage remain the main focus on modelling. It will be important to identify the new risk zones and bring modelling up to speed.

Questions for the board

- How reliable is the risk modelling and pricing of SAAAME market risks?
- How can you make up for limited risk data and modelling output in these regions?
- Do multi-territory policies take sufficient account of the new risk zones?
- Do you have the underwriting capabilities on the ground to understand the risks?
- How can you secure the talent needed to develop risk understanding on the ground?

2 Global Construction 2020, published in association with PwC, 09.03.11

3 World Bank World Development Indicators (from website 14.06.12)

4 Financial Times, 21.08.12

5 Swiss Re Sigma 'Natural catastrophes and man-made natural disasters in 2011', 28.03.12

Harnessing the potential of ILS

Increasing liquidity in insurance-linked securities (ILS) including side car investments offers opportunities to expand the market overall.

2012 has seen a surge in capital market convergence with reinsurance. Many investors see ILS as an opportunity to diversify their portfolios, while achieving attractive risk-adjusted returns – a significant amount of the new money is coming from pension funds. ILS allows investors to move in, capitalise and withdraw more quickly than mainstream reinsurance – private equity is playing a prominent role in the establishment of new funds and side-cars.

As the ILS market evolves, developments in risk analytics, mitigation and transfer are allowing sponsors to enhance technical pricing, develop more finely-tuned ILS structures and align them more closely with investors' different risk and reward appetites. They are also paving the way for greater product transparency and standardisation within the ILS market, which is helping to attract a broader base of institutional investors and promote greater liquidity.

Taking advantage of ILS

ILS is sometimes portrayed as a threat to mainstream reinsurance by taking away investment and risk transfer business. But more and more traditional market participants are setting up their own ILS vehicles, teams or segments, seeing this as a complement rather than a threat, which can help to bring in investors that may not want to commit capital to conventional reinsurance. Bermuda has seen a new wave of 2012 start-ups that are more akin to asset managers than the traditional reinsurance structures of the past.

As some routine areas of reinsurance become more commoditised, competition from the capital markets for risk transfer was always inevitable and is likely to increase. Forward-thinking reinsurers recognise this as an opportunity by allowing them to provide their expertise to ILS sponsors for a fee, harness new sources of capital and provide their clients with a better blend of risk transfer options and hence manage their risks more effectively. Growth in ILS would also allow reinsurers to transfer some of the routine risks off their balance sheets and onto the capital markets and free up capital and underwriting resources to focus on new and potentially more profitable risks.

From an investment perspective, the growth in ILS demonstrates that transparently conveyed pure uncorrelated risk is what many investors are looking for from reinsurance. It will be important for reinsurers to look at how they could convey their risks in a comparably transparent way and align their portfolios, risk profiles and business development plans more closely with investor expectations.

In the longer term, ILS also opens up opportunities to bring capital and risk closer together in fast growth markets. A sizeable proportion of new investment in ILS is coming from China, the Middle East and other SAAAME markets. Much more investment could come into ILS as structures are developed for local risks. In turn, as local reinsurance centres continue to develop, they could provide valuable regional risk expertise and channels for attracting further capital into ILS.

Questions for the board

- Could ILS allow you to attract investment that may not come to your mainstream operations?
- How can you make sure that your risk analysis is sufficiently reliable to assure and attract investors?
- How can you deliver stable yields while taking risk on both sides of the balance sheet?
- How can you align your ILS structures with the different risk appetites and return expectations of potential investors?
- How do you manage differing needs of ILS consumers and shareholders?
- How can you attract more interest and capital from SAAAME investors?
- How can you develop the risk analysis and understanding to develop ILS structures for SAAAME market risks?

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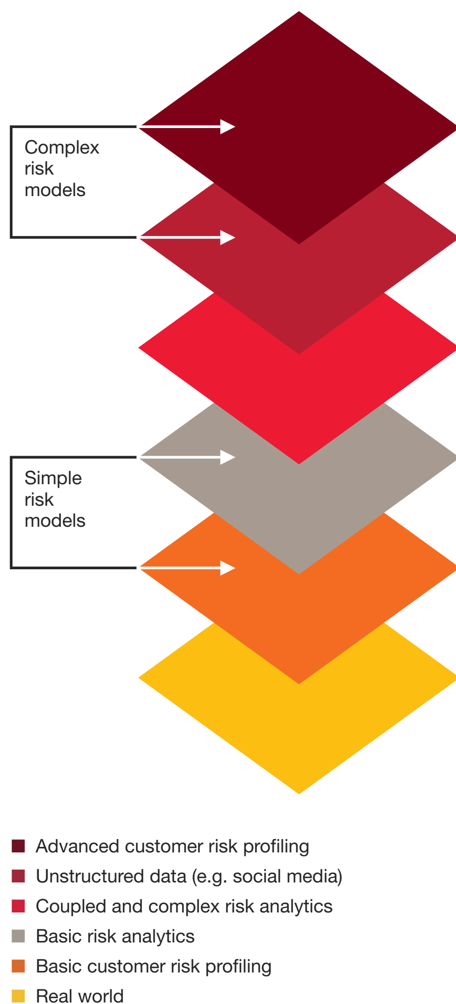
2012

Competing on two fronts

The new market realities are creating significant strategic, risk management and investor relations challenges. As many of the mainstays of traditional reinsurance business become increasingly commoditised on the one side and companies seek out new sources of growth and value on the other, they will also need to adapt their operating models.

Figure 1: Harnessing new capabilities to sharpen risk insights



Source: PwC

The key operational challenge is how to accommodate two very different trajectories of growth. On the one side are the more mature low growth markets of Japan, Europe and North America, where differentiation and price are going to be ever more important. On the other is SAAAME, which offers significant opportunities for market growth, but is also taking underwriting and risk management into less familiar areas. The underlying challenge is how to control costs and improve service on routine business, while redirecting talent and resources towards more profitable openings.

Forward-thinking reinsurers are already looking at how to balance the success factors of scale, skill, risk partnership and risk transformation that will allow them to meet market and customer demands, while sustaining profitability in this twin-speed global marketplace.

Skill is needed to understand and manage more complex and unfamiliar risks and devise the agile and efficient strategies needed to capitalise on unfolding opportunities.

Scale can deliver cost advantages, but only up to a point and it can't differentiate the business on its own.

Risk partnership could help to reposition reinsurance as a strategic risk and capital management tool and enhance the value it delivers by working with insurance clients and their policyholders to help them understand their evolving risks and manage them more effectively. Examples include the supply and production chain risks described earlier.

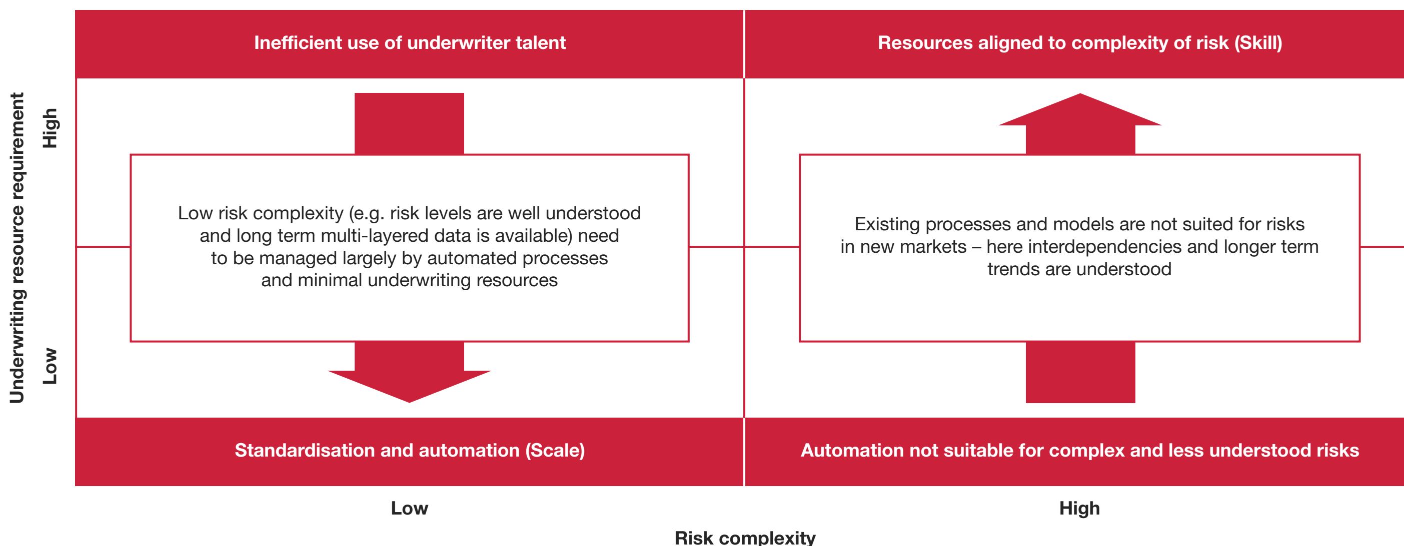
Making the most of risk transfer opportunities would allow reinsurers to manage their risks and capital demands in more efficient ways. Ultimately this will allow reinsurers to pursue the risk transformation role they are best suited for. This would include aligning risk transfer demand with the risk appetite from capital markets, either directly as sponsors of ILS and/or aggregators with diversification backed by capital market investment.

Focusing resources

Risk analytics are already a key differentiator, allowing reinsurers to gain a better understanding of their risks, price more keenly and move in to capitalise on opportunities that competitors may miss or be reluctant to pursue.

Within direct insurance, developments such as in-car sensors are allowing companies to tailor and price cover more effectively. They can also proactively reduce risks, in this case by encouraging policyholders to drive more carefully in return for lower premiums. Further opportunities include extracting risk and customer profiling data from the all the purchasing, GPS and other digital trails people and businesses leave. Figure 1 provides an example of how insurers are overlaying this unstructured data on existing post code maps to provide a more predictive and tailored approach to risk assessment, selection and cover.

Figure 2: Aligning talent and resources with the complexity of risk



Source: PwC

Harnessing 'big data'

Reinsurers tend to cover less frequent and higher value exposures and therefore look at risk through a different lens from direct insurers. But they too will be looking to harness the latest developments in technology and 'big data' analysis to fine tune their underwriting, reduce losses and enhance returns. This includes the development of real-time monitoring, new pricing and modelling platforms and automated capture of key risk metrics. They will also be looking to improve efficiency through greater automation in underwriting, quotation, submission and administration. Embryonic developments include advances in the monitoring of 'horizon risks', allowing agile reinsurers to make strategic entries and exits into specific segments more quickly than their peers.

As the underwriting of routine risks becomes more automated and better controlled, underwriters could devote more time to oversight and challenge, advising and developing solutions for clients and analysing complex, specialised and unfamiliar risks (see Figure 2). This includes getting on top of the risks in growth markets where existing data analysis may be limited. Working closely with brokers and modelling teams, smart reinsurers can offer clients a better understanding of how to manage the political, environmental, supply chain interdependency and other risks as they enter new markets and shift production to different parts of the world.

Questions for the board

- How strong is your business in the different attributes of scale, skill, risk partnership and risk transformation?
- How can you harness the latest advances in analytics to sharpen underwriting?
- How will these developments change the way your clients underwrite?
- Could greater automation of routine underwriting allow you to refocus talent on higher margin opportunities?

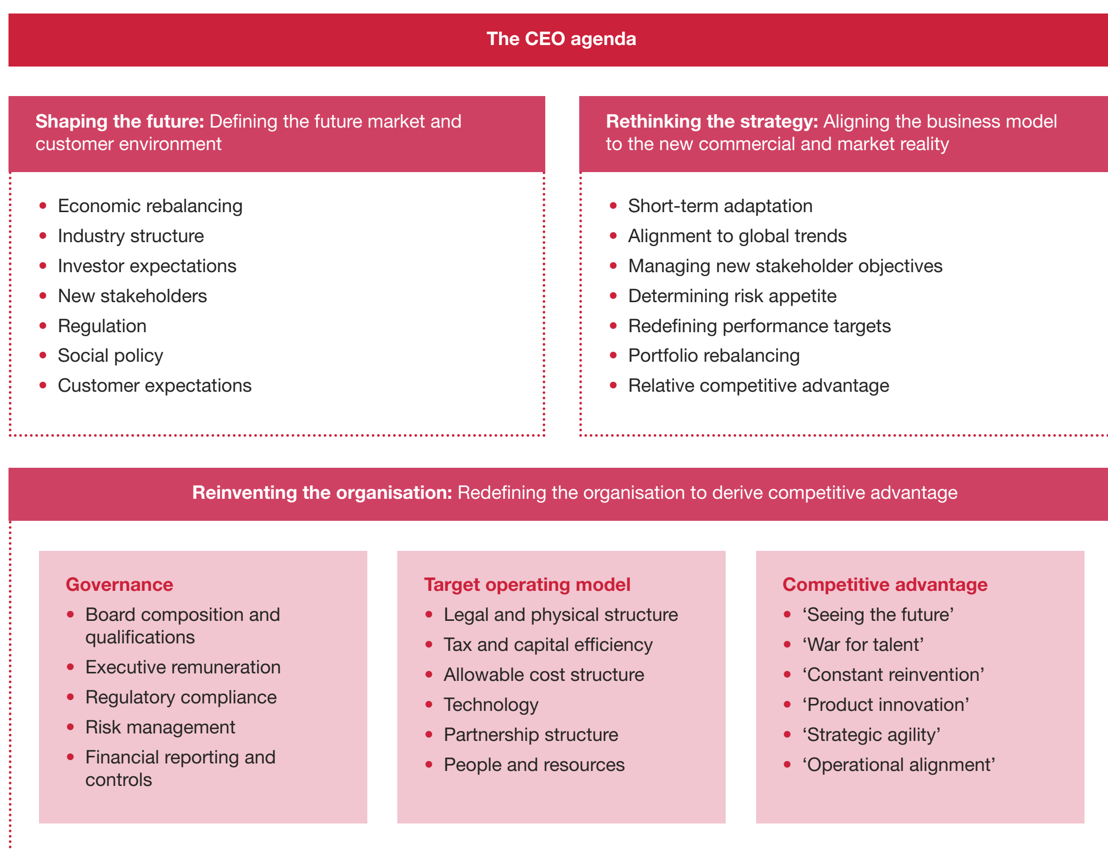
Reaping the rewards

Reinsurers have a unique and well established place within the risk transfer market and wider global economy. Their modelling systems are already highly sophisticated. But they will face the winds of change in the same way as any other business sector, creating openings for some and threats for others. Many of their target markets are already highly competitive, underlining the importance of strategic differentiation and clarity. Alternative risk transfer mechanisms such as ILS could eat into their business on the one side, but also offer new fee opportunities and could allow them to concentrate on more profitable risk management opportunities.

Figure 3 outlines some of the main considerations for boards as they look at how they can best compete and attract investment in this changing landscape. This includes identifying untapped growth opportunities in both mature and SAAAME markets and developing the skill, scale, risk transfer and risk partnership capabilities needed to capitalise on them. It also includes looking at how the centre of gravity of the business may need to change and discerning the markets where the best talent should be focused.

There is no single answer to these issues as the reinsurance sector will always include businesses that build underwriting relationships and capabilities for the long-term and others that prefer to dip in and out quickly as rates move. But all reinsurers will need to be clear about where and how they are going to play and what they can offer that competitors cannot. In mature markets this will include how to make the most of core competencies and control costs more effectively. In SAAAME markets, this includes how to develop the risk expertise and access to key business needed to perform profitably. Building on these basics of strategic clarity, differentiation and ever sharper risk understanding, smart reinsurers can create real value and win over investors.

Figure 3: Framework for strategic evaluation



Source: PwC

Contacts

Our teams around the world are helping reinsurers to assess and address the strategic and operational implications of the changing global risk and commercial landscape. If you would like to know more about what the changing landscape means for your business and how to make the most of the opportunities, please talk to your usual PwC contact or call:

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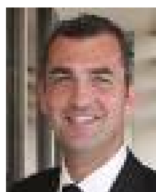

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