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Through Innovation, Global Reinsurers Race to Remain Relevant

By A.M. Best's Reinsurance Team

Declining rates, broader terms and conditions, unsustainable flow of net favorable loss reserve development, low investment yields and continued pressure from convergence capital are all negative factors that continue to adversely impact global reinsurance companies. These weak operating fundamentals in the reinsurance sector also are being exacerbated by continued weakened demand from primary insurers as they retain more business to leverage their own excess capacity. As a result, companies have intensified their efforts to develop new strategies in order to adapt to structural market changes.

These significant challenges prompted A.M. Best to revise its rating outlook to negative on the sector in August 2014 and has maintained it there since, citing how these obstacles are hindering the potential for positive rating actions over time and may eventually translate into negative rating pressures.

With regard to the low investment yields, the prospects for any meaningful relief have been delayed as a consequence of the decision by U.K. voters to leave the European Union in the so-called "Brexit" vote. Following the vote in late June 2016, A.M. Best said in a statement that it did not expect to take rating actions in the near term as a direct consequence of the referendum results though it would monitor exit negotiations and would discuss with rated companies what prospective changes will mean for their competitive positions and ability to continue to access business in the United Kingdom and the European Union (EU).

The full consequence of the "Brexit" vote is difficult to gauge at this point. A.M. Best noted that Solvency II's market-consistent approach to valuing the economic balance sheet meant that financial market volatility will be closely reflected in European insurers' reported solvency capital ratios. However, operationally, the transacting of reinsurance business should not be affected as trade restrictions between the United Kingdom and EU are unlikely to apply to reinsurance.

The dearth of opportunities to enhance results with investment income remains an issue for primary and reinsurance companies. Management teams have reiterated intentions to remain disciplined and reduce books of business if necessary in order to achieve desired results. Due to the hyper-competition for reinsurance opportunities, limited in number by the strong balance sheets of primary insurers, risk portfolios of global reinsurers have begun to shift in terms of business mix. This underlying trend began several years back, when reinsurers, in an effort to better cycle manage their risk portfolio, looked for opportunities to grow in specialty insurance. Pricing for this business is proving to be a little more attractive than on the reinsurance side, although increased pressure is mounting in this sector as well, rendering some specialty classes as less than "special." Over the recent term, property, marine, energy and aviation pricing pressures have become more acute, even on the primary side.

The reality is capital market capacity has triggered structural changes in the market. The trend started as a trickle but now is creating enough of an impact on the property catastrophe market that it is displacing capacity to other lines of business, distribution sources, and geographies. Recent indications of a market bottoming are emerging, but the overriding trend remains negative. A broader cyber (re)insurance solution in the market, as well as regulatory changes in the European Union and China, may over time provide some new business opportunities for reinsurers.

SEEKING SOLID FOOTING THROUGH M&A

A.M. Best's annual analysis of the Top 50 reinsurers confirms some of the aforementioned industry themes. With robust capacity, the market remains competitive, and given the continued low investment yields, underwriting discipline continues to be critical. While some of the Top 50 reinsurers have grown organically, others have grown through acquisitions (Exhibit 1).

Most of these transactions can be characterized as attempts to build scale, product and distribution capability, while improving

EXHIBIT 1: NOTABLE CHANGES IN A.M. BEST'S RANKING OF TOP GLOBAL REINSURANCE GROUPS

UPWARD	2015	2016	Δ	DOWNWARD	2015	2016	Δ
Qatar Re	50	35	15	IRB - Brasil Resseguros	31	36	-5
RenaissanceRe	26	20	6	Allied World	37	41	-4
Arch Capital Group	27	22	5	Maiden Re	38	42	-4
Taiping Re	42	37	5	Sompo Japan Nipponkoa	44	48	-4
Third Point Re	49	44	5	QBE Insurance Group	20	24	-4

Source: A.M. Best data and research

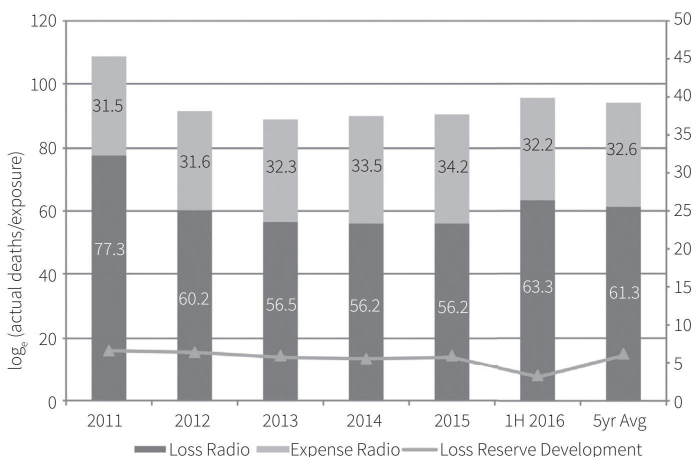
operating and capital efficiency. It is not yet clear if all these objectives have been fully realized for the recently merged organizations. What is evident is that the acquired entities, which, by and large, were focused on U.S. property catastrophe reinsurance, are better off as part of a larger, more broadly diversified organization. While these transactions have done little to alleviate the excess capacity that exists in the market, they have provided the respective organizations greater flexibility in deploying capacity across a broader spectrum of opportunities globally. The broader product and distribution capability also should be a significant advantage in attracting capital market capacity as money managers seek to expand their horizons beyond property catastrophe risk.

The market leaders continue to dominate, with the Top 10 reinsurers of 2015 remaining in the top quintile of the 2016 rankings, and writing more than 70 percent of the total life and non-life unaffiliated gross reinsurance premiums written. Munich Re, Swiss Re and Hannover Re have occupied the first, second and third spots, respectively, since 2010.

Overall, the year-over-year declines in premium have accelerated. In 2015, total life and non-life gross premiums declined 1.5 percent year-over-year, versus less than a 0.5 percent decline in the prior year. The decrease in premiums is attributable to discipline among many players in the market, but the significant depreciation in foreign currencies relative to U.S. dollars, on which the top 50 ranking is based, also accounts for some of the decline.

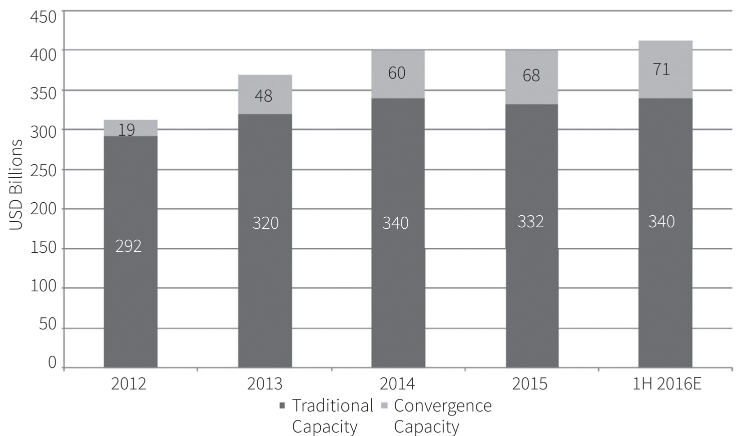
While 2015 was not devoid of severe natural catastrophes, many events were either away from population centers or were in areas of low insurance penetration. The relatively benign catastrophe environment has put significant downward pressure on rates. Still, reported operating performance among reinsurers remained buoyant (Exhibit 2). Combined ratios for nearly 90 percent of the Top 50 reinsurers were below 100, driven in part by continued favorable development and well-diversified books of business. Surplus growth once again outpaced net premium revenue growth. Alternative capacity in the form of catastrophe bonds, sidecars, and other structured products continue to fuel strong price competition. It is currently estimated that alternative capital represents approximately USD 71 billion of capacity, roughly 20 percent of the total dedicated capacity of the reinsurance market (Exhibit 3).

EXHIBIT 2: GLOBAL MARKET - COMBINED RATIO COMPONENTS



Source: A.M. Best data and research

EXHIBIT 3: ESTIMATED DEDICATED REINSURANCE CAPITAL: 2012 TO MID-YEAR 2016



Source: A.M. Best data and Guy Carpenter

CONVERGENCE MARKET MATURING

Alternative capital will continue to flow to the reinsurance sector for the foreseeable future. Insurance-linked securities (ILS) fund managers will be major players in the reinsurance sector as more collateralized reinsurance programs covering nonpeak exposures are ceded to the capital market; catastrophe bond risk capital continues to grow; and the potential for longevity risk transfers becomes part of the ILS transaction mix. The next major catastrophe will be the first for most ILS fund managers. If capacity issues arise, history has shown that new capital will enter the market. However, A.M. Best expects that this additional capacity is more likely to come from capital market solutions than the more traditional creation of "brick and mortar" reinsurance/insurance companies.

Another manifestation of this convergence capital is the hedge-fund-sponsored reinsurer. In an environment where rate-online has become much more competitive and the peaks of the underwriting cycle have softened in recent history, reinsurers are looking for strategies to optimize the risk-reward balance. There are many ways to accomplish this, one of which is the hedge-fund-sponsored reinsurer model of which most are still in the start-up phase. To that end, it is uncertain what the specific long-term

EXHIBIT 4: HEDGE FUND COMPOSITE - TREND SUMMARY (USD MILLIONS)

	2-YR AVG	2015	2014
NPW (P&C only)	1,606.9	1,946.4	1,267.3
Net Earned Premiums (P&C only)	1,305.5	1,585.3	1,025.6
Net Investment Income	423.0	176.0	670.0
Realized Investment Gains / (Losses)	-	-	
Total Revenue	1,703.1	1,760.0	1,646.2
Net Income	(81.4)	(278.9)	116.1
Shareholders' Equity (End of Period)	5,510.3	5,982.7	5,037.9
Loss Ratio	67.2%	70.3%	64.1%
Expense Ratio	41.0%	41.1%	40.8%
Combined Ratio	108.2%	111.5%	104.9%
Loss Reserve Development - (Favorable) / Unfavorable	2.0%	3.2%	0.8%
Net Investment Ratio1	38.2%	11.1%	65.3%
Operating Ratio	70.0%	100.4%	39.6%
Return on Equity	-1.2%	-4.7%	2.4%
Return on Revenue	-4.4%	-15.8%	7.1%
NPW (P&C only) to Equity (End of Period)	28.8%	33%	25%
Net Reserves to Equity (End of Period)	13.6%	20%	8%
Gross Reserves to Equity (End of Period)	18.4%	22%	15%

Source: A.M. Best data and research

results will be compared with more traditional reinsurers.

Hedge-fund-sponsored reinsurers were not immune to the adverse market trends in 2015. Premium growth and underwriting performance was unfavorable across A.M. Best's composite of hedge-fund-sponsored reinsurers, with a combined ratio of 111.5 percent, a loss ratio of 70.3 percent and an underwriting expense ratio of 41.1 percent for 2015 (Exhibit 4). The start-up nature of most of these entities and related costs, along with less-than-optimal premium volumes compared with fixed expenses, led to the inflated expense ratio. A.M. Best also notes that none of the companies in its "hedge fund re" composite were able to avail themselves of prior-year reserve takedowns that have been heavily utilized by companies in A.M. Best's U.S. and Bermuda composite, which for 2015, represented a six-point benefit to the loss and combined ratios.

Investment results for 2015 for the hedge-fund-sponsored composite were similarly disappointing, with a 0.9 percent investment yield, with the most adverse performance in the composite being down 22.2 percent and the most beneficial in the composite being up 25.9 percent. This composite also recorded an USD 279 million net loss for 2015.

While investment and overall performance has been poor, A.M. Best believes it is too early to jump to the conclusion that the "hedge fund re" model does not work. The level of investment volatility experienced is expected and is contemplated in A.M. Best's various stress tests as part of its stringent start-up require-

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ments. The success of these strategies has to be evaluated over the long term and through various market cycles. The robust capitalization of these companies provides the bandwidth to achieve success. It generally takes several years for a strategy to take hold and reach adequate economies of scale.

CAPACITY CALLS FOR INNOVATION

Reinsurers increasingly seem to be viewing capital market capacity as an opportunity as opposed to a threat. Despite a progressive deterioration in pricing, terms and conditions, capital market capacity has continued to be attracted to the reinsurance sector and underwriters that have the market knowledge and distribution capability to assess risk are benefiting. Companies have been utilizing retrocessional capacity in various forms as a cycle management tool. Over the past few years, new sidecar facilities have been created or existing ones increased. The capability to transfer risk to capital market facilities in exchange for fees and profit sharing is a desirable alternative to have available for clients when risk-adjusted pricing prohibits the use of traditional on balance sheet capacity.

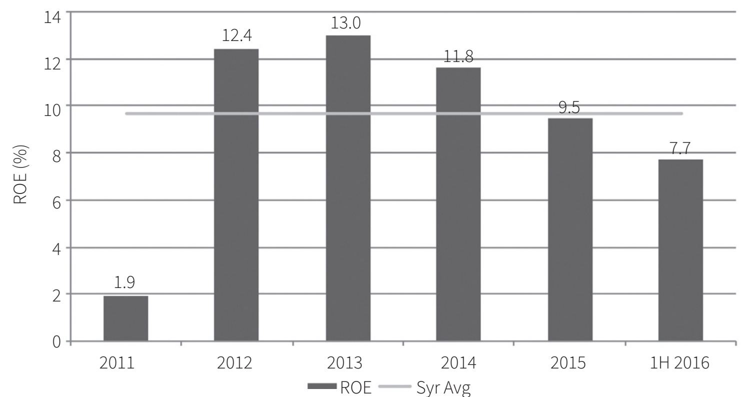
There have been a number of strategic acquisitions or investments in MGAs by reinsurance companies and capital market facilities seeking to strengthen their distribution channel as traditional access to business continues to contract. Direct ownership of a distribution source serves the dual purpose of stabilizing the flow of business and reducing acquisition costs, while providing the insured client with

a competitively priced product. Owning the MGA as opposed to just providing the capacity has the added benefit of greater ability in maintaining quality underwriting standards.

There is also a push for innovation and trying to find ways to close the protection gap. Reinsurers appear to be leading the initiative to penetrate uninsured and underinsured exposures such as flood, cyber and terror by working with government and taxpayer-backed pools to find risk transfer solutions to alleviate the post-loss burden on society. This is an area where ideas are plentiful but progress is slow. It remains a huge frontier with great potential and may be the ultimate solution to the excess capacity problem, providing for greater strategic alliances between traditional and capital market capacity.

Clearly, capital market capacity is pressuring the reinsurance sector to work to charge less. With more capital in the market, the ultimate winner should be the insured client as this drives down the cost of insurance. But it is the long-term value proposition that really matters for all parties involved and that outcome is still very unclear. Given where rate adequacy is, A.M. Best thinks it will continue to take optimal conditions, including benign or near-benign catastrophe years, a continued flow of net favorable loss reserve development, and stable financial markets to produce even low double-digit returns. Such return measures would have been considered average or perhaps mediocre just a few short years ago (Exhibit 5). The reality of the current situation is that a major catastrophe will occur at some point and the mask of redundant reserves will eventually be removed to reveal the true ramifications of current market conditions.

EXHIBIT 5: GLOBAL MARKET - RETURN ON EQUITY (ROE)



Source: A.M. Best data and research

It is A.M. Best's view that companies with diverse business portfolios, advanced distribution capabilities and broad geographic scope are better-positioned to withstand the pressures in this type of operating environment and have greater ability to target profitable opportunities as they arise. It also places increased emphasis on dynamic capital management in order for companies to manage the underwriting cycle and remain relevant to equity investors and the capital markets. ■