www.pwc.com/insurance

Daring to be different

Reinsurers need to stand out in the face of continued market uncertainty and limited growth prospects in traditional reinsurance. But they have a real opportunity to focus on repositioning the economic value of risk transfer.

September 2011

pwc

Reinsurers need to stand out in the face of continued market uncertainty and limited growth prospects in traditional reinsurance. But they have a real opportunity to focus on repositioning the economic value of risk transfer.

Daring to be different

Reinsurance industry fundamentals continue to disappoint...

For the reinsurance industry, 2011 is proving to be another year of unfulfilled hopes and promises. After a challenging 2010, with earthquakes in Chile and New Zealand and an increase in the frequency and severity of man-made disasters, the substantial catastrophe losses in Q1 2011 wiped out a meaningful portion of the industry's excess capital. But these losses, and arguments that the greater frequency and severity of disasters warrant a review of risk analytics and redefinition of risk-adequate pricing, have failed to trigger a directional change in the market. Overall, the rate environment remains lacklustre.

At the same time, existing capital frameworks are being challenged by forthcoming new regulation under Solvency II. On the asset side of the business, with the meaning of 'risk-free' being redefined through the seismic shifts in sovereign credit ratings and with interest rates at exceptionally low levels, it is difficult to generate adequate returns. Meanwhile, greater diversification by reinsurers, urged by the credit ratings agencies in the wake of Hurricane Katrina (2005), has failed to deliver the expected benefits. Indeed, efforts to diversify by writing catastrophe business in a wider range of countries, served merely to increase exposure to recent losses in Japan and New Zealand.

...and material challenges to the business model are on the horizon

Looking beyond the immediate market environment reinsurers also need to consider what factors will drive their future strategies and how these drivers could alter their business model. To develop a set of future scenarios, PwC has conducted extensive research (What the future holds: Insurance 2020, June 2011), which assesses the impact of global social, technological, environmental, economic and political (STEEP) factors across four major sectors (personal, commercial, reinsurance and life, annuity, retirement).

From our analysis, it is clear that, faced with limited growth potential in the traditional risk transfer market, the reinsurance industry's positioning in the risk transfer value chain as well as its geographic and product focus are set to change significantly:

- Volumes of risk transfer business are developing and being transacted outside the established markets of the Americas, Bermuda and the EU. Increasingly the focus of the industry will need to be on the developing markets, where the emergence of new sources of institutional and personal risk will fuel local growth. As commercial and personal affluence increase, so too does the need for risk protection, risk and wealth management, creating substantial volumes of growth in insurance and reinsurance demand. For example, the proportion of world GDP spent on insurance premiums is expected to increase from 5.6% (2006) to 9% by 2015, creating a significant opportunity for reinsurance.[1] With growing urbanisation in emerging markets, the probability of a greater frequency, complexity and magnitude of commercial catastrophe events could also increase with the growth in developing nations.

Figure 1: STEEP Drivers

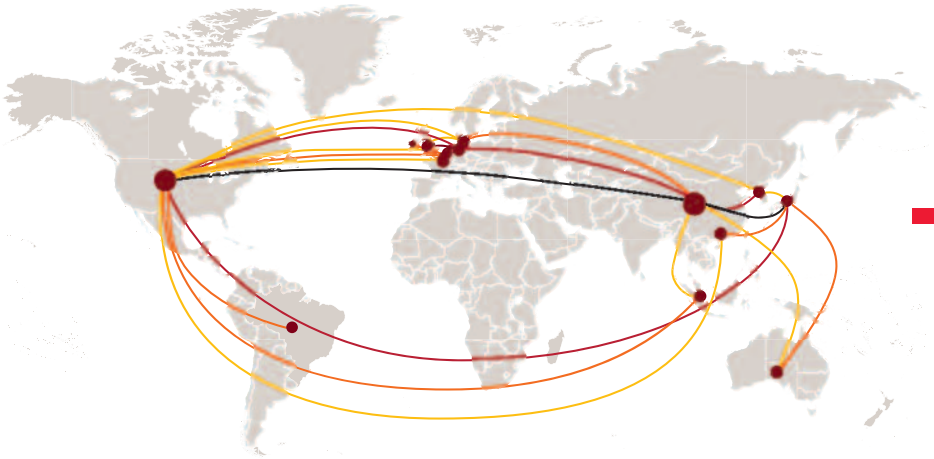
Social	*Technological*	*Economic*	*Environment*	*Political*
Customer behaviours • Social networking • Customer expectations • Risk awareness • Health **Demographic shifts** • Rise of the middle class • New family structure • Dependency ratio • Aging **Stakeholder trust** **Talent drain** **Corporate social responsibility**	**Information and analytics** **Devices and sensors** **Software and applications** **Medical advances**	**Urbanization** **New growth opportunities** **Fiscal pressure** **Inflation/deflation** **Risk sharing and transfer** **Social security and benefits** **Distributor shift** **Partnerships**	**Climate change and catastrophes** **Sustainability** **Pollution**	**Regulatory reform** **Geo-political risk** **Rise of state-directed capitalism** **Terrorism** **Tax treatment** **Sharia compliance (Takaful)**

Source: PwC

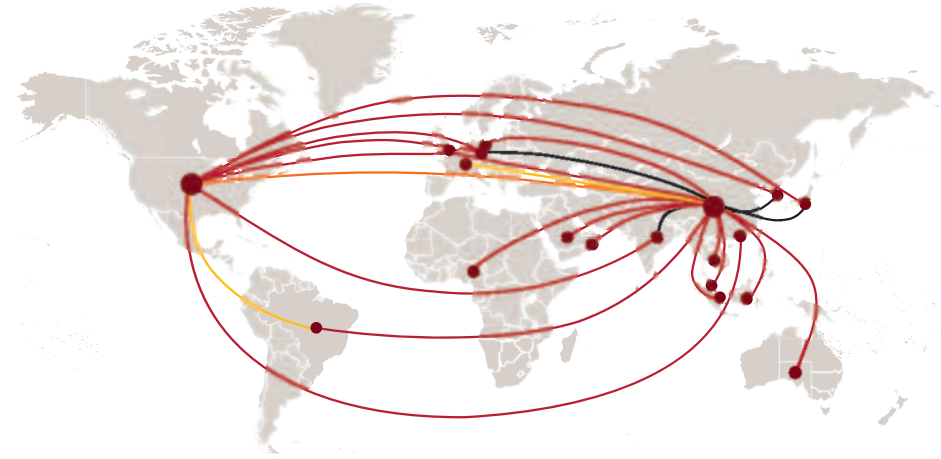
1 Datamonitor, "Swiss Re Strategy, SWOT and Corporate Finance Report" (2011).

Figure 2: Size of bilateral trade flow ($USm)...

...in 2009



...in 2030



■ Under 50,000 ■ 50,001–100,000 ■ 100,001–200,000 ■ 200,001–350,000 ■ 350,001+

Source: PwC

9%

The proportion of world GDP spent on insurance premiums is expected to increase from 5.6% (2006) to 9% by 2015, creating a significant opportunity for reinsurance.

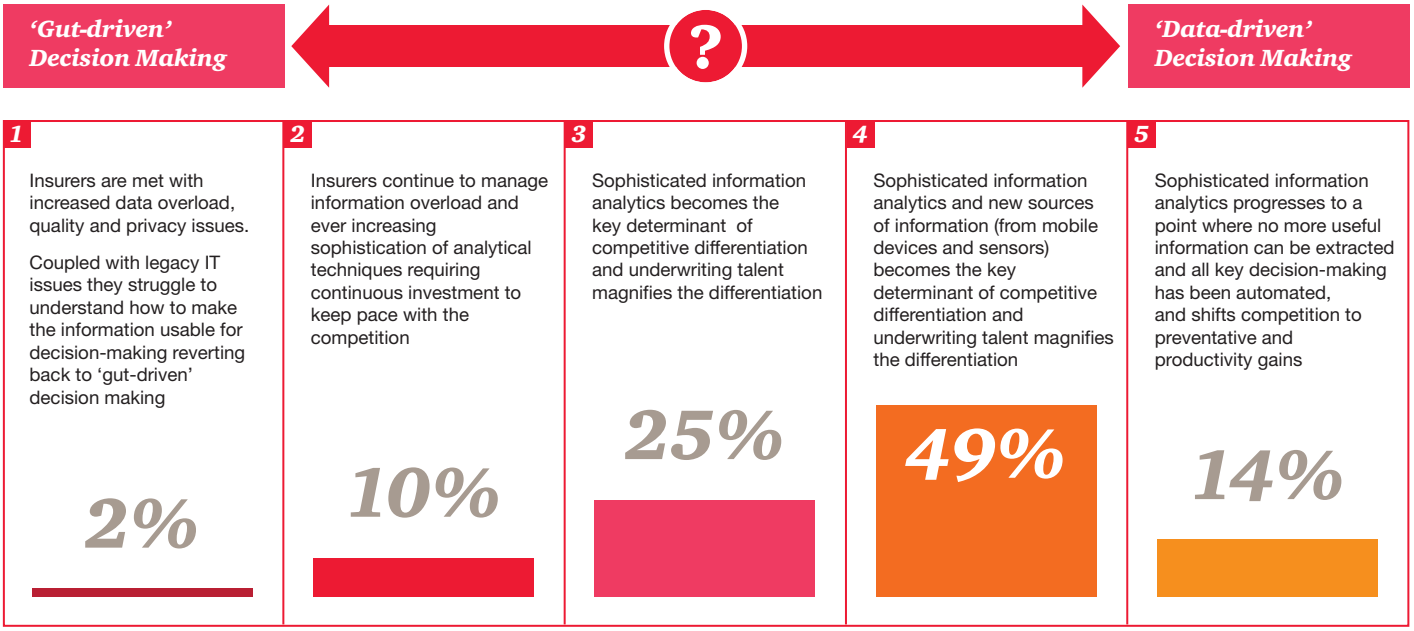
- In 2009, the US still dominated global trade flows, despite the explosion of trade with China over the last 10 years. China will overtake the US and dominate global trade in 2030 and financial flows will follow similar trends. Figure 2 shows the difference twenty years will make as trade evolves.
- With the primary insurance industry grappling with the same challenges, attention will shift to reviewing business models and focusing on activities where differentiation and value can be created, which will lead to a break up of traditional insurance models. This will offer reinsurers a substantial opportunity to shift away from a three-party model, which comprises insurer, distributor and reinsurer, to a two-party model, which cuts out the insurer, thereby ultimately increasing the effectiveness of risk transfer.

Anand Rao
Partner, PwC (US)

"Reinsurers should use information and analytics to better understand existing risks as well as to identify new emerging sources of risk. In addition, alternative risk transfer mechanisms and capital market instruments should be explored to allow more efficient capital management."

- While the developing and emerging economies will offer substantial growth potential, the developed markets will also present opportunities outside the traditional risk transfer market. With a dynamically changing risk environment, individuals, corporations, institutions and sovereign organizations are looking for risk management solutions, which mitigate material risks (new risk classes and risk profile aggregations that can materially destroy wealth or disrupt financial stability). This offers the reinsurance industry the opportunity to leverage its wealth of risk insight and technical expertise to create risk management solutions that matter in a future world and help move the industry away from a heavily commoditised risk transfer market.
- The speed at which the capital markets have been able to supply capital to reinsurance has been transformed in the last decade in terms of both traditional direct equity investments and through the development of insurance-linked securities and derivatives of these products. This development will continue to have profound implications for the shape of the industry. Furthermore, the ability to turn information into smart insight and the proliferation of cloud technology will reduce the barriers to entry in the industry, increase transparency and lead to a value chain transformation facilitating a direct connection between the insurance risk and capital markets.
- At the International Insurance Society, PwC asked delegates for their views on the extent to which the industry expects sophisticated information analytics to develop. Figure 3 shows that 63% opted for more 'data driven' scenarios.

Figure 3:



Source: PwC presentation at the International Insurance Society Annual Seminar June 2011 including audience feedback from 150 delegates

Capital markets continue to display a healthy appetite for exposure to 'un-correlated' risks such as reinsurance...

Putting this into a capital markets context, the 'good news' is that risks which are uncorrelated both to other asset classes and to fluctuations in macroeconomic variables are of considerable interest to investors. This is particularly true in the current environment, which is characterised by a high degree of macro uncertainty due to sovereign debt concerns and their potential impact on GDP growth.

A wide range of investors is active in the sector. For example, US private-equity groups Apollo and CVC Capital between them bought Brit Insurance at the end of 2010, while hedge funds have invested in side cars, catastrophe bonds and longevity bonds.

Three Bermuda-based reinsurers – Validus, Lancashire Holdings and Alterra Capital Holdings – have set up sidecars in 2011 with capital supplied in part by third party investors. New registrations in Bermuda, particularly SPVs, are running at record levels.

CAT bond issuance, meanwhile, reached $1bn in the first quarter of 2011, compared with $650m in the same quarter last year.[2] Sovereign Wealth Funds (SWF), too, are considering increasing their exposure to insurance risk through insurance-related securities, while in August 2011 China's SWF revealed that it holds a 3 per cent stake in Munich Re.

...but, despite this investor appetite, capital market valuations of listed reinsurers continue to disappoint

However, the 'bad news' is that virtually all the mainstream listed reinsurers currently trade at material discounts to tangible book value and have proved disappointing investments over the last couple of years. While many financial services companies trade at discounts to book, the gap is easier to explain for banks, which are a play on economic health and often have materially higher exposure to peripheral European sovereign credit risk, than for reinsurers, which offer uncorrelated risks ranging from catastrophe to longevity protection.

The discount in part reflects the fact that reinsurers are perceived by investors to be financial equities and their performance fluctuates with the fortunes of the broader financial services sector. But this raises the question of why investors do not draw more of a distinction between reinsurers and other financial services companies?

While easy to blame the capital markets for failing to understand the industry, a large part of the answer can be found in the absence of investor confidence in the diversified reinsurance business model. Instead of serving to reinforce the distinctive investment attractions of the reinsurance sector, the search for diversification is often viewed by investors as undermining accountability and as a justification for growth and 'mission creep' over returning cash to shareholders. In this respect, what might be viewed as the 'traditional' reinsurance industry faces a continuous challenge to develop clear and differentiated strategies where 'diversification' is not an end in itself, but demonstrably produces tangible benefits which are fully aligned with investor interests. (The need to differentiate is examined in greater detail in the recent PwC publication 'Standing out is in your hands', July 2011).

James Quin
European Insurance Market Reporting leader, PwC (UK)

"The 'uncorrelated risk' argument for investing in reinsurance ought to be very attractive in the current environment, but the fact that virtually all traditional reinsurers are trading at material discounts to tangible book value shows that the benefits of being 'diversified' are far from obvious to the capital markets. Reinsurers need to ask themselves why investors own their stock – or perhaps more pertinently, why do investors not own their stock?"

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

The time seems right for a thorough reconsideration of future strategies, value chain positioning and value communication

The main drivers of value, such as distinctiveness, specialism, effectiveness and orientation with stakeholder interests have been discarded. Instead, strategies have been built on diversification as an excuse to be everything to everybody and the result is a commoditised and opaque industry.

But the risk environment is changing dramatically, focusing minds on the longer-term material risks identified through analysis of STEEP factors. Looking ahead, reinsurers must recognise that their customer base will be undergoing substantial transformation and will look and act differently from today's client base. As reinsurers pursue growth in emerging markets, for example, their product lines and business models must keep pace with the different needs of this new customer base. (See PwC's 'What the future holds: Insurance 2020', June 2011 for further detail). In developed markets, where growth of traditional products may be static or even in decline, reinsurers need to tap into this capital pool by providing new solutions for non-commoditised risks such as new technologies, changes in global supply flows and longevity.

Those companies, which do not have a response for the future, which have not translated the emerging challenges and opportunities into a value accretive strategy, or those who fail to communicate the underlying value drivers effectively to the markets, will lose their capital access and ultimately be marginalised.

Arthur Wightman
Partner, PwC (Bermuda)

"Reinsurers need proactively to address capital market concerns about the sector, by clearly demonstrating their value creation proposition and seeking to provide straightforward and multiple access points to suit varying investor strategies."

How should reinsurance leadership teams consider responding?

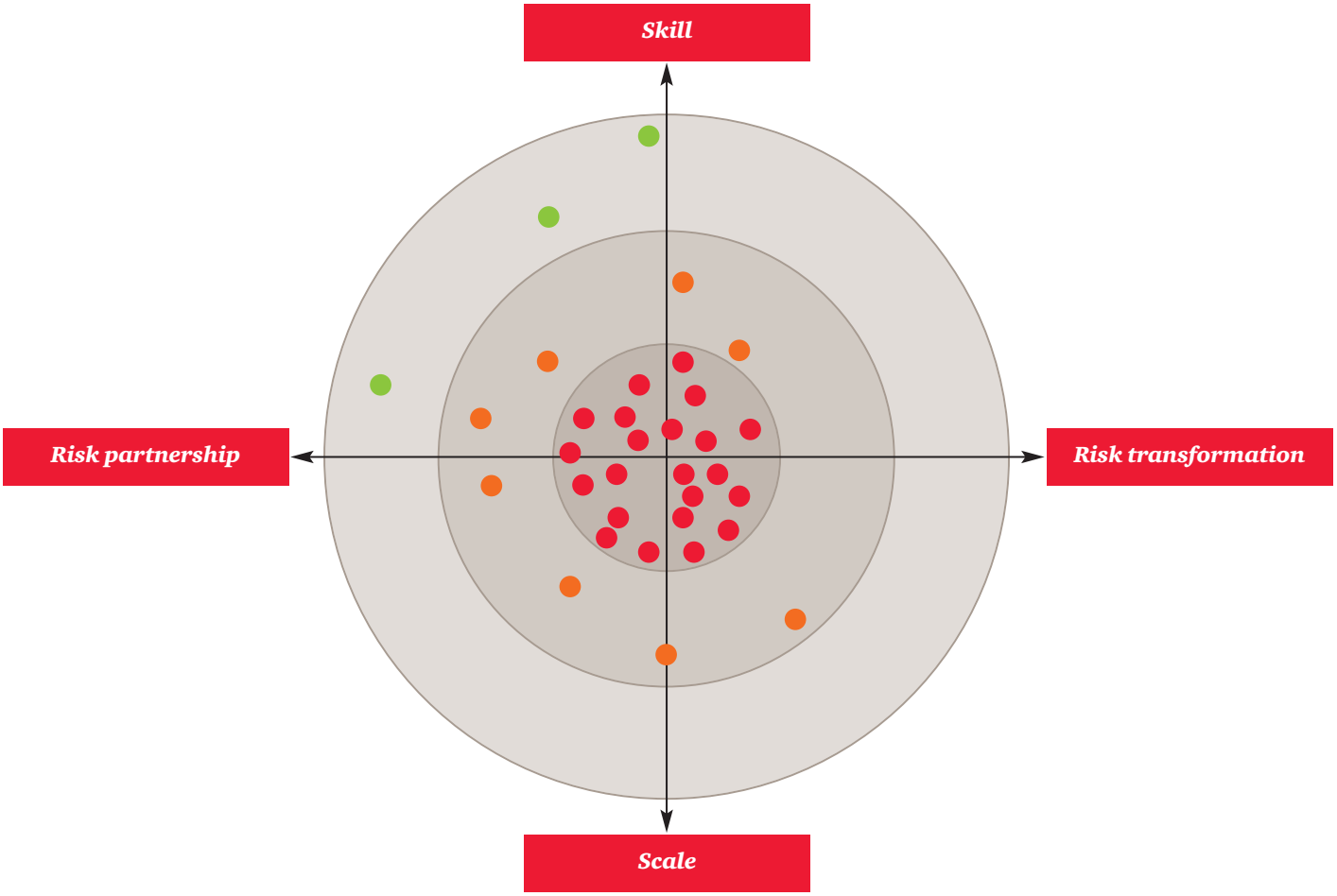
Reinsurers need to look beyond "managing the cycle" to anticipate longer-term challenges. You need to define the future scenarios, which best reflect what you can believe and then start positioning your business against them, considering both evolutionary and radical approaches.

Define a clear and clean business model, which clearly aligns future stakeholder demand with your organisation's capabilities and capacities: ask yourselves the question 'why do investors own our stock?' and decide who and what you want to be. Diversification can no longer be used as a default position that supplies a rationale for the company's existence. Instead, reinsurers need to move from the zone of competitive disadvantage, where the majority currently reside, into the zone of competitive advantage (See Figure 4).

The reinsurers that will emerge with renewed investor interest will be those that move away from the undifferentiated centre by developing further and utilising their superior risk insight, operational infrastructure, client relationships and understanding of investor risk appetite to promote their growth prospects.

The focus should be on how robust and sustainable value can convincingly be created – how a differentiating position can be created in this evolving future risk transfer market. Emphasis is also needed on effective internal steering and external value communication strategies, which need to support the rationale for your strategy, business and operating models.

Figure 4: 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. From PwC's 'Standing out is in your hands' July 2011.

Achim Bauer
Insurance Strategy Leader, Partner, PwC (UK)

"Too often, diversification is merely the justification for growth for growth's sake and companies have failed to address the need to change. Those companies that differentiate their strategy by focusing on strong leadership, anticipating future trends and assessing demand in the evolving global risk landscape will ultimately emerge as the industry's winners."

How can PwC help?

As part of our advice and support for reinsurance companies, we have 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.

Our proprietary research and analysis into the future of insurance can help your strategic thinking around positioning for growth and help you consider the different possible approaches to implementing a well-planned and executable strategy that is specific to your unique goals.

If you would 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:

Achim Bauer
Insurance Strategy leader, Partner, PwC (UK)
+44 (0)20 7212 1405
achim.r.bauer@uk.pwc.com

Anand Rao
Partner, PwC (US)
+1 617 530 4691
anand.s.rao@us.pwc.com

Arthur Wightman
Partner, PwC (Bermuda)
+1 (441) 299 7127
arthur.wightman@bm.pwc.com

James Quin
European Insurance Market Reporting leader, PwC (UK)
+44 (0) 20 7212 5173
james.b.quin@uk.pwc.com

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PricewaterhouseCoopers does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

www.pwc.com/insurance

© 2011 PwC. All rights reserved. Not for further distribution without the permission of PwC. “PwC” refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network. Each member firm is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way. No member firm is responsible or liable for the acts or omissions of any other member firm nor can it control the exercise of another member firm’s professional judgment or bind another member firm or PwCIL in any way.