The key considerations for survival and success in a sector facing disruptive and rapidly accelerating change.

Reinsurance 2020: Breaking the mould

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Introduction

Many reinsurers are focusing on the short term challenges of soft rates and low investment returns. But with limited growth in traditional markets and a range of disruptive new threats on the horizon, could this be the time for a more radical rethink of how to build for the future?

Most reinsurers will look back at 2012 with some satisfaction, having increased revenue and profitability[1] following the record losses of 2011.[2] Their ability to withstand Windstorm Sandy while still sustaining strong returns underlines the resilience of the sector.

But clouds remain. Low interest rates and the impact on returns have persisted for much longer than initially anticipated and could linger on for some time yet. Moreover, premium rates haven't hardened by anything like the extent that would have been expected after such a significant loss year as 2011. One of the main reasons for the continuing soft rates in some market sectors is the surge in fresh capital coming into the Insurance Linked Security (ILS) market, much of which has been driven by pension funds and money managers' search for yield. So while low interest rates have dampened returns for the sector overall, they have at least provided an important catalyst for innovation and growth in one of its most important new frontiers.

What both flatter cycles and the rapid advance of ILS demonstrate is that this is a sector in which evolution is gathering pace and where old certainties may need to be rethought. While all attempts to read the tea leaves and forecast precisely what is happening are ultimately doomed to failure, responsible management involves being prepared to think the unthinkable and to formulate plans and strategies that look not only at the gradual evolution of current business models, but at new target operating models taking account of the drivers for change that are disruptive forces impacting on the business. This paper attempts to look beyond the immediate focus on renewal rates and investment returns onto a series of game-changing developments in areas ranging from the shifts in global investment and growth to greater retention, capital market convergence, more exacting customer expectations, growth in computing power and availability of data and greater government intervention. The lines between insurance and reinsurance are also blurring leading to insurers and reinsurers repositioning their business in various markets. The attributes for success and even what we understand by 'reinsurance' could be transformed as a result. We have deliberately attempted to be thought-provoking and to 'think the unthinkable', using our research as a background to challenge management teams about the future direction of the industry.

1 Insurance Journal, 15.03.13, the Actuary 09.04.13 and Business Insurance, 08.07.13

2 Munich Re media release and Reuters, 04.01.12

Low interest rates and the impact on returns have persisted for much longer than initially anticipated and could linger on for some time yet. Moreover premium rates haven't hardened by anything like the extent that would have been expected after such a significant loss year as 2011.

With reinsurers facing slowing and sporadic growth in developed markets, expense ratios under scrutiny, competition from new players and shrinking margins in many of the traditional mainstays of their business, a particular challenge is how to seek out profitable new openings and increase the aggregate size of the market. There are clear opportunities to cover new risks and push back the borders of reinsurance. As new regulatory models are developed, primary insurers are looking for assistance with managing their solvency capital and the development of new products. There are also opportunities to get closer to customers and advise them on how to manage an increasingly complex and uncertain risk environment. The key to success is going to be keeping one step ahead of the market by sustaining an edge in analytics, innovation and the development of new markets and the coverage of new risk types. Broker intermediation remains an important factor, but in certain areas there is an increasing readiness from both corporations and primary insurers to deal direct.

Reaching into new markets

A further focus is the still underpenetrated markets of South America, Asia, Africa and the Middle East (together these fast growth regions make up what PwC refers to as 'SAAAME'). The challenges here include how to gain access to restricted markets. But as the insured values in these markets continue to rise, state-owned reinsurers and the governments that ultimately underwrite the losses may be readier to spread some of the currently locked-in exposures to private reinsurers. What can your business offer that competitors can't?

The SAAAME market challenges also include how to price accurately and adequately when risk data is so limited. The unexpectedly high reinsurance losses from the Chilean earthquake in 2010 and the Thai floods of 2011 highlight the dangers of reinsurers wishing to capitalise on the growth opportunities at the right price. They are therefore going to have to take determined and proactive steps to build up the necessary data and modelling capabilities on the ground. How can your business get up to speed?

Crucially, this isn't just going to be a one-way path, with Western reinsurers moving into emerging markets. Developed market reinsurers may face increased competition on their home turf if a well-capitalised SAAAME giant decided to move in and compete aggressively, either using rates or trading political clout and access to their markets for business from established clients in developed markets. Is your business prepared for this potential threat?

The strong growth of ILS in recent years has already reshaped parts of the market and offers huge further potential as it moves firmly into the mainstream. The key question for sponsors is how to develop untapped markets rather than cannibalising existing reinsurance demand. This challenge is mirrored on the investor side. As more capital moves into the market, investors may need to accept new types of risks or more extreme risks to maintain their target yields. What areas can ILS reach into as it moves to the next level?

The need to access SAAAME markets may also require a series of new regional hubs. What are the key questions for your business as it looks at how to balance the capital, tax, reputational and business access considerations over location?

Reinsurance is also a sector on the move as new regulation and reputational issues over tax spur a renewed rethink over domicile. The need to access SAAAME markets may also require a series of new regional hubs or produce greater use of platforms with market access such as Lloyd's. What are the key questions for your business as it looks at how to balance the capital, tax, reputational and business access considerations over location?

Doing what you're doing a little better is no guarantee of survival or success in this evolving marketplace. Similarly, your 'fiercest competitors' may not be your traditional rivals, but new entrants or new ways of doing business that you haven't accounted for. The speed at which your business is able to anticipate, innovate and adapt to change rather than simply reacting to events is going to be a key differentiator in the shake-up ahead.

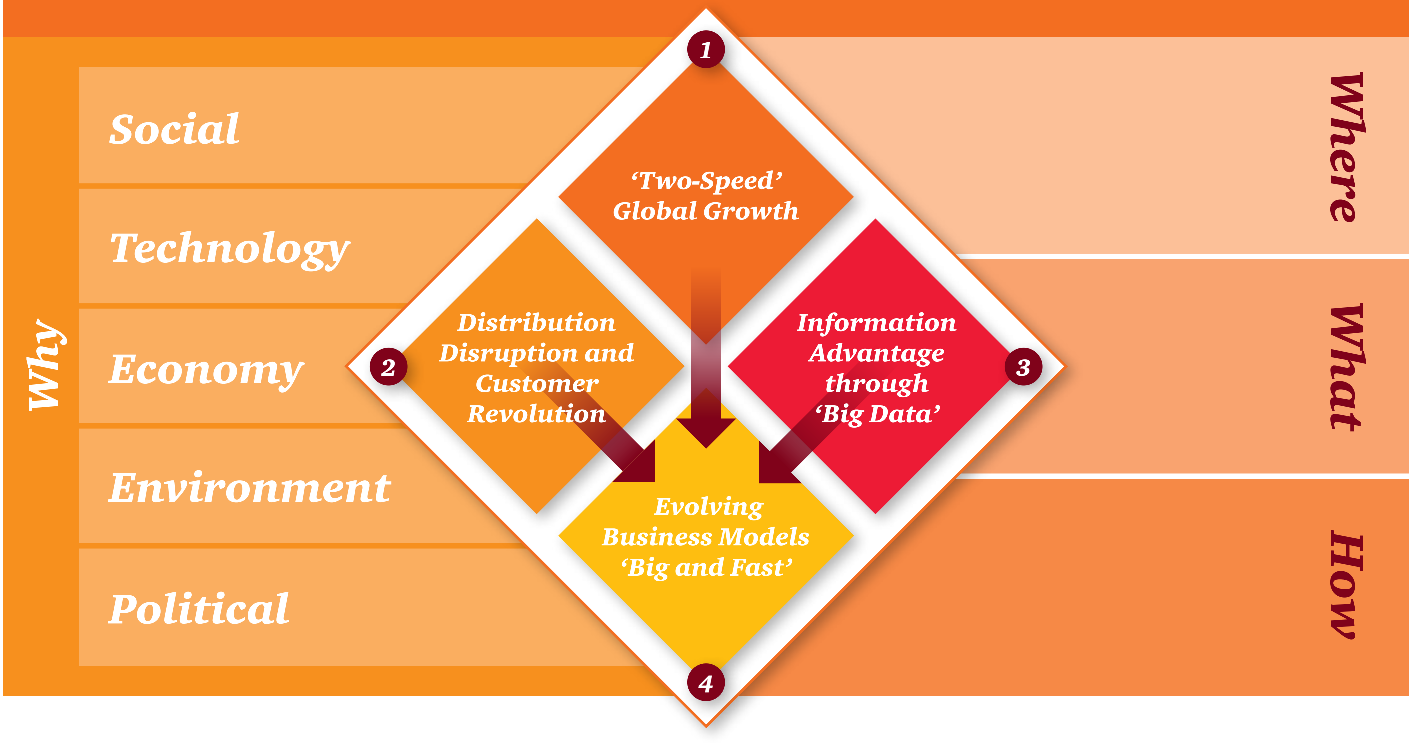
PwC has been carrying out extensive research into the major trends that are reshaping the global business outlook for reinsurers as part of our Insurance 2020: Future of Insurance programme (see box below).

In this paper we look at how these developments are impacting reinsurance and the key considerations for sustaining profitable growth.

Insurance 2020: Future of insurance

Reinsurance 2020: Breaking the mould is the latest viewpoint in PwC's Insurance 2020 framework, which explores the major trends that are reshaping the competitive environment for insurers, reinsurers and other financial services businesses around the world and the markets and societies in which they operate (www.pwc.com/insurance/future-of-insurance and www.pwc.com/projectblue).

Our clients are using Insurance 2020 to help them judge the implications of these trends for their particular organisations and determine the strategies needed to respond. The central message from Insurance 2020 is that whatever your organisation is doing in the short term – be this dealing with market instability or just going about your day-to-day business – it also needs to be looking at how to keep pace with the sweeping social, technological, environmental, economic and political (STEEP) developments ahead.



Multi-speed and multi-dimensional global growth

While growth rates in SAAAME and developed markets are diverging, the solutions needed to address the challenges on either side of the global growth divide may be mutually supporting.

Advanced economies still account for nearly 85% of the global insurance market. But growth was only 1.5% in 2012 compared to 8% for emerging markets,[3] underlining the need to secure your position in core markets and the importance of the SAAAME economies in long term growth plans (Figure 1 compares the trajectory of growth worldwide).

The challenge of how to sustain growth in traditional reinsurance markets is heightened by greater retention of risk by clients, limited differentiation and the low margins being generated in many increasingly commoditised product lines. Some larger and better informed primary insurers are ceding less risk and moving away from proportional to non-proportional covers. In addition, pressure on prices is coming from low perception of value and an influx of alternative capital; the growing size and momentum of ILS is attracting more mainstream investors, suppressing spreads and producing an environment of continuing soft rates.

Figure 1: Comparing the trajectory of global growth

Source: International Monetary Fund

3 Swiss Re Sigma 'World insurance in 2012'

So how can your business bolster margins and reinvigorate growth? Scale is clearly an advantage, with many of the bigger reinsurers getting bigger and putting pressure on their smaller rivals. But size is not enough in itself, with the need to be fast as well as big blurring the traditional distinction between scale and specialist niche players. Reinsurers may also face growing competition from primary insurers. Farsighted reinsurers recognise that they can't rely on commoditised areas of business to sustain returns. They're therefore refocusing capital and expertise on product innovation, new markets and the development of more effective risk transfer, though they may come up against primary insurers taking similar steps within the reinsurance spectrum. A key way to differentiate yourself is in making much greater use of your risk expertise to help clients understand and proactively mitigate their risks rather than simply being a reactive claims payer.

The shift in the balance of power from broker/primary insurer to risk managers is going to open further opportunities to diversify into primary insurance. A number of leading reinsurers are seeking to build up their non-life, life and health businesses. Prominent examples include ERGO, a leading primary insurer, which is part of the Munich Re Group and generated €18 billion of premium income in 2012.[4] Swiss Re has actively split its business between reinsurance and corporate solutions.[5]

As corporations and pension funds look at how to mitigate longevity risks, life reinsurance will also continue to be one of the key growth frontiers for reinsurers. Recent developments include Scor Re's acquisition of Generali's US life reinsurance operation. The acquisition forms part of the group's 'twin engine' diversification strategy (55% life and 45% non-life).[6]

Life clients primarily look to reinsurers to help them optimise capital and provide technical expertise rather than risk transfer. These demands could increase with the advent of Solvency II-type regulations. Key areas of focus could include reducing earnings volatility or technical support for new and non-standard products (e.g. impaired annuities). The reinsurers in the best position to capitalise will have the necessary analytical edge. Investors will also need to be prepared to take on long term risks.

New risk areas

Pandemic risk is another of the areas where there is significant potential for more effective solutions and profitable growth. Traditional reinsurance cover can be costly and many insurers, and indeed reinsurers, don't hold sufficient protection for what could be a sizeable 'capital event'. Extreme mortality bonds could offer more effective risk transfer, building on the wider capital market interest and investment in the catastrophe bond market. On the non-life side, there will be opportunities to extend expertise and cover in areas such as cyber risk and onshore energy, where fracking technology has produced a new growth marketplace. Private reinsurers are also likely to make further inroads into areas where the government currently acts as insurer of last resort, but may no longer have the funds to retain all of the exposure, including terrorism, windstorm (e.g. Florida) and some high-risk flood cover (e.g. Mississippi).

Further opportunities come from the growth in renewable energy, with $2 trillion of investment expected between now and 2030. As the renewable energy sector continues to grow, so will its demand for risk management services. Owners and developers are especially keen to gain insurers' and reinsurers' assistance in helping them to reduce the construction risks and revenue volatility associated with renewable energy projects as they look to attract more institutional investment. The offshore locations of many of these facilities also make them vulnerable to climatic risks. By the end of this decade, a 50% increase in renewable energy investment is likely to produce more than a doubling of insurance spending in six of the world's leading renewable energy markets alone, according to a study carried out by Swiss Re and Bloomberg New Energy Finance.[7] Annual expenditure on risk management services could reach between $1.5 billion and $2.8 billion by 2020, says the study.

Making SAAAME viable

Developing and strengthening protection in SAAAME markets offers further opportunities for the ambitious reinsurer. 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.[8] During this period, the combined

4 Munich Re Group website, 02.09.13
5 Swiss Re Website New Company Structure, February 2011
6 Scor Re media release, 04.06.13
7 Profiling the risks in solar and wind, July 2013
8 Global Construction 2020, published in association with PwC, 09.03.11

A study by the Kuwait Financial Centre (Markaz) states that the insurance industry in the GCC will grow from $16 billion in 2012 to $40 billion by 2017, clearly illustrating the scale of opportunity in this region alone.[9]

manufacturing output of these three emerging superpowers more than doubled to reach $2,310 billion in 2010 (adjusted to current USD values).[10] Yet insurance penetration (premiums as a proportion of GDP) is 2.7% in emerging markets, compared to 8.7% in advanced economies,[11] highlighting the room for further growth.

With this potential come significant challenges. Many Western reinsurers face licensing and ownership restrictions. Insurers may also be required to cede a quota of reinsurance to local companies (in Brazil this is 40%, for example), with competition for the remaining business driving down prices and leaving foreign firms to grapple over the less attractive risks.

This protectionism is set to abate gradually, however, with pressure to open up insurance markets coming from the World Trade Organisation (WTO). Moreover, most governments simply don't have the resources or political will to keep covering what are escalating insured values in markets such as China and India and will need to open up their reinsurance sectors. More private involvement is also going to be crucial in overcoming chronic under-insurance in many SAAAME markets – a Lloyd's report comparing the level of insurance penetration and natural catastrophe losses in countries around the world found that 17 fast growth markets had between them an annualised insurance deficit of $168 billion,[12] creating threats to sustained economic growth and their ability to recover from disasters. A key question for your company is how to develop the presence and partnerships needed to take advantage of the eventual opening up of these local markets.

It will also be important to look at what breakthrough opportunities remain. One of the regions where, on the one hand, infrastructure and other asset values are rising most quickly, and on the other, under-insurance is most marked, is the Middle East. There could be particular opportunities in Sharia-compliant takaful reinsurance, both in the Middle East and in other major markets with high Muslim populations such as Malaysia and Indonesia. At present, a lack of re-takaful capacity forces takaful entities to place their business in the conventional market. The increased importance of religion in several SAAAME countries means that developing a re-takaful option is going to be crucial in meeting client demands, especially within the state-owned sector, and sustaining overall insurance market development. But is has been difficult to make re-takaful work in practice either as a standalone business or as a subsidiary operating on takaful terms. The company that is going to make the breakthrough will need to combine cultural understanding with the capacity and risk transfer solutions to make re-takaful viable.

But even if foreign reinsurers can gain access to SAAAME markets, the difficulties of assessing and pricing risks appropriately when risk data is limited remain. In the absence of pricing accuracy and adequacy, SAAAME markets are never going to realise their growth and profit potential. Rather than waiting for a market-wide alignment of data and pricing, some reinsurers have moved people onto the ground to build up the necessary data sets and tagged geographical information, often working in partnership with governments, regional and local development authorities and banks and local business groups. But this is still likely to be a long haul. Rather than trying to capture the risks within an entire market, it might be more manageable and effective to adopt a sector-specific focus in line with the particular expertise within your business. Having assessed the underwriting risks of fracking in North America, for example, you could extend this to other Western countries where the techniques are less established, but the shale opportunities exist. Similarly onshore energy underwriting can be extended to a developing gas extraction market such as Azerbaijan. This sector-specific focus would also better reflect the increasingly divergent growth trajectories between industries and countries.

Is a local presence vital? Some reinsurers are able to move in and out to take advantage of shifting prices. But growth over the longer term will need more enduring local relationships and understanding of risks. It's notable that a number of global (re)insurers have established themselves as 'local' businesses in Brazil[13] to be able to compete on an equal basis with the local market and with state-owned market leader IRB Brazil Resseguros (IRB). This kind of firm foothold can be used as a hub to develop relationships and attract business in the wider region.

Smart use of technology and re-allocation of resources are going to be crucial in creating sustainable solutions for the challenges on either side of the growth divide. There are opportunities to automate a considerable amount of mature market underwriting. This does not, however, mean purely mechanical underwriting without the involvement of expert decision making based on technical analysis.

9 Markaz Research - GCC Insurance Report 18 August 2013

10 World Bank World Development Indicators (from website 14.06.12)

11 Swiss Re Sigma World insurance in 2012

12 Lloyd's and the Centre for Economics and Business Research, Global Underinsurance Report, 27.11.12 (www.lloyds.com/news-and-insight/riskinsight/underinsurance-report)

13 CNSeg, Reinsurers authorised to operate in Brazil, updated 12.03.12

As the SAAAME giants move onto the global stage, developed market reinsurers are going to face new competition on their home turf. With their strong capitalisation, they could adopt aggressive pricing strategies, or use their local political clout to enhance the access of potential clients to their local markets.

Combined with a re-distribution/re-allocation of talent within the organisation, greater automation within mature markets would have the particular advantage of allowing the top underwriters to concentrate on assessing and pricing risks in the less data rich markets. It would also free up talent to provide risk management and product development advice and other higher value support for clients.

SAAAME giants go global

SAAAME is often seen as a long term and one-way bet by Western companies, but what if a SAAAME giant such as IRB, China Re or General Insurance Corporation of India (GIC Re) were to emerge as a major global player?

At present, many of the leading state-owned reinsurers in SAAAME markets enjoy a guaranteed market share. But as markets are opened up to greater competition, the local players will come up against global reinsurers that may be able to offer lower premiums as a result of the international diversification of their businesses. This competitive pressure will add impetus and urgency to international moves by the SAAAME reinsurers.

As the SAAAME giants move onto the global stage, developed market reinsurers are going to face new competition on their home turf. With their strong capitalisation, they could adopt aggressive pricing strategies, or use their local political clout to enhance the access of potential clients to their local markets. Small and mid-size reinsurers could become targets for acquisition as the SAAAME groups look to build up their expertise, diversification and international footprint or larger domestic companies seek to consolidate in the face of new global threats.

India's GIC Re already generates around 40% of its premiums from overseas business and is one of the leading reinsurers in the Middle East. Its ambition to become a top five global player (it is currently 15th on a premium basis) includes plans to acquire syndicates at Lloyd's.[15] Other notable developments include China Re's strategic partnership with Catlin, which is designed to "help build a foundation for China Re to grow into an important player in the world reinsurance market".[14] The tie-up includes sending a number of China Re staff on secondment to its UK partner, helping the corporation to build up its "experience of international reinsurance operations and management".

The question for the wider reinsurance market is how many global players it can accommodate once the SAAAME giants begin to realise their international ambitions, opening up the possibility of mega-mergers in the future.

Questions for your organisation

- ? Where is growth going to come from and how can you refocus resources on the most profitable opportunities?
- ? Do you have sufficient expertise in growing niches and emerging risks such as cyber or onshore energy?
- ? How can you make up for limited risk data and modelling output in SAAAME markets?
- ? How vulnerable is your business to a sustained period of price undercutting from potential new entrants and how can you compete?

14 Deccan Chronicle, 27.05.13

15 Catlin media release, 18.11.12

Rethinking domiciles

Reinsurers are always looking at where best to be based in order to maximise their competitive advantage. Tax rates and regimes, capital demands, the quality of regulation and access to talent and key markets all come into the equation. But while these ingredients are common to all reinsurers, their relative importance depends on the characteristics and ambitions of the company. For example, a business started up or spun out to take advantage of new rating opportunities could look for a domicile that would provide the fast licensing approval needed to begin writing as quickly as possible. In contrast, an established business may have more time to weigh up a broader set of tax and capital structuring options. The underlying consideration is how to balance the desire for certainty and stability in areas such as tax and regulation with being nimble and mobile enough to compete with new entrants which are able to move in and take advantage of the most favourable options.

The 1990s saw a number of companies shifting from the US and Europe to Bermuda. The ability to set up in business quickly also helped to attract the classes of 2001 and 2005. Some international groups have moved the other way in recent years. Ireland, Switzerland, Luxembourg and the Netherlands have been among the chosen destinations as companies look for domiciles that combine competitive tax regimes with stable regulatory frameworks.

One of the reasons for the rethink has been proposed tax changes in the US, with a particular focus continuing to be the ceding of reinsurance to overseas affiliates. But there is also a growing reputational dimension as some insurers and reinsurers grow uncomfortable about operating from what are perceived to be tax havens, and public pressure weighs on politicians to close loopholes and strengthen tax transparency. It's telling that taxation and the reputational issues that surround it rank number one in the latest Lloyd's Risk Index.[16] Reinsurers aren't just looking at the tax policies in place at present, but how stable they're likely to be and the extent to which public pressure might lead to a major reversal for their business.

Lloyd's is once again growing in attractiveness (partly as the UK's tax regime becomes more competitive). The Lloyd's global licence has always been attractive for businesses wanting to extend their international footprint. The recent reduction in corporation tax rates and new rules on the taxation of foreign profits under the controlled foreign companies' regime in the UK have attracted a lot of interest from reinsurers. Companies are working with the tax authorities to understand whether their structures are fit for purpose under the foreign taxation rules. Reported moves by the UK Treasury to attract back companies that have re-domiciled[17] highlight the competition between governments to secure the primacy of their financial centres.

As the continuing start-ups in Bermuda illustrate, however, the direction of travel has been far from clear cut. Bermuda is hugely important to insurance risk and capital management in the US – it accounts for around 60% of reinsurance capacity bought by Florida domestic insurers,[18] for example. Its attractions include both talent and effective regulation.

Reinsurers are looking closely at the stability of regulation. There have been questions over the capacity of local regulators in some smaller states to oversee large and complex global operations. This could make operating from a jurisdiction with a sophisticated and well-resourced market supervisor more attractive.

The increasing harmonisation of international regulation is a further factor. Equivalence under Solvency II will allow EU insurers to treat reinsurance contracts in the same way as if they had been written by a local reinsurer, with no need for additional capital or re-statement of the numbers. Bermuda's class of large internationally active reinsurers could be covered by equivalence in the first wave (but not smaller captives), with a number of other markets including Australia and Singapore covered by the transitional provisions. Some form of mutual agreement between the EU and the US that would confer the same benefits as equivalence is likely.

Access to talent will continue to be critical, as without it reinsurance is no more than trading in paper promises in isolation, which does not really work. The need to secure people with the right expertise means that major reinsurance operations are clustered in a number of leading markets including London, Munich, Zurich, Bermuda, New York, Hong Kong and Singapore. These centres not only have the regulatory infrastructure and reputation but also offer access to brokers, legal, accounting and actuarial talent pools that companies are looking for when selecting a locale.

We can expect a number of established players to move location again over the next few years. Traditional centres such as Bermuda will continue to develop and react and retain their positions.

In addition to a global HQ, there may be regulatory and tax reasons to operate through theatre specific reinsurance hubs, for example if seeking to access growth markets. The relative certainty of tax and regulation is going to be a key consideration in where to locate the hub.

Looking ahead, the choice of domicile will remain fluid and we can expect a number of established players to move location again over the next few years. Leading reinsurance centres will need to continue to develop and respond to regulatory and tax changes within competing domiciles as they look to retain their positions.

Ultimately, this is a competitive issue. However much your company may want stability, it still faces the risk of being undercut by a new entrant which is able to operate with more competitive tax, cost and capital structures. So looking at how various scenarios would affect your business and being nimble enough to take advantage will continue to be critical.

16 The Index assesses corporate risk priorities and attitudes among business leaders around the world

17 Independent, 11.08.13

18 Bermuda: Re, 11.04.13

Information advantage through big data

For many clients, the main differentiator is price and financial rating. But by using the latest developments in analytics to help them understand and mitigate their risks more effectively, the true value and differential of your risk management expertise would become more tangible.

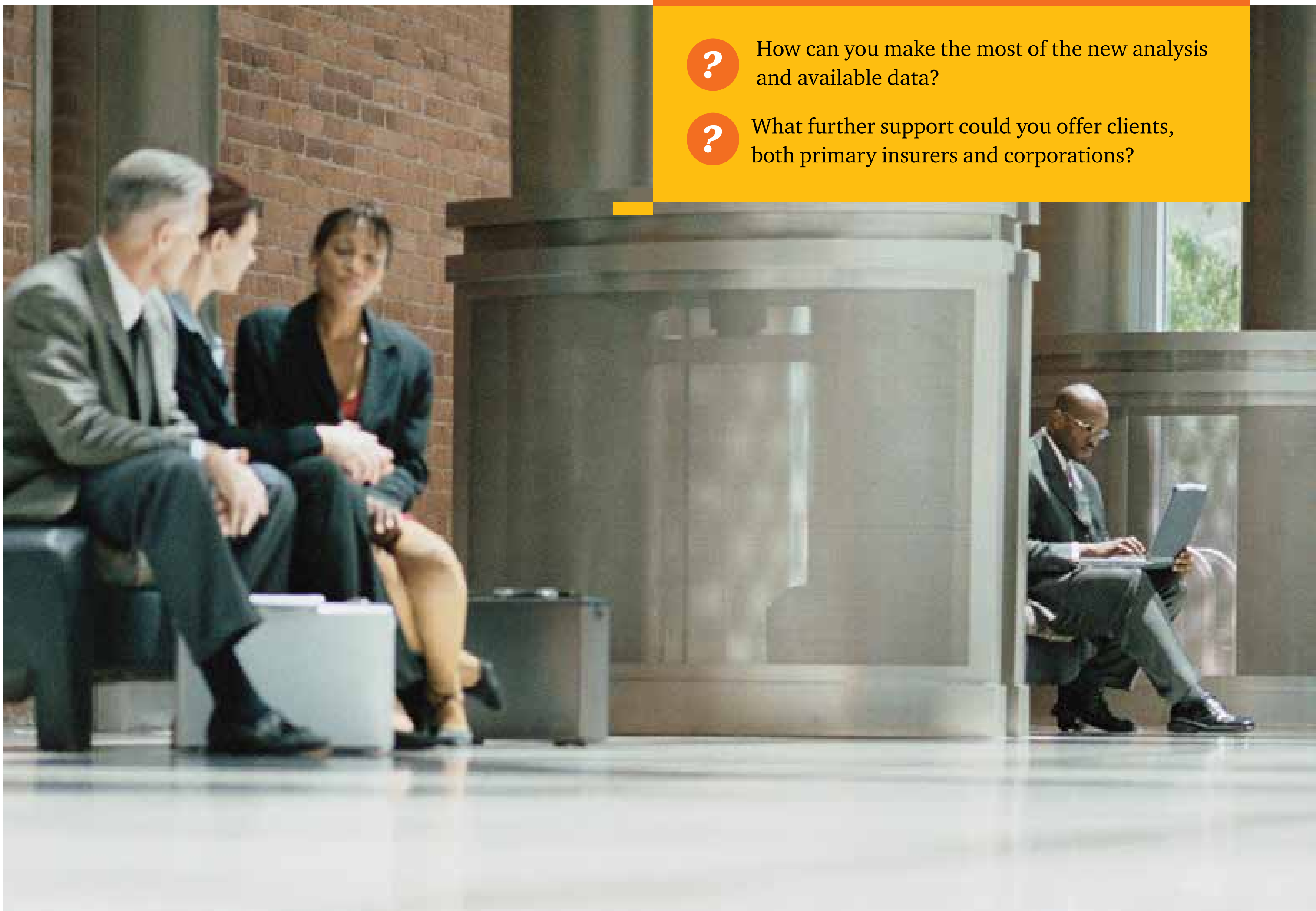
Reinsurers have led the way in the development of risk analytics. These advances have taken risk evaluation from hindsight to insight. The latest 'big data' developments are raising the benchmark once again, from insight to foresight.

Analysis of structured and unstructured big data could enhance risk evaluation and allow for more precise risk pricing. In the property market, for example, we're seeing how companies are overlaying unstructured and sensor data on top of basic GIS information to analyse and better manage concentration risk. On the commercial property side, unstructured data analysis might include identifying hazardous shipments or a depletion of trained fire safety teams at a plant because of cutbacks or illness.

Real-time analysis and pricing is also now a genuine possibility and could be a key differentiator. Examples include digital tracking of barcoded containers, which would allow real-time analysis of risks including location, value of contents and, if aligned with other satellite information, factors such as weather. Risk could be priced to the minute, using traditional primary and available secondary data extracted from wider information sources.

For example, one of the issues identified by the storm surge associated with Sandy was the positioning and protection of emergency generators. Buildings with generators in the basement without specific flood protection took far longer to re-commission than those where the generators were in upper level service pods. This location information is generally available from unstructured data about individual buildings. Other areas that would benefit from unstructured data analysis include the flow of trade and associated supply chain concentrations. We expect that the increase in computing and analytical power will mean that many secondary aspects will be taken into account in the pricing of individual risks.

As corporations' and primary insurers' technical capabilities continue to improve, reinsurers face the challenge of how to make sure their analytics remain one step ahead. The other key challenge is how to secure access to critical data. Corporations are collecting and analysing far more data than ever before. But much of this data isn't being used to inform reinsurance underwriting, or reinsurers may not see it as they've tended to be at least one step removed from the end client. For example,



Questions for your organisation

- How can you make the most of the new analysis and available data?
- What further support could you offer clients, both primary insurers and corporations?

pharmaceutical companies maintain detailed records on the distribution of their drugs and types of users, though this data tends not to be used to inform product liability pricing. If your business could get closer to clients and their data, you could not only price and manage your risks more effectively, but also offer them smarter risk financing solutions. The result would be both higher premium income and more enduring partnerships with clients.

A key part of the support for primary insurers will be advising on the product innovations and efficient risk transfer structures needed to compete in the new risk-based capital environment ushered in by Solvency II and other comparable regimes elsewhere. You could also help them to take up new investment opportunities in areas such as infrastructure by advising on the risks and capital demands and helping them to offload the risks they may not have the expertise or capital capacity to retain (e.g. construction risk).

The advisory opportunities from partnering with corporations could be even bigger. This includes helping them to understand and mitigate the ever more complex political, environmental and supply chain risks thrown up by an increasingly globalised economy. In short, risk insight is set to be the dominant currency and differentiator with reinsurance.

If your business could get closer to clients and their data, you could not only price and manage your risks more effectively, but also offer them smarter risk management solutions.

Distribution disruption and customer revolution

Broker intermediation continues to be the primary distribution model for non-life reinsurance, but the market is opening up as clients seek out more flexible and cost-efficient solutions.

As better informed companies retain more risk and the reinsurer's role shifts from reactive claims payer to proactive risk financer and manager, the market is going to demand more specialised, creative and finely targeted solutions. These developments could be accelerated by the expansion of ILS, which is likely to absorb a lot of the commoditised traditional reinsurance business. As customer expectations and sources of capacity continue to evolve, we could see the disruption of the traditional three-party model relationship. The parties in the best position to secure and retain business in this more fluid market are the ones (insurer, reinsurer or broker) with greatest access to client specific and wider risk data and risk financing capacity, underlining the importance of getting closer to clients.

We discussed the changing role of reinsurers as they look to forge closer risk partnerships with the direct carriers or corporates in our 2011 paper, 'Daring to be Different'[19] and there are signs that these moves are accelerating. As corporations' dedicated risk management units become larger and more sophisticated, they are increasingly looking to brokers to provide advice on the risk transfer options and then seeking the risk financing structures that are tailored to their needs. Reinsurers have the expertise of building specific products targeted at this market and are beginning to expand their underwriting teams here, in competition with their direct insurance counterparts. The opportunities and threats in each case are large. The June 2013 renewal season further highlighted the shift as both traditional and alternative markets sought to provide risk transfer solutions directly with corporates and new private sponsors, essentially working around the syndicated markets. The syndicated markets serve a useful purpose, not least through their potentially stabilising effect on pricing and the ability to spread risk across a large number of capital providers. But distribution strategies will continue to broaden and evolve, opening up new ways to serve clients and extend risk coverage.

Similarly, within the broking world, we have also seen the development of strategically important constructs in the market, as represented by the Aon deal with Berkshire Hathaway and the Willis 360 programme. The market reaction to these deals is currently unclear, as they are bringing the large brokers new and more complex ways of accessing dedicated capacity, which could be at the expense of smaller brokers and reinsurers. While the strict division between broking, insurance, reinsurance and underwriting has always been blurred, as evidenced by the existence of broker underwriting pools in the past and the fact that many brokers provide analytical and technical pricing services for some of their smaller clients, the new deals could represent a significant and game changing move that could further disrupt existing market relationships.

19 Daring to be different, (www.pwc.com/gx/en/insurance/reinsurance-rendezvous/daring-to-be-different.jhtml)

Taking ILS to the next level

ILS now makes up 15% of the overall property catastrophe reinsurance market.[20] Traditional reinsurers and investment banks have been moving into the market. But the surge in investment chasing finite demand runs the risk of simply cannibalising existing capacity and driving down prices. Continued innovation and the ability to reach into new and untapped markets are therefore going to be crucial in realising the full potential of ILS.

With the principal focus continuing to be wind and earthquake exposure in the US, with some limited exposure to European wind and Japanese earthquake there is considerable room for growth into peak risks in these latter markets. SAAAME markets also remain largely untapped, with the potential to attract sovereign wealth and other sources of local capital.

From an investor perspective, too much capital is chasing too few risks. This pressure has provided an important catalyst for the growth in private deals between cedents and investors. Many investors are looking to private placements as a way to increase their access to the market, bolster spreads and be more selective over the risks they take on. Many specialist investors are developing their own modelling and due diligence capabilities to support these moves.

Even with direct placement, however, there is still going to be an imbalance between capital and investment targets within the traditional risk areas covered by ILS. Investors may therefore have to accept new types of risks or more extreme risks to maintain their target yields. In keeping with the opportunities in the market overall, these areas include pandemic risk, longevity risk and non-life risks such as terrorism. Investors may also have to embrace areas where there is less data and advanced modelling available.

Up until now, the main focus of ILS has been peak risk. There is an argument that securitisation of long term profit streams could therefore provide another avenue for investors and much needed capital relief for companies (for more detailed analysis of the prospects for ILS please see the PwC paper *Expanding the potential of ILS*).

From competing to partnering with governments

Government policies are having a challenging and possibly distorting impact on reinsurers and their returns. But there are also opportunities to partner with governments and take on the risks they can no longer afford to retain.

The distorting impact of government intervention is most pronounced in today's artificially low interest rates. This has affected investment returns, though it is encouraging greater underwriting discipline and the development of higher margin opportunities.

Governments also cover a significant amount of windstorm, flood and terrorism risk. One of the more high profile examples of this state intervention is in Florida. The state legislature in Florida has moved to limit its exposure by making the publicly-owned insurer, Citizens, more of an insurer of last resort. But despite recent attempts to lower public support, funding for the state reinsurer of last resort, the Florida Hurricane Catastrophe Fund (FHCF), remains intact. As the controversy over whether to activate the hurricane clauses or not following Windstorm Sandy highlights, insurance and reinsurance may also become subject to the kind of political pressures and controls seen in Florida and other such peak zones.

But no government has the financial resources to sustain this kind of direct intervention indefinitely. As pressure on public finances increases they will need to look at how the private sector could assume either all or part of the risks. The Caribbean Insurance Pool is a specific example of this type of intervention where the governments, via the pool mechanism, seek commercial reinsurance in excess of the base cover offered by the pool. The Turkish Earthquake pool is also a good example of a public/private partnership where the government encourages local cover for earthquake and involves the private sector, initially with some subsidy, to participate in providing cover to exposed regions. We would expect to see more of these partnerships in increasingly diverse areas where the expertise of reinsurers would be invaluable. A key challenge will be how to maintain adequate returns in the face of public and political scrutiny, which will require a close partnership with government in areas such as data sharing.

Solvency II and comparable regulations in other parts of the world (including Bermuda and Singapore) are going to transform the capital demands of both insurers and their reinsurers. Risk-based regulation may encourage some direct insurers to buy more reinsurance to manage capital demands, but clearly only if this is a more cost-effective option. The big opportunity is therefore to provide smart solutions that would allow insurers to manage their capital more efficiently and ensure that their product offerings reflect changing customer and regulatory demands.

Questions for your organisation

? How can you get closer to customers and understand their needs better?

? Are there opportunities to lead the market by moving ILS into new areas?

20 PwC analysis

Who is best able to compete?

Your business can no longer rely on traditional sources of differentiation in a market where customer expectations, geographic focus and analytical possibilities are changing so fast. What is the likely profile of the market leaders of the future?

As part of Insurance 2020, we've been working with reinsurers to assess the threats and opportunities facing their businesses over the coming years, both from traditional competitors and beyond. This 'fiercest competitor' analysis underlines both the huge potential and the significant vulnerabilities faced by reinsurance companies in an increasingly dynamic marketplace. Drawing on this analysis, we believe that the companies best able to overcome their fiercest competitor and lead the market in the future are going to be marked out by the following attributes:

1. They will be global players, but have sufficient local presence in the major markets to ensure that they can access business in each market effectively. They will accept a diverse range of risks reflecting diversity by territory and risk type.

2. They will be known for their advanced capital and risk modelling and technical excellence in pricing. These companies will aim to make an underwriting profit over the cycle and to deploy their capital effectively to accept risks efficiently.

3. They will be headquartered and have subsidiaries in tax and regulatory efficient domiciles. They will be able to balance the need to sustain capital fungibility, draw on a pool of talented staff, optimise tax arrangements and be viewed as being well regulated.

4. They will write both direct and reinsurance business. Distribution is a key challenge for the reinsurance industry, and access to the peak risks that they manage efficiently is an important part of their competitive rationale. Increasingly, large global companies want access to the wholesale market and would probably prefer to do this without the need for a captive.

5. They will have access to the capital markets, both to originate solutions for basic business, as well as to reload with capital in the face of a large market event that threatens their rating or long term viability. This will see them as originators or sponsors of new securitisation issues capable of protecting their or their clients' balance sheets or having tools that will allow them to access capital efficiently.

6. They will use their data, technology and client data to create pricing and risk management advantage for themselves. They will also exploit technology's ability to minimise costs and thus offer more competitive pricing.

7 They will be innovators on products and risk type, providing real-time reporting of claims and risk management tools that best meet clients' underlying needs.

8 They will have strong brands within and outside the insurance sector which will help them to access profitable business via a range of distribution channels and capital from a variety of sources.

9 They will focus on the need to manage their asset portfolio and extract maximum returns from this activity consistent with their risk appetite.

10 They will be politically savvy, working with governments and other key stakeholders to offer cover in areas where others may be reluctant to enter.

Your fiercest competitor

The American author Ray Kurzweil has talked about 20,000 years of evolution and progress being crammed into the next 100 years. And if we think of the relentless and often disorientating change we've already seen in this century, your business needs to be ready for what's coming next. What happened to the music industry in the face of the onslaught of digital distribution shows how quickly established businesses can be swept aside.

Could you as a reinsurer be vulnerable to a similar upheaval? The transformational changes in the music industry highlight the importance of looking beyond immediate competitors at the potential threat from new entrants and developments in technology and customer expectations – what we call your 'fiercest competitors'.

A good way to assess the threats and opportunities is to put yourself in your fiercest competitor's shoes and identify your potential vulnerabilities. Imagine that you've just been fired from your company. You know the soft underbelly. You know where products, systems and distribution capabilities are not strong enough. If a backer came to you with investment, you'd know how to take the initiative and seize market share from your old firm. Looking at your company on that basis, how can you address these vulnerabilities and take the initiative in this way?

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Conclusion

While many reinsurance CEOs have fixed their sights on the immediate challenges of low interest rates and the softening in premium prices, they can't afford to ignore the transformational changes ahead.

The coalescing impact of new market openings, changing customer expectations and new analytical techniques offers farsighted businesses the opportunity to use their expertise to the full and sharpen differentiation, rather than simply competing on price.

Getting closer to clients would allow your business to make the most of its expertise and develop higher margin solutions, with risk insight and innovation becoming the key competitive differentiators they always should have been.

Less agile counterparts could face the slow death of margin erosion as they compete over increasingly commoditised low value business. They may even run the risk of complete marginalisation if an ambitious and strongly capitalised new market entrant moves in to sweep up business where the only differentiator is price.

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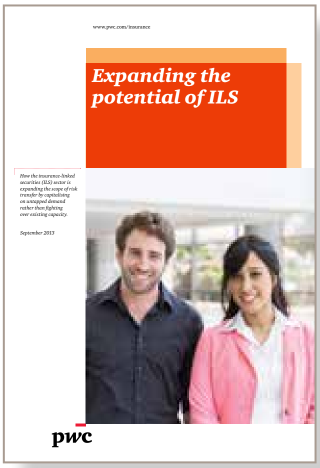

Expanding the potential of ILS (Sept 2013)
In this paper, Arthur Wightman and Bryan Joseph explore how the insurance-linked securities (ILS) sector is growing the scope of risk transfer by capitalising on untapped demand rather than fighting over existing capacity.

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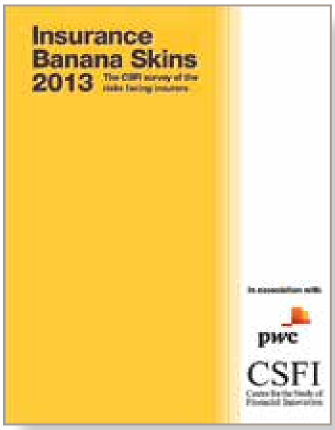

Insurance Banana Skins (July 2013)
Insurance Banana Skins is a piece of research conducted by PwC in association with the Centre for the Study of Financial Innovation (CSFI), an independent Think Tank. This survey of insurers seeks to ask their views on current risks and future trends.

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Confronting the new market realities (Sept 2012)
We tackle the questions around the generation of ongoing sustainable profits for reinsurance companies.

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Unlocking the potential of ILS (June 2012)
This paper examines the prospects for ILS as the reinsurance and capital markets continue to converge and presents ways in which sponsors and investors can overcome fundamental challenges to help move it to the mainstream.

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