Reinsurers with undifferentiated 'me too' strategies could be squeezed out of the market. Which business models will be viable in five years' time and what steps do you need to take to position your business out in front?

Reinsurance 2020: Taking control of your destiny

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Introduction

Welcome to Reinsurance 2020: Taking control of your destiny.

This paper is a follow-up to 2013's Reinsurance 2020: Breaking the mould[1], which looked at why a radical rethink of how to build for the future is needed within a fiercely competitive and rapidly evolving reinsurance marketplace.

Reinsurers are facing a threat to their relevance. Mid-sized generalists could be particularly vulnerable as customers demand more specialised, creative and finely-targeted solutions from their reinsurers, and brokers respond by placing business with reinsurers with the highest rating or greatest expertise. With limited growth in traditional, primarily developed, insurance markets and a range of disruptive new threats on the horizon, a clear focus on cost, risk insight and innovation is needed to break away from competitors.

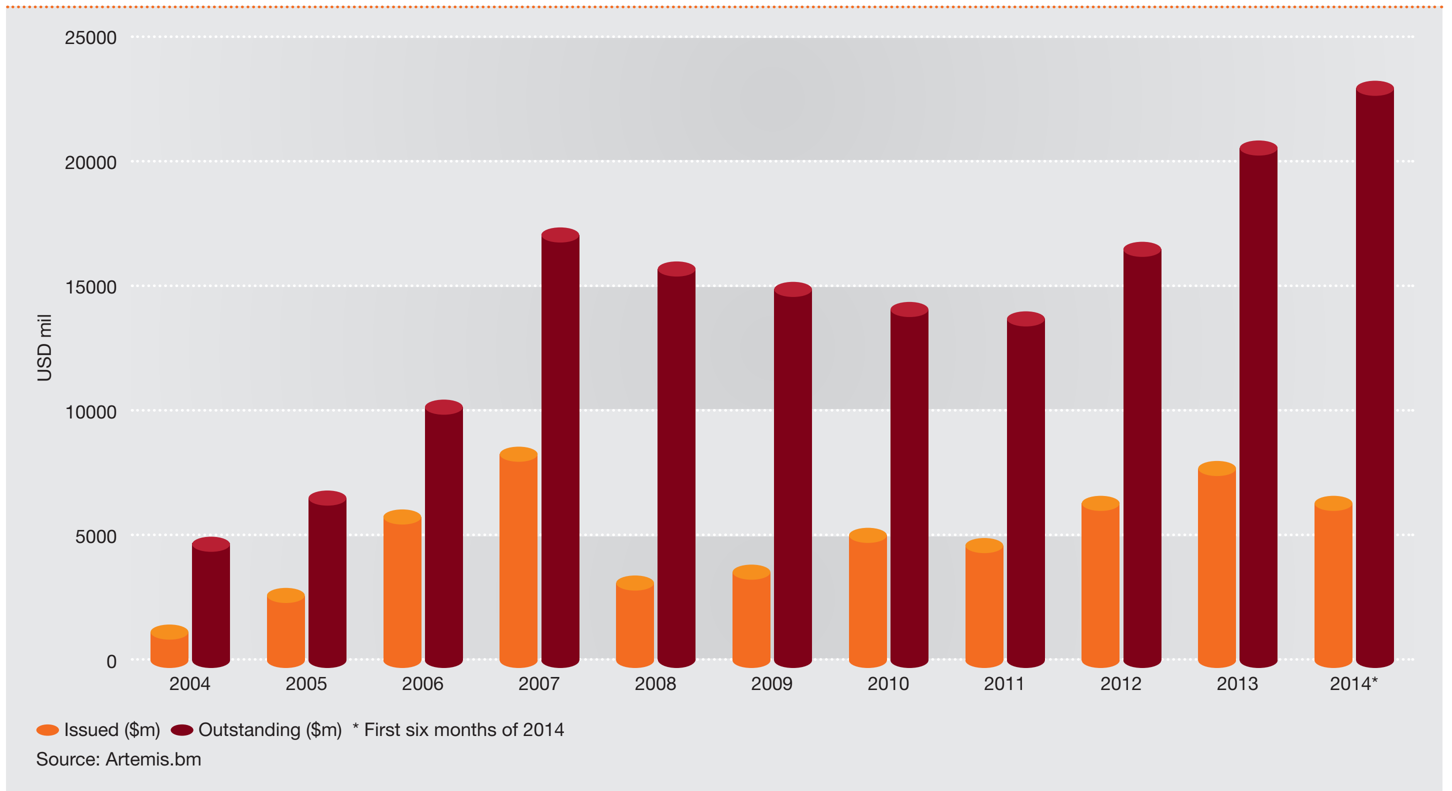
The forces driving change have continued to intensify since we published our 2013 report. The low interest rate environment is proving especially disruptive, requiring a much tighter focus on underwriting quality and the need to accept more profitable business. Premium rates in many classes of business have also continued their decline and in some cases these falls have been masked by changes to terms and conditions.

Some businesses are clinging on in the hope that a major loss event will lead to a significant hardening of rates. But any rises, particularly within the property catastrophe segment, are likely to be marginal at best as a result of the increase in Insurance-Linked Securities (ILS) capacity coming into the market (see Figure 1). The next 12 months are set to see even more capital market investment, both directly and through joint ventures with traditional reinsurers. The longer term threat is that organisations will bypass brokers, insurers and reinsurers altogether by simply looking to place their risks directly with willing capital market risk-takers.

So what are the options for survival and success? We're already seeing a renewed wave of cost-cutting and consolidation as reinsurers look to bolster scale and sharpen price competitiveness. Yet, fighting over the commoditised crumbs in declining markets does not represent a viable long-term future. Unless the undifferentiated generalists change tack, it's only a matter of time before they're absorbed or squeezed out of the market altogether. If your company wants to survive and thrive in 2020, it will have to address searching questions about 'What are we in business to do?', 'What is our distinctive proposition?', 'Where are we going to compete?' and 'What will the resulting operating model look like?'.

1 http://www.pwc.com/gx/en/insurance/reinsurance-2020-breaking-the-mould.jhtml

Figure 1: Growth in ILS



Source: Artemis.bm

Even if companies have these capabilities, they will need to broaden their business horizons as they strive to keep pace with changing customer demands and take advantage of new and untapped opportunities.

In this paper, we set out six business models that we believe offer the foundations for success in this new market landscape:

1	**Superior scale:** Big and knowledgeable on either a global or regional level
2	**Nimble innovators:** Using analytics and specialist expertise to punch above their weight
3	**Lloyd's:** Combining depth and breadth with smaller company agility and expertise
4	**Float accumulators:** Delivering superior investment returns
5	**Risk transformers:** Specialist capital market funds
6	**Go direct:** Partnering with clients to provide targeted capital market protection

Some of these models build on existing strengths, be this advanced analytics, access to key customer data or exceptional reach, scale and capital efficiency. But even if companies have these capabilities, they will need to broaden their business horizons as they strive to keep pace with changing customer demands and take advantage of new and untapped opportunities. If they don't, they risk losing out to a new set of 'fiercest competitors'[2], including the option to 'go direct' to the capital markets and hence cut out the insurer and reinsurer. The onus will therefore be on management teams to take charge of their destiny and look beyond current conditions to create winning strategies.

We hope that you find the paper challenging and useful. If you have any queries or would like to discuss any of the issues in more detail, please speak to your usual PwC contact or one of the authors listed on page 18.

2 As customer expectations change and routes to market evolve, an organisation's 'fiercest competitors' are no longer just their traditional rivals – but new entrants or ways of doing business

Insurance 2020: Future of insurance

Reinsurance 2020: Taking control of your destiny is the latest viewpoint in PwC's Insurance 2020 series, which explores the megatrends that are reshaping the competitive environment for insurers, reinsurers, brokers and the markets in which they operate[3].

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 organisations are doing in the short-term – be this dealing with market instability or just going about day-to-day business – they need to be looking at how to keep pace with the sweeping Social, Technological, Economic, Environmental and Political (STEEP) developments ahead.

3 www.pwc.com/insurance/future-of-insurance and www.pwc.com/projectblue

1

Caught in the middle

Many reinsurers are caught in a downward spiral of declining margins and depressed investment returns. Taking out costs may prolong survival for a short while. But only the companies that can meet fast-changing customer expectations and push back the risk and commercial frontiers will make it through to the next decade.

After another year of declining rates, many reinsurers are now wondering where to turn.

The unrelenting slide in property catastrophe prices must be especially troubling. The June 2014 renewals were marked by yet more decreases in both Florida and non-Florida rates[4]. There has also been pressure to broaden terms and conditions. Particular concerns centre on the inclusion of less well-modelled risks such as cyber or terrorism.

In times gone by, reinsurers could have ridden out a soft market in the expectation that rates would climb after a major loss event. They could also rely on the cushion of positive investment returns on their technical reserves. Yet, low interest rates mean that securing significant returns requires much more active investment strategies and the ability to manage these against stiffening regulatory capital demands. There is a clear contrast between the roles reinsurers play in the capital markets. On the one hand, reinsurers are viewed as providing access to a diversifying risk portfolio with minimal investment risk. On the other hand, reinsurers are investors in their own right, managing the market risk diversification within their own asset portfolios and seeking, in some cases, increased returns by accepting more market risk.

ILS changes the playing field

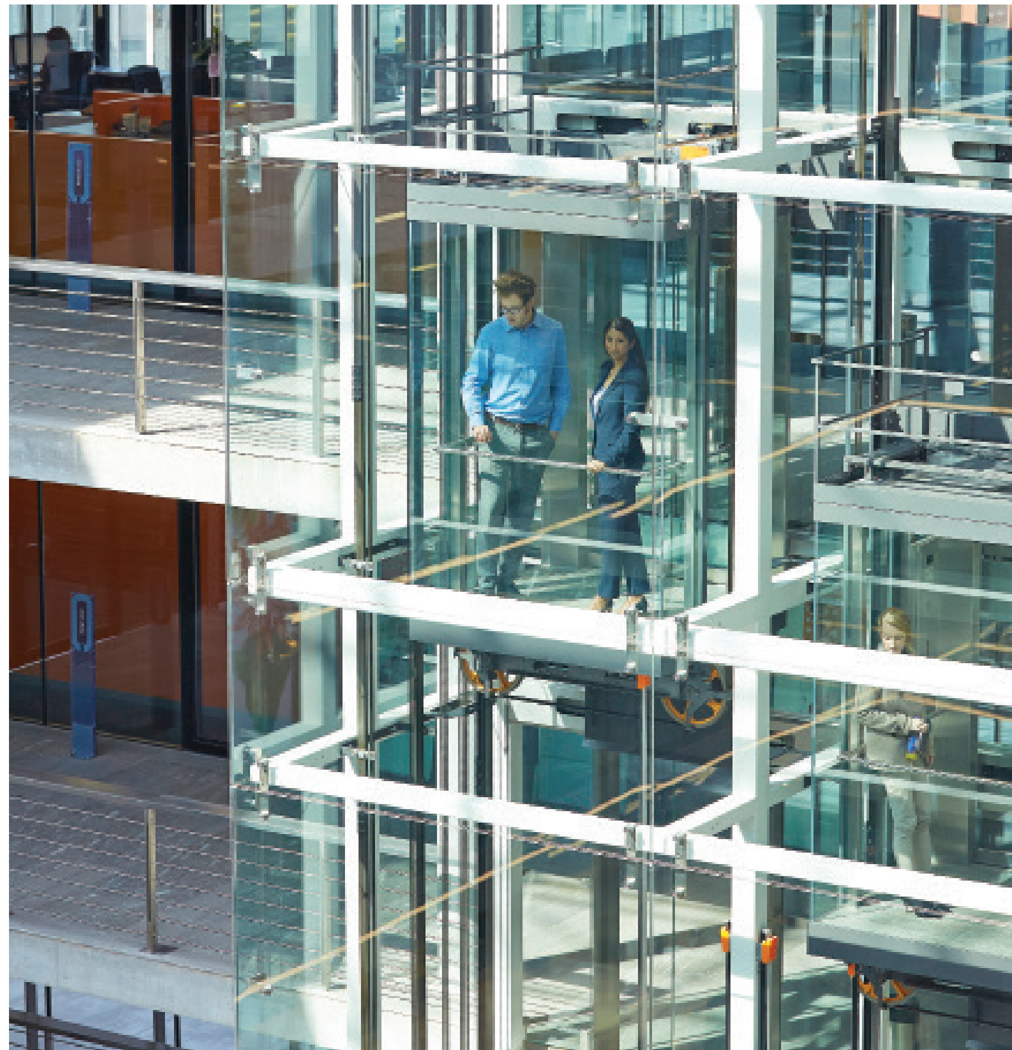
Moreover, the surge in new ILS capacity coming into the property catastrophe segment is not only holding down prices now, but is also likely to temper any hardening of rates in the future.

ILS now makes up around 15% of the reinsurance limit in property catastrophe[5]. In Bermuda, ILS issuance reached a record in the first quarter of 2014, double the comparable period in 2013[6]. Existing ILS investors are busily taking on staff to strengthen their expertise. Looking ahead, we expect to see a flurry of new companies or funds coming into the market over the next six months.

4 Guy Carpenter June 2014 renewal briefing

5 Guy Carpenter June 2014 renewal briefing

6 Bermuda Monetary Authority ILS report, May 2014



Yet, the full potential of ILS is still untapped. As we explored in our 2013 paper, *Expanding the potential of ILS*[7], investors are facing competition to put their money to work within their current market focus, primarily US East Coast property catastrophe. We are therefore set to see alternative capacity moving into wider geographical zones and extending its reach into a broader set of exposures such as flood, terrorism or pandemic risk.

Risk of becoming redundant

Clearly, there is room in the market for both the fully collateralised models (ILS-based entities) and the leveraged models (traditional reinsurance). We're certainly seeing strong expansion of traditional as well as ILS capacity around the world. Yet, the influx of ILS investment is driving down returns within traditional reinsurance. It is also forcing established companies to change how they source capital. This includes setting up reinsurer-owned ILS investment funds.

Further challenges stem from the expense of distribution within traditional reinsurance, which can be as high as 30% of the cost of the product[8]. This isn't sustainable over the long-term. Just as a lot of corporations will decide it's cheaper to miss out brokers and insurers by transferring risk directly into the capital markets, many cedents will opt to bypass reinsurers or brokers in the same way. Traditional reinsurers need to create the sharper capital efficiency and competitive costs to stave off this threat or seek to develop alternative risk transformation models.

Sustaining relevance

Further disruption is coming from increased retention by corporations and primary insurers, and the mounting commoditisation of much of the business that is left. However, customers are prepared to pay a premium for more informed and innovative solutions for their less well-understood and manageable risks. A survey of corporate risk managers carried out for the new PwC study, *Broking 2020: Leading from the front in a new era of risk*[9], found that emerging risks are by far the biggest priority for corporate clients. These range from cyber-attacks to breakdowns in today's increasingly diffuse global supply chains. In a highly competitive market for 'standard' business this provides some room for sophisticated risk carriers to differentiate their market position and access new and potentially profitable lines by extending their value chain into newer and more complex risk offerings. The challenge is how to underwrite business where there is little experience.

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7 www.pwc.com/insurance/expanding-ILS

8 PwC analysis of acquisiton market data

9 Broking 2020: Leading from the front in a new era of risk (www.pwc.com/insurance/broking2020)

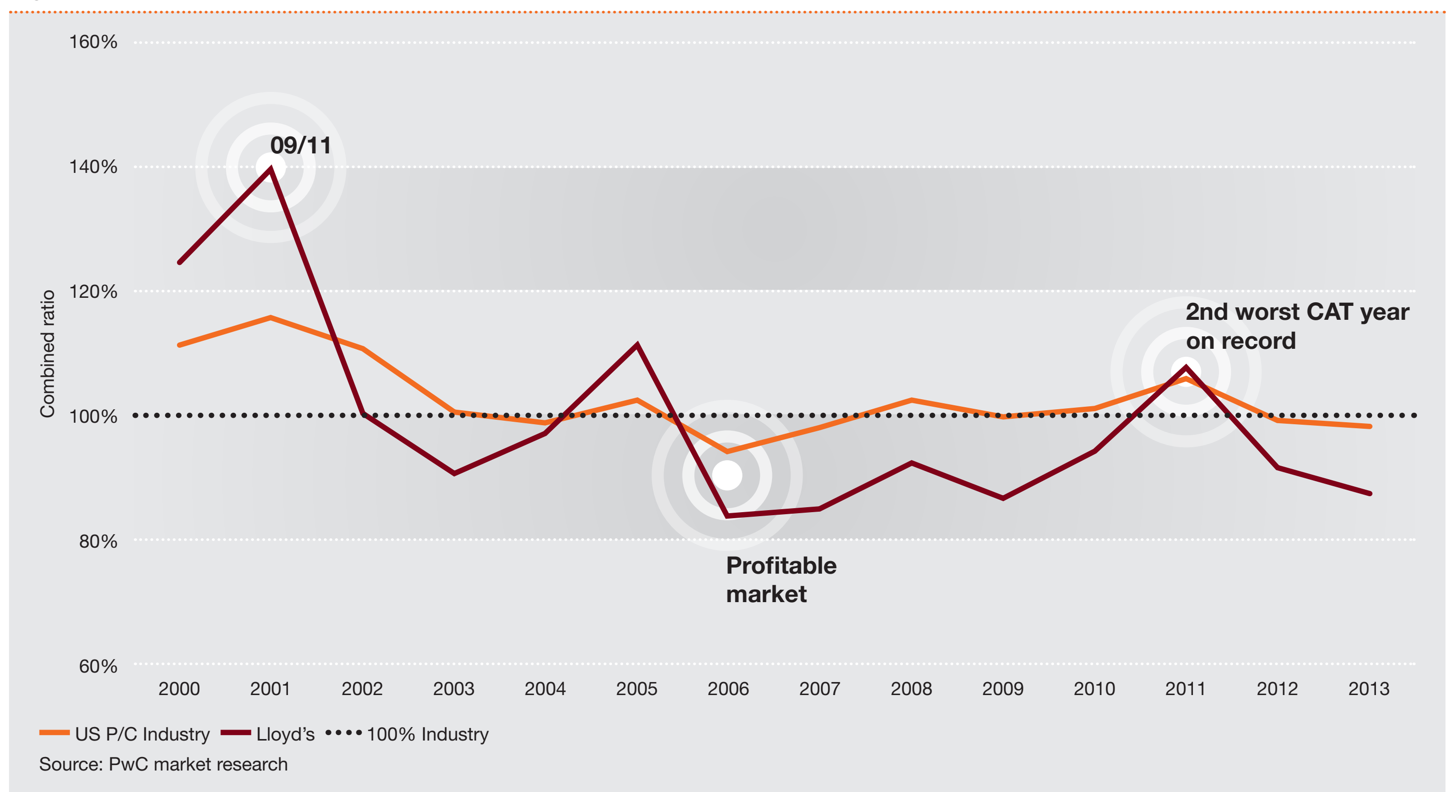
> Our own evaluations suggest that around 40% of the market by capacity could be vulnerable[9]. With prices low, clients can afford to gravitate to a select panel of higher rated, often larger, reinsurers, leaving some of their smaller and less well-rated counterparts in the margins.

All these drivers favour businesses with scale, specialist expertise or knowledge, advanced analytics and/or access to key customer data. Those without these capabilities are forming an increasingly 'squeezed middle'. Our own evaluations suggest that around 40% of the market by capacity could be vulnerable[10]. With prices low, clients can afford to gravitate to a select panel of higher rated, often larger, reinsurers, leaving some of their smaller and less well-rated counterparts in the margins. Some of the mid-sized generalists may also struggle to match the close customer contacts and investment in analytics (people and systems) needed to compete.

Pressure for consolidation

The pressure to build scale is already being reflected in growing moves towards consolidation within the less specialised mid-market segment. Reinsurers' share prices have generally outperformed market averages in recent years[11]. But poor investment returns, climbing combined ratios (see Figure 2) and drying up of prior year reserve releases are raising concerns among analysts[12] and could thereby add further impetus for consolidation. The big question is whether these mergers will be enough to sustain competitive relevance over the longer term. Even with multiple tie-ups in the middle of the market, these newly combined entities may still lack the scale to take on one of the global or even regional giants. As we explore in this paper, what is therefore needed is a much more radical rethink of where and how to compete.

Figure 2: Pressure on combined ratios



Source: PwC market research

10 Based on assumptions drawn from Swiss Re Annual Report 2012 (http://reports.swissre.com/2012/financialreport/financialyear/marketenvironment/reinsurancenon-life.html) and AM Best's Special Report: Global Reinsurance – Segment Review The Capital Challenge (http://www.bestweek.com/europe/promo/GlobalReinsurance.pdf)

11 Guy Carpenter Mid-Year Market Overview

12 Examples of concerns within the market include Moody's Investor Services' shift in the sector outlook from stable to negative in June 2014 and Keefe, Bruyette & Woods' shift from 'less positive' to 'outright negativity', reported in artemis.bm on 13.08.14, though analysts see opportunities within selected stocks

2

The new competitive battlegrounds

The competitive differentiators now go beyond price and even underwriting expertise to embrace a new set of customer expectations and investment strategies.

If these are challenging times for some segments of the reinsurance sector, the prospects for the industry as a whole are strong. Both insurers and corporations are looking for partners who can provide the risk understanding and incisive solutions needed to help them manage a more complex and uncertain risk and regulatory landscape.

Information advantage is critical. Advanced analytics are already providing a key source of risk insight within underwriting. The next frontier is how to use these developments to create a better understanding of customers' particular characteristics and objectives. This might include using industry and customer insights to proactively identify risk vulnerabilities within a particular client, or gaps in the market as a whole. It could also include developing new solutions that go beyond traditional underwriting and risk transfer into areas such as equipment maintenance or supply-chain management. Access to customer data is critical (direct and through secondary data) in a model that blurs the delineations between broker, insurer and reinsurer.

Today's relatively unfocused diversification is set to give way to a more targeted approach. This includes a mix of traditional and alternative products on the one side and a combination of mature and fast-growth market business on the other. Securing continuing underwriting profits is now critical, given that cycles are getting shorter and the poor investment environment appears set to continue.

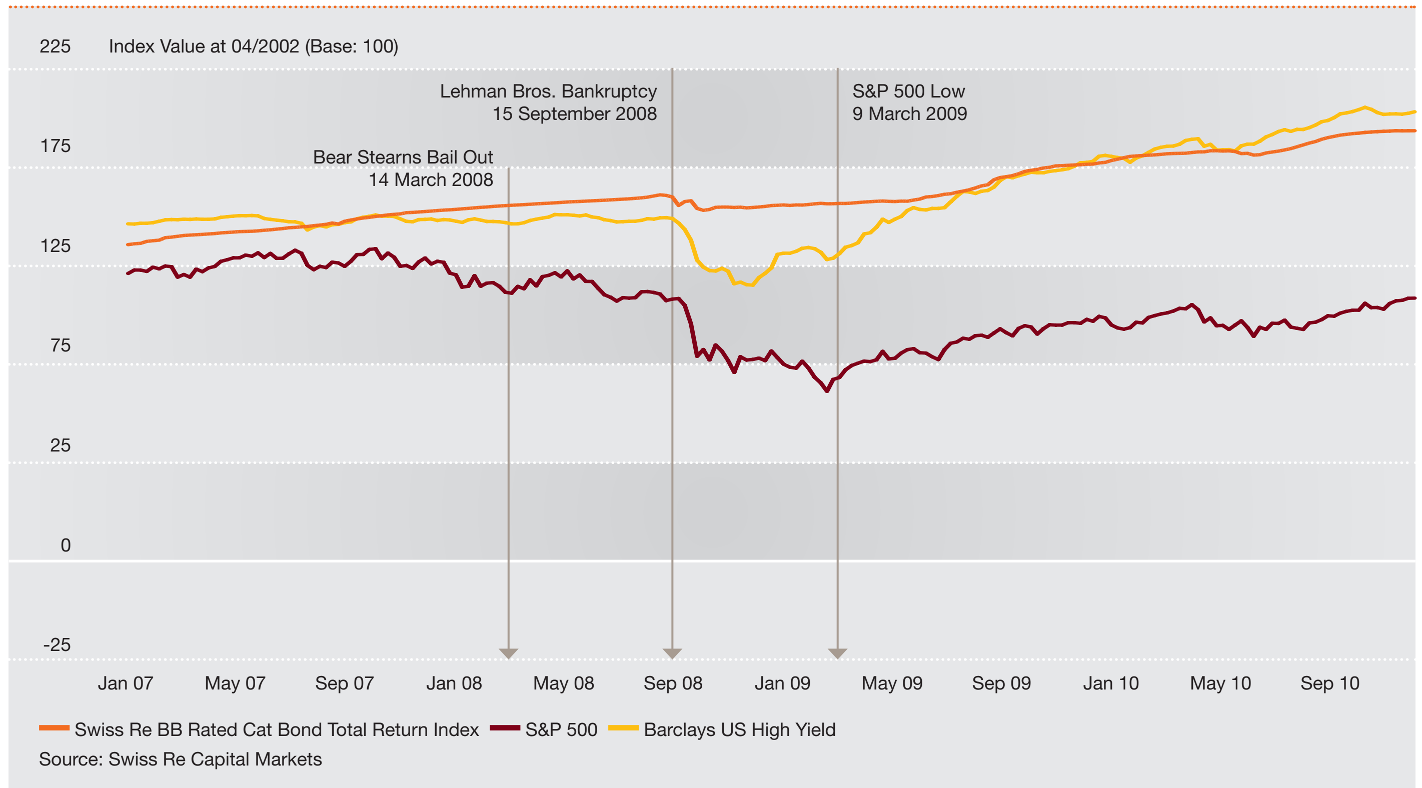
Both hedge funds and reinsurance groups with a strong investment-orientated strategy are able to use their presence within the reinsurance market to attract a flow of funds that they wouldn't have access to otherwise. These are then managed by specialist asset managers. In many cases, the risk profile of hedge fund reinsurers is weighted towards the financial market rather than underwriting risk. However, capital providers are no longer prepared to accept the use of investment returns to undercut prices or subside poor and loss-making underwriting. Moreover, any potential pricing differential may be offset by the capital charges for investment risk. There is therefore a clear focus on profit, both underwriting and economic, from all stakeholders.

Within funds that require deep and extensive due diligence before committing capital, this new breed of investors has also made significant efforts to get their investment committees comfortable with these types of assets and are thereby unlikely to abandon the asset class at the first sign of trouble.

Reinsurance is also now regarded as a specific asset class with investors entering via side cars or some form of ILS. Some have questioned whether the capital market investment would be sustained after a major loss event. Questions have also been raised about whether the new money would remain within the sector after the current period of monetary stimulus ends and interest rates start to rise. However, the low correlation between ILS and financial market risks (see Figure 3) provides investors with an opportunity to diversify their portfolios.

Further indications of some alternative investors' long-term commitment include the hiring of specialist teams with reinsurance expertise to increase their transaction throughput. Within funds that require deep and extensive due diligence before committing capital, this new breed of investors has also made significant efforts to get their investment committees comfortable with these types of assets and are, as a result, unlikely to abandon the asset class at the first sign of trouble. Moreover, even if there were losses, the ILS investments would only make up a relatively small proportion of the overall portfolio.

Figure 3: Cat bond performance during times of stress



Source: Swiss Re Capital Markets

3

Successful models for the future

The drivers of change and new competitive frontlines within the reinsurance sector are paving the way for the emergence of six dominant business models for the future:

1

Superior scale:

Big and knowledgeable on either a global or regional level

The advantages of scale can only increase, conferring price competitiveness, international reach and a dominant presence within reinsurance buying panels. But these organisations will also need to be incisive as they strive to keep pace with changing customer risks and expectations.

This model will be especially attractive to clients with complex and extensive international operations and supply chains, or those with a dominant presence in particular local markets. The reinsurers will be marked out by capital and pricing efficiency. Both clients and investors will be drawn by the assurance of their capital strengths (reflected in high credit ratings) and strong underwriting tradition (reflected in a consistently well-performing combined ratio). They can also use their expertise in complex specialty risks such as aviation, oil and gas or pharmaceutical liabilities to improve client safety and reduce exposures.

They will operate a diversified book of business, both by risk and market. They will use their pricing expertise and business development strengths to lead the way into new and under-penetrated markets.

2

Nimble innovators:

Using analytics and specialist expertise to punch above their weight

The nimble innovators will use superior customer understanding, service and solutions to carve out differentiated capabilities and strongly performing specialist niches.

They will accept a targeted range of reinsurance, traditional and non-traditional portfolios, developing specialist capabilities within particular risks, industries or client segments. They will have the flexibility and reach to operate across a variety of platforms including Lloyd's, Bermuda, ILS or side-car capital. There may be some diversification by geography or specialism.

3

Lloyd's:

Combining depth and breadth with smaller company agility and expertise

The Lloyd's cooperative model provides its member companies with a number of key advantages, which they can use to benefit their market competitiveness and stakeholders:

- A central rating (currently AM Best A, S&P A+, Fitch AA-), which is more attractive than can be gained by the majority of its individual members
- Global licences, which open up market access in the majority of territories worldwide
- Centralised compensation fund, which guarantees the settlement of claims
- Attractive capitalisation structure, which allows participants to post part of their capital as lines of credit or reinsurance and hence reduce the need for cash capitalisation and in effect provide leverage to the risk-bearing capital of the Lloyd's member

The model also allows underwriters to be creative and innovative within a small structure, yet still reap the benefits of global licences and market reach.

As a result, syndicates are able to punch above their weight and compete on a more level playing field with the global underwriters. The resurgence of Lloyd's has been a particular feature of the reinsurance market with a flurry of new market locations opening from Shanghai and Singapore through to Dubai and a clear focus on the traditional market strengths.

4

Float accumulators:

Delivering superior investment returns

Companies would accept a range of reinsurance business within this investment-led model as part of their aim to accumulate large and stable funds for management.

Carefully targeted risk selection is crucial in a model that looks for low volatility of liabilities. This balances the potential for fluctuating investment returns in the pursuit of yield. Investments are managed by specialist fund managers. These companies often seek to create bespoke solutions for clients.

A leading group has been able to combine this model with the advantages of scale. Its size means that it's able to accept a greater diversity of risks and hence generate funds from a wider range of sources than smaller counterparts adopting this model. The group is also able to deliver higher and more consistent underwriting profits than smaller counterparts, which are generally run to achieve neutral underwriting returns, with most profit coming from the investments.

5

Risk transformers:

Specialist capital market funds

The risk transformers channel capital market investment into reinsurance business through a combination of alternative investment and technical reinsurance expertise. They're fee rather than premium-driven and mainly focused on the transformation of 'peak risks', but are beginning to move into new lines and new geographies.

The ability to match risks with willing capital market risk-takers cuts out a lot of the expense of distribution. Other key differentiators within this model include capital efficiency and transparency for investors.

6

Go direct

Partnering with clients to provide targeted capital market protection

The go direct option allows organisations to partner with large corporates or public bodies to provide cost-efficient capital market protection against discrete risks.

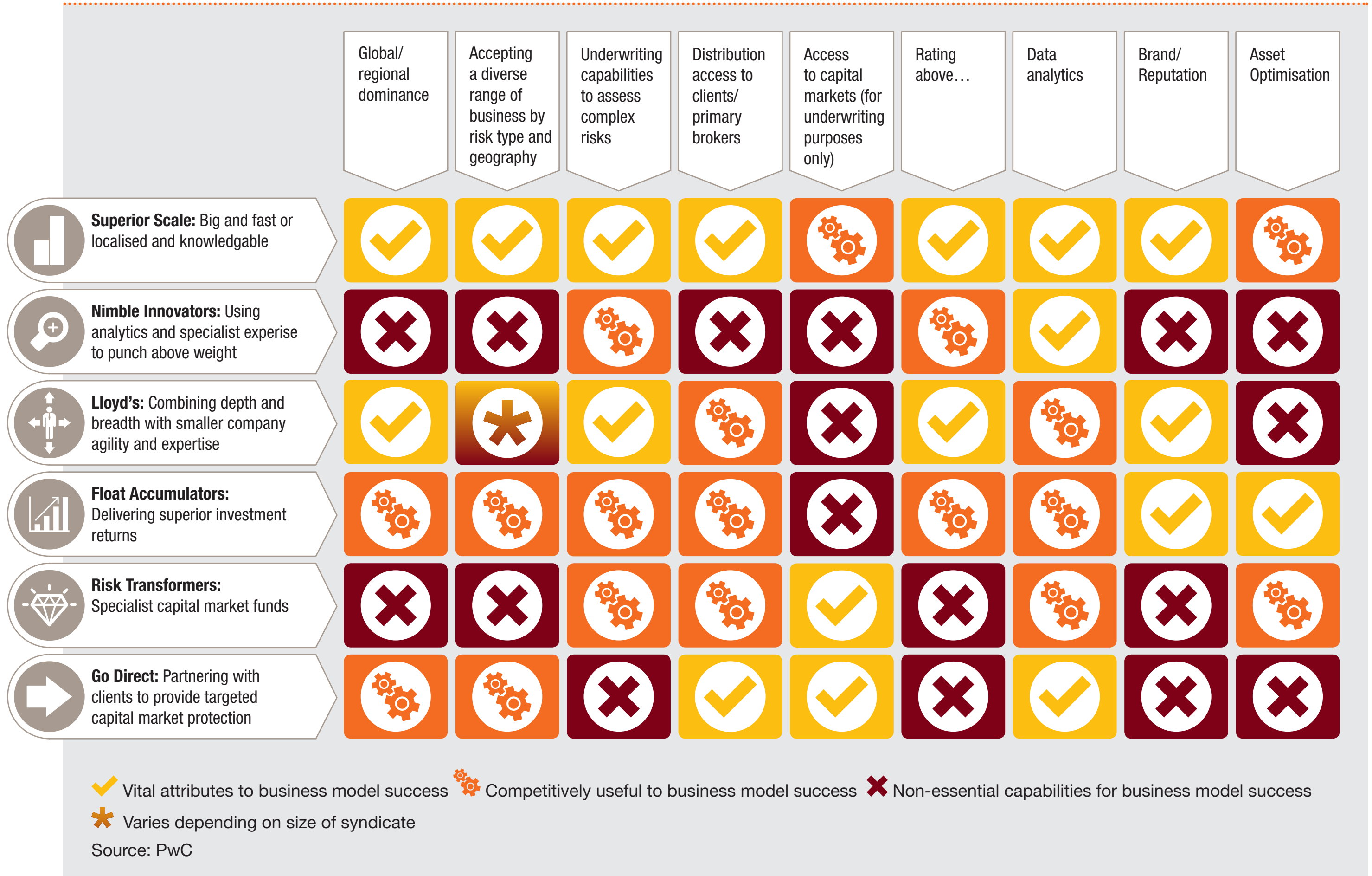
Organisations would model out and secure indemnity coverage from their own capital market arms, with the transparently priced risk transferred to portfolios of investors. They could bypass the broker, insurer and reinsurer, creating a disruptive 'fiercest competitor'. The challenges to overcome include investor information asymmetry and pricing for standalone cat covers versus all-risk covers.

Deals that already come close to this model include 'Metrocat', a $200 million storm surge layer secured by the New York Metropolitan Transport Authority[13].

13 Wall Street Journal, 31.07.13

The key questions for your business are which of these models best reflects your current strengths and strategic ambitions and how to bring your current capabilities up to speed with the key attributes for success.

Figure 4: What capabilities will you need?



Source: PwC

The capabilities to succeed

The key questions for your business are: 'Which of these models best reflects your current strengths and strategic ambitions?' and 'How can you bring your current capabilities up to speed with the key attributes for success?'

Figure 4 rates the vital attributes, competitively useful and non-essential capabilities for each of these models across the various success factors we identified in our 2013 study, *Reinsurance 2020: Breaking the mould*[14]. Quality ratings and underwriting capabilities are clearly essential for a scale business, for example. But while asset optimisation can boost returns, it is not a precursor to being part of this group. Similarly, nimble innovators would seek to build a reputation in particular areas rather than the overall brand of a Lloyd's or major scale business.

Coming up against your fiercest competitor

Even with all the necessary capabilities, there will be vulnerabilities. As customer expectations change, the pricing cycle softens and routes to market evolve; an organisation's fiercest competitors are no longer just their traditional rivals, but new entrants or ways of doing business. For a sector where distribution costs are high and risk diversification is essential, reinsurers would be especially vulnerable to a competitor that could go direct to clients, more insightfully analyse and manage an underwriting portfolio, and have access to the full diversification potential of the capital markets.

14 www.pwc.com/insurance/breaking-the-mould

4

Where does your business want to be?

Hunkering down in the hope of a more favourable rating environment ahead is no longer a viable strategy for survival. Even with lower costs and some uplift in premium rates, many reinsurers will struggle to sustain investment and competitive relevance.

The ability to establish a value proposition that is differentiated, source new markets where pricing is at a premium and innovate outside the commoditised corners will truly set a course for long-term success.

There is no one model for the future. Indeed, it is this differentiation and ability to play to your particular strengths that will be crucial.

The key questions for your organisation are: 'Which of the successful models for the future best applies to your business?' and 'How can you ensure that you develop the capabilities needed to compete?'

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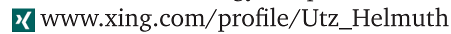
www.xing.com/profile/Utz_Helmuth

Other related PwC publications

Broking 2020 – Leading from the front in a new era of risk (Sept 2014)

Protecting against a new breed of emerging risks requires coordination across corporations, insurance companies and policymakers. Insurance brokers are ideally placed to lead this 'risk facilitation'. But as the pace of change within the marketplace accelerates, a major rethink of how they operate and compete is needed.

www.pwc.com/insurance/broking2020

Survey of Discontinued Business in Europe – eighth edition (Sept 2014)

The eighth edition of PwC's Survey, produced in conjunction with Insurance and Reinsurance Legacy Association (IRLA), analyses questionnaire results from over 200 parties across Continental Europe and the UK.

www.pwc.com/surveyofdiscontinued insuranceeurope

Reinsurance 2020 – breaking the mould (Sept 2013)

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 time for a more radical rethink of how to remain competitive and build for the future?

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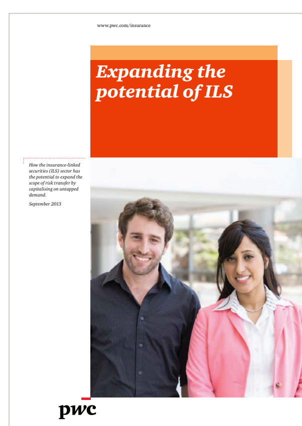

Expanding the potential of ILS (Sept 2013)

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.

www.pwc.com/insurance/expanding-ILS

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.

www.pwc.com/insurancebananaskins

Confronting the new market realities (Sept 2012)

We tackle the questions around the generation of ongoing sustainable profits for reinsurance companies.

www.pwc.com/insurance/new-market-realities

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