Bermuda Reinsurance 2012
The Risk Management Balancing Act

Conference summary
With 2012’s Hurricane Sandy as a fresh reminder, the continued unpredictable global economy defined by stagnant growth and low yields combined with opportunities in new markets and for innovative solutions has left reinsurers playing a balancing act. How to address this challenge through redefining business models while meeting investors expectations, was the central focus of the seventh annual Bermuda (Re)insurance Conference, co-sponsored by PwC Bermuda.

The two-day annual conference is Bermuda’s premier industry gathering. The 2012 conference attracted over 200 delegates from Bermuda, New York and the UK who converged at the Fairmont Hamilton Princess Hotel for an agenda of panel discussions led by the industry’s key leaders and brightest minds.
Content

View from the Top: The C-Suite Perspective
Industry leaders have a unique perspective on how (re)insurers can manage risk and take advantage of opportunities in this unpredictable economic environment. Our panelists discussed the significant trends, pressing matters and issues facing (re)insurance, and gave their perspectives on key strategies for balancing the interests of their stakeholders and achieving long term sustainable growth and success.

The Earnings Challenge – Pricing, Profits and Capital
Macroeconomic uncertainty, low investment yields and modest premium rate rises have created an interesting dynamic for reinsurers to protect their balance sheets and still generate earnings that meet stakeholders’ expectations. A panel of experienced finance executives discussed the challenges in meeting those profit expectations while maintaining discipline and controlling risk, in spite of the headwinds. The discussion also examined the tools and techniques being employed, including pricing, reserving and capital management, to achieve this delicate balance.

Executive Survey of the Reinsurance Landscape
In the wake of the record-breaking natural catastrophe year 2011, three veterans of the global reinsurance industry discussed the road ahead and the challenges and opportunities it presents. What lessons were learned from 2011 and how has this impacted operational decisions and management’s strategy? Will enterprise risk management prove to be the silver bullet going forward or simply a key plank in (re)building a solid corporate platform? Do the recent events show the industry’s resiliency or is there still more to learn, particularly when it comes to detecting and preparing for emerging risks? This panel provided an insider’s view into the thinking around these issues.

Navigating the Path to Innovation
In an environment challenged by continued equity market volatility, inflation/deflation, interest rates and lack of growth, reinsurers must differentiate and innovate to succeed. The only certainty in today’s environment is uncertainty. A change in demand is underway, with investors looking increasingly for more comprehensive, holistic and integrated risk management solutions such as structured products like insurance-linked securities (ILS). Those that will come out on top are the forward-thinkers with innovative techniques and the agility to stay ahead of the game. The panelists of this discussion gave their perspective on how to embed innovation into business process, structures and market solutions.

Welcome to Wall Street, Bermuda HM 08
Wall Street, meet Bermuda. Bermuda, meet Wall Street. This discussion set the stage with views on sector trends, ratings drivers, criteria and assumptions. A panel discussion, which followed, featured varying perspectives from market participants. With numerous and diverse factors impacting the industry and capital markets, views were exchanged on the strategies that insurers and investors are implementing to address risks and capitalize on potential opportunities available within the industry. From the low interest rate environment, the appetite for catastrophe bonds, and the potential for new products and investment vehicles in the evolving global macro-markets, panelists left no stone unturned.

Insurance 2020
The future may be hard to predict, but need not be hard to prepare for. This panel explored the key drivers of change for reinsurance and the implications for the industry. A presentation was given of PwC’s extensive research into the sweeping changes happening within the mega-trends all sectors of the industry are experiencing including: two-speed global growth, distribution disruption and customer revolution. Panelists provided their views on strategies to consider to turn these changes into opportunities.
Moderator: Arthur Wightman, Partner, Insurance Leader, PwC Bermuda
David Cash, Chief Executive Officer and President, Endurance Specialty Holdings, Ltd.
Christopher Harris, President and Chief Executive Officer, Montpelier Re Holdings
Don Kramer, Chairman and Chief Executive Officer, ILS Capital Management
Major loss events are becoming almost commonplace and reaching beyond the traditional peak zones. The Thai flood losses showed that the highest severity events are no longer confined to developed markets. Just before the conference, Superstorm Sandy cut a wide swathe of damage across areas of the US not normally associated with high levels of wind or flood risk.

But the mood of the Chief Executive Officers taking part in the opening panel session was nonetheless positive. While estimates of the Sandy losses have been continuing to mount, they were seen as an earnings rather than a capital event in a year when returns had otherwise been strong. Speaking on the following day, a representative from rating agency Standard and Poor’s suggested the losses would need to exceed $50 billion to affect capital.

Although the wide reach of the storm, uncertainty over business interruption claims, and the inability to activate the ‘hurricane clause’ could make Sandy as complicated for the reinsurance industry as Katrina, it was felt that the financial losses would be much smaller. Moreover, Bermuda’s ability to absorb the losses and support affected clients was seen as underlining the value and resilience of its insurance and reinsurance industry within the American market.

Panelists highlighted the fact that returns in many Bermudian companies have been cushioned by the release of unrealised gains in recent years. But with the quotient of unrealised gains receding and interest rates likely to remain low for the foreseeable future, the pressure on earnings is going to increase. This underlines the importance of effective and disciplined underwriting.

Some in the industry believe that the increased capacity emanating from the growth in insurance-linked securities (ILS) is raising the pressure on rates. However, it was argued that the relative ease with which capital can move in and out of ILS investments can help to cut short the peaks and troughs in the rating cycle.

Although some of the companies are making inroads in Asia and Latin America, this was seen as a long-term play. Developed markets were seen as the main source of profitability and potential in the near-term. In particular, the US is seen as a dynamic market with a growing demand for the kind of specialised and analytically-driven underwriting in which Bermuda excels.

However, difficult questions remain. In particular, will companies that rely on largely commoditised lines of business be able to generate the underwriting profit margins to sustain investor interest or withstand a severe future event? Sharper differentiation or further consolidation may need to be considered as the market positions itself for the continuing challenges ahead.
The earnings challenge – pricing, profits and capital

Finance and treasury chiefs discuss the strategies needed to sustain earnings and investment in a tough premium and interest environment.

Share values are generally disappointing, with many companies dipping below book value. How can they reinvigorate prices?

With rates low, the 15% return on equity (RoE) targets that had come to be seen as the industry benchmark may now be unrealistic. Indeed, there were concerns that the pursuit of 15% RoE may encourage some companies to take risks that would stretch their risk appetite. Moreover, with the risk-free rate falling from around 5% before the financial crisis to less than 2% now, target RoEs may need to be adjusted accordingly.

The share price challenge is being heightened by what several panelists saw as a lack of analyst and investor focus on insurance and reinsurance, with many market participants lumping companies together or simply ignoring the sector as too difficult to understand. Several noted the limited attention given to the particular strategies or relative performance of individual companies. Even companies at the top end of profitability are not receiving the share price boost this would normally attract. The fundamental differences in business focus and model, such as specialty versus casualty, may also be largely ignored in the investment appraisal. Instead, analysts and investors can often be more comfortable looking for catalyst events that would lead to a hardening of rates market-wide than delving into the strategies of particular companies. To get the value message across, speakers stressed the importance of a clear and simple explanation of strategy and how this will translate into returns – ‘giving the markets something to hold on to’.

As companies look to reduce the cost of funding and diversify sources of capital, the growing interest in ILS was seen as broadening their options. But long-term equity finance was seen as the most prized form of finance despite the potentially higher cost.

While rating agency demands have tended to be the main determinant of capital adequacy levels, regulatory requirements may come to the fore in the wake of the move to new risk-based regimes. To highlight the step change, a panelist noted that the capital on its European operations is set to see a five-fold increase once Solvency II finally goes live.

As to whether the sector is over-capitalised, it was noted that the Sandy losses could equate to the $25 billion that many commentators believe is the excess of capital. Nonetheless, some consolidation is likely to be necessary to restore the capital equilibrium. Share buybacks are also likely to form part of the response, though a panelist cautioned against ‘biting so far into the bone’ that there are not enough funds to capitalise on opportunities.
Moderator: Dennis Sugrue, Director, Standard & Poor's Ratings Services
Simon Rich, Senior Vice President and Global Treasurer, XL Group plc
Elaine Whelan, Group Chief Financial Officer and Chief Executive Officer, Lancashire Insurance Co. Ltd.
Michael McGuire, Chief Financial Officer, Endurance Specialty Holdings Ltd.
Even though the conference took place two weeks after Superstorm Sandy, there was still no clear consensus on the size of the eventual losses. This was seen as underlining the limitations of current models and the need for better evaluation of business interruption in particular.

Katrina led to markedly revised assumptions in areas such as ‘storm surge’ and a more granular modelling focus on the specific property type and location. Sandy is likely to see a similar step change, especially in the evaluation of business interruption scenarios and a more precise focus on determinants of flood risk such as whether service equipment and mechanical systems are located in the basement or on the roof.

Sandy was also seen as underlining the importance of effective enterprise risk management (ERM). ERM was seen as especially important for reinsurers as they are further back along the risk management chain.

The location of Sandy means that its impact could be as much psychological as financial. Many Wall Street investors and analysts were personally caught up in the storm, which brought home the impact in the way that many other recent events such as the Thai floods or Japanese earthquake have not. As the commendable way that Japanese insurers supported claimants after the 2011 catastrophe demonstrated, this personal sense of loss is an opportunity to raise the perception of the industry’s value in society.

As a game changer, the impact of Sandy is further heightened by the fact that it happened in the North East of the US rather than the South East where events of a similar loss scale are much more common. Many clients will look to extend and deepen cover as a result. But as highlighted by the controversy over whether to activate the hurricane clause or not, insurance and reinsurance in the region may also become subject to the kind of political pressures and controls seen in Florida and other such peak zones.

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Executive survey of the reinsurance landscape

Leading executives discuss the lessons from Sandy and other recent losses.

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Moderator: Taoufik Gharib, Director, Standard & Poor’s Ratings Services
W. Marston (Marty) Becker, President and Chief Executive Officer, Alterra Capital Holdings Ltd.
Joseph P. Brandon, Executive Vice President, Alleghany Corporation
Neill Currie, President and Chief Executive Officer, RenaissanceRe Holdings Ltd.
Bermuda has become the premier centre of innovation and development in a rapidly expanding ILS market. As ILS moves into the mainstream, what role is it going to play in the development of the Bermuda market overall?

The growth in ILS has increased risk transfer capacity for insurers and their clients. In turn, a combination of greater market understanding and the opportunity to secure higher returns than are available in the current low interest rate environment are attracting ever more institutional investors such as pension funds.

Bermuda was seen as offering a natural environment for reinsurance and capital market convergence. This includes access to the necessary talent and expertise. It also includes a robust and supportive regulatory environment, in which supervisory authorities are liaising closely with market participants and seeking to ensure that regulatory evaluation and reporting requirements are in keeping with the true level of risk.

But an evolving ILS market still has some way to go before it fully moves into the mainstream and fulfils its potential. Greater transparency in areas such as pricing would help to improve familiarity, appetite and liquidity.

Panelists also addressed the challenge that ILS is a threat to the conventional reinsurance market by adding to overcapacity, cannibalising existing business and driving down rates. Panelists countered that the market would be better to focus on the potential benefits for return on investment and earnings multiples than constantly fluctuating rates. ILS could help to isolate and offload pure catastrophe risk relatively cheaply. Companies could thus hold levels of capital that are more in keeping with their risk profile, which will in many cases be lower. Moreover, by stripping out the commoditised risks, the market focus will be on underwriting expertise and the value this creates, which should help to enhance strategic differentiation, investor interest and price-to-book.

In stressing the complementary nature of ILS, panelists insisted that it can help to increase the size of the risk transfer business coming into Bermuda overall. This includes opening up opportunities to strengthen coverage in areas where the amount of risk coming into the conventional reinsurance market does not reflect the size of the insurance market such as Florida. The fact that many mainstream reinsurers have or plan to establish ILS vehicles suggests that they see opportunities for investment and market development that would not come to them otherwise.

The underlying question for the market overall is why is ILS attracting a certain amount of investment that isn’t coming into the conventional reinsurance market. How could conventional reinsurers compete for this capital more effectively? How could they isolate and convey their risks in a comparably clear and understandable way?

Moderator: Scott Watson-Brown, Partner, Asset Management Leader, PwC Bermuda
Jeremy Cox, Chief Executive Officer, Bermuda Monetary Authority
Frank Majors, Managing Partner, Nephila Capital
Lixin Zeng, Chief Executive Officer, AlphaCat
A combination of changing risk appetites, regulatory and rating agency demands was seen as having a significant impact on the balance of risk, reward and underlying capital within the insurance and reinsurance sector. In particular, many companies are now taking much less risk per unit of capital than five years ago.

But the situation in the markets they serve is very different. Many clients only buy insurance because they have to and may see few discernible incentives to make them want to seek out more effective cover. Indeed, while many insurers and reinsurers are holding more capital per unit of risk to meet rising capital demands, panelists noted a disconnect in the fact that the amount of insurance a client buys may have only a limited impact on its credit rating.

The panelists looked ahead to more interest and investment to come from the capital markets. Catastrophe bonds have performed well in comparison to other assets since the advent of the financial crisis. The panelists once again highlighted the opportunities for institutional investors to diversify their portfolios and enhance yields. If US property catastrophe has been the primary focus, then covering risks in other parts of the world is a clear opportunity. Other areas of potential include longevity.

But the session also sounded a note of caution. Widening the investor base is going to be a challenge. Panelists pointed to the fact that catastrophe bonds have incurred their fair share of sustained and disputed losses. There is also a reluctance to invest in what are seen in many parts of the capital markets as volatile catastrophe risks.

A further challenge is competing for attention. Despite recent growth, ILS is still only a tiny fraction of the bond market overall. It will take a long time before there are the clear incentives, benchmarking and other forms of transparency and comparison that would make ILS look and feel like more conventional capital raising markets. If interest rates do start to move up again, there were also concerns that ILS may lose investment to other seemingly lower risk assets.

If US property catastrophe has been the primary focus, then covering risks in other parts of the world is a clear opportunity.
The main focus of market participants was the immediate challenges of pressure on rates and investment returns. Yet, a number of transformational developments are coming over the horizon that could have decisive implications for survival and success over the next decade.

The first mega trend is the divergence between the slower growing mature economies and rapidly expanding markets of South America, Asia, Africa and the Middle East (SAAAME). Many of the earlier panel sessions saw SAAAME as at best a long-term play for Bermuda. But as more and more global commerce goes between SAAAME markets and misses out the West, panelists in this session highlighted the need to be more proactive in tapping into the new trade flows. Bermudian and other Western reinsurers could also find themselves under threat on their home turf if a well-capitalised SAAAME giant decided to move in and undercut them in their core markets.

The second mega trend is the information advantage. Smart analytics has always provided a crucial edge in the reinsurance market, but now there are opportunities to extract risk and customer profiling data from all the purchasing, GPS, social media and other digital trails that people and businesses leave. The example cited in the session was the ever more sophisticated tracking on container cargoes, which would allow people with access to this data to offer precise real-time risk evaluation and cover. This would in turn allow them to price more keenly, while offering lower premiums.

The third trend is distribution disruption. We’ve seen in the primary market the impact of aggregation sites. Car manufacturers are also beginning to offer insurance as part of their package, with buyers who opt for additional safety features such as self-parking benefiting from lower premiums. These developments mark a shift in the insurance and reinsurance model from reactive claims payer to proactive risk manager. For reinsurers this is an opportunity to move beyond the commoditisation in much of the market by getting closer to end customers and providing creative cutting edge risk management solutions.

The fourth trend is a new competitive model. Before, the complementary models were scale players (‘big’) and niche specialists (‘fast’). But now big may also need to be fast in the face of competition from new entrants able to use the giant leaps in analytical and computing power to develop automated underwriting and customer relationship management capabilities from scratch. They can then use these capabilities to undercut established players, while offering the fast and responsive cover people want. The unwieldy legacy systems of many larger players may be unable to keep pace.

Corporate boards tend to concentrate on what is happening inside their company and at what their main competitors are doing, but they often fail to look at the threat from new entrants or new ways of doing business. In a world where all sectors are facing unrelenting change, the closing remarks of the conference emphasised the vital importance of insurers and reinsurers thinking and acting at the same rate as customer expectations and the risks they underwrite are evolving.
Moderator: David Thompson, Partner, PwC Bermuda
Bryan Joseph, Actuarial Leader, PwC Global
Brad Kading, President and Executive Director, Association of Bermuda Insurers & Reinsurers
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