Insurance

The day after tomorrow

Challenging prospects for reinsurers

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Is the financial crisis set to create fresh opportunities for the reinsurance industry or could reinsurers face increasingly challenging prospects as a result of a potentially more volatile risk profile and higher cost of capital?

In this special report, PricewaterhouseCoopers[1] assesses the various scenarios for market demand and their implications for strategy and growth within the reinsurance industry.

PricewaterhouseCoopers recently published 'Emerging from the storm: The day after tomorrow for insurance' (to download the report please visit www.pwc.com/insurance), the latest in its 'day after tomorrow' perspective series. Drawing on input from a range of leading industry figures, financial market participants and PricewaterhouseCoopers specialists from around the world, the study examines how the lasting impact of the financial crisis is set to reshape the insurance and reinsurance industry over the next three to five years. Views on the future of reinsurance fell into two polarised camps. As we look in more detail in this supplement to the report, one school of thought believes that reinsurance demand will revert to pre-crisis levels and may even increase as primary insurers in the markets most affected by the crisis seek to transfer more risk. The other view predicts a far rockier and uncertain future for the sector.

Bright future

The positive view sees reinsurance playing a key role in strengthening capital management in the face of market instability and the move to risk-based prudential regulation under EU Solvency II and parallel developments elsewhere in the world. Although equity prices have rallied, they remain well below their peak, which continues to affect the capital base of life insurers and may encourage some companies to increase reinsurance cover to bolster their balance sheets. The capitalisation of non-life insurers tends to be less exposed to the impact of asset price volatility. Nonetheless, without the cushion of the strong investment income seen in recent years and with the sector continuing to face questions over its cost efficiency and the sustainability of returns, many non-life insurers may also seek the earnings stability of greater reinsurance protection.

Uncertain future

The more pessimistic view envisages a fall in demand for reinsurance as the trend towards higher retention of straightforward risks by large primary insurers, which had already been evident in many developed markets prior to the crisis, continues. As companies' risk understanding and control continues to improve as a result of regulatory demands and related advances in enterprise risk management (ERM), they will be better able to choose what risks to write and retain and what risks to reinsure. The expected capital benefits of reinsurance under a risk-based approach would be reduced by an increased loading for credit risk, especially if reinsurers continue to face downgrades. Insurers may also face tighter regulatory rules on the use of reinsurance in their capital management.

The bulk of the exposures that large insurers in developed markets seek to transfer to reinsurers could thus be concentrated around the most volatile and high-impact risks, which will change the risk profile of many reinsurers, increase their capital requirements and raise the return expectations of capital providers. This would in turn increase reinsurance prices, make reinsurance a less cost-effective form of contingent capital for primary insurers and ultimately force many reinsurers to rethink how they sustain growth.

Emerging indicators

The market and economic situation remains highly uncertain and it is probably too early to predict which of these scenarios or combinations thereof is likely to prevail. However, it is noticeable that neither reinsurance demand nor prices across most lines of business have picked up at anything like the rates anticipated by the more

1 PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Ltd, each of which is a separate and independent legal entity.

optimistic voices. This is reflected in the results from a survey of reinsurance trends carried out by PricewaterhouseCoopers to accompany this supplement, which reveals that most life and non-life insurers do not plan to buy more reinsurance as a proportion of GWP over the next 12 months.

Whether the lack of a significant boost in reinsurance demand at present is the continuation of a long-term trend or the result of the greater short-term leeway over solvency margins and/or asset markdown put in place for the insurance industry within many territories is hard to judge. While the sources of opportunistic capital have largely left the industry, there remains enough capacity to chase business aggressively and keep prices down. As our survey confirms, a number of reinsurers are beginning to benefit from the broadening of the reinsurance panel by many cedants as they seek to diversify their counterparty risk, which reverses a previous trend towards consolidation of reinsurance panels.

Looking ahead, the survey results to date reveal a fairly even split between respondents who believe that primary insurers will cede more or alternatively less risk in the medium- to long-term and whether or not traditional reinsurance will continue to grow in the longer term.

Weighing up the options

Supposing that reinsurance demand in many of the more developed markets does fall away, how can reinsurers refocus their businesses and sustain growth?

We are already seeing signs of renewed consolidation within the sector as some reinsurers seek to strengthen scale, reduce strategic risk and diversify their risks/earnings streams. A number of reinsurers are also entering new markets such as health or exploring ways to move their offering closer to the original risk. Looking ahead, there will be opportunities to extend the boundaries of insurability and support emerging industries/technologies by providing new risk transfer solutions.

Further opportunities lie in the continued development of fee and advisory business. As clients face further capital constraints and greater scrutiny of risk, reinsurers are well placed to use their sophisticated analytical capabilities to position themselves as key providers of capital management solutions. For some, this will include a closer partnership with cedants or even their customers, with most of the reinsurers who have taken part in our survey considering alternative distribution strategies to the broker channel to at least some extent. As our survey further found, most of these reinsurers expect that interest in securitisation as an alternative to traditional reinsurance will come back, though at present the market for structured solutions continues to be hampered by investor uncertainty. Ultimately, the risk landscape is changing rapidly within the developed markets and reinsurers will need to be strategically flexible and responsive to evolving client demands if they are to adapt and succeed.

Growth potential in the emerging markets continues to increase. In particular, the financial crisis has forced many international insurers to scale back their expansion plans, leaving domestic insurers to take up the slack, which will in turn increase their demand for reinsurance. It is notable that most of the reinsurers who have taken part in our survey expect to increase underwriting in emerging markets to at least some extent. However, whether these markets are sufficiently developed to offset possible declines in business elsewhere is doubtful in the short- and medium-terms. Most emerging markets are yet to be fully liberalised, state-run reinsurers still tend to dominate their local sectors and insurers generally have sufficient capital reserves to fall back on. Technical underwriting is also yet to reach a stage of development where risks can be passed on to reinsurers on economic terms. Success in the long-term will require local understanding, a significant investment in relationships and a clear readiness to support the continuing development of these markets.

Coming through stronger

While the full impact of the financial crisis is as yet unclear, the competitive, investment and regulatory environment that emerges from the turmoil is set to be very different from today, presenting reinsurers with both threats and opportunities. The worst-case scenario would put the traditional reinsurance model at severe risk of marginalisation as the ability to price competitively, meet evolving client demands and attract investment on economic terms becomes ever-more difficult.

However, reinsurance is a highly sophisticated and adaptable sector and new business models are certain to emerge. The companies that are set to come through strongest are already looking at how to reduce expenses, enhance efficiency and lower capital demands by reshaping their operational platform, risk analysis and controls. They are also looking at how to sharpen the flexibility with which they are able to deploy capital, respond quickly to unfolding opportunities and swiftly withdraw capacity in line with changes in market economics. With the competition for capital both within the sector and against other industries likely to be far tougher in the post-crisis environment, it will be these agile and efficient reinsurers who will be able to meet investor demands for more favourable and sustainable returns, not just across, but through the cycle.

Contact us

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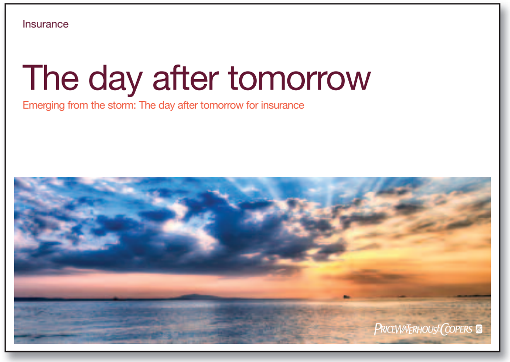
Emerging from the storm: The day after tomorrow for insurance
'Challenging prospects fro reinsurers' is one of the nine key impacts explored in this new point of view from PricewaterhouseCoopers. This publication examines how the financial crisis is set to reshape the industry as a whole, along with some of the key developments that are likely to affect particular segments and geographical markets. For more information, visit pwc.com/dayaftertomorrow.



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