BY JOHANNES BENDER

S&P Global Ratings Sees The Global Reinsurance Market Bulking Up

The reinsurance sector has been facing significant headwinds and weak business conditions for a number of years now, and we do not foresee a significant change in the underlying conditions. The pressure is more intense for reinsurers that have relatively greater exposure to the property-catastrophe business and for those that benefit less from diversification and have narrow or commoditized product offerings.

During the past two years, the global reinsurance sector had no respite. Despite back-to-back active catastrophe years in 2017 and 2018, which were the third- and fourth-costliest insured catastrophe years in the past few decades, global reinsurance price increases remain modest at best. With about $80 billion in natural catastrophe insured losses in 2018, market participants were keenly awaiting the renewal season hoping to restore their underwriting profits. But global reinsurance pricing was, once again, only flat to up about 3% in aggregate during the January 2019 renewals - mimicking a similar scene from a year ago that played out during the renewal season in January 2018. Moreover during the recent renewals, we saw more and more regionalization of reinsurance pricing. In other words, we no longer witness a rising tide that lifts all boats, but rather, targeted price increases limited to policies and regions that were affected by losses without any spillover effect to other lines of business or regions.

For several years, excess reinsurance capacity has been putting pressure on premium rates, thereby reducing profit margins. As a protagonist of this rerun, alternative capital continues to influence reinsurance pricing, property catastrophe in particular. Alternative capital includes capacity from financial investors such as pension funds or other institutional investors that invest into the reinsurance market in the form of insurance linked securities (such as catastrophe bonds, collateralized reinsurance or sidecars). Traditional capital usually describes capital stemming from reinsurance companies such as Munich Re or Swiss Re.

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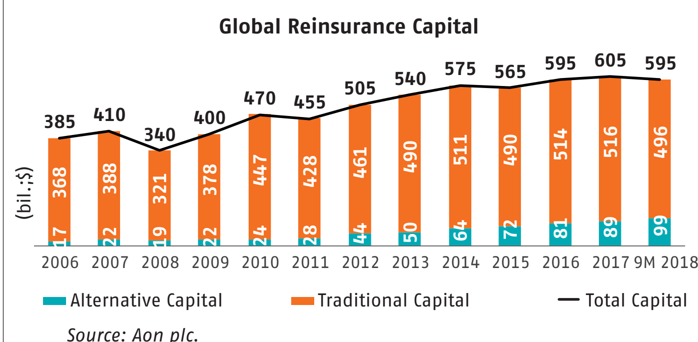
Through the first nine months of 2018, the influx of alternative capital continued with an 11.2% jump to $99 billion as of the end of third-quarter 2018 from $89 billion as of year-end 2017.



Source: Aon plc.

Furthermore, cedants' expectations have evolved. They look for not only capacity providers, but also for risk partners: those that can provide a plethora of value-added services, assist in evaluating risk, provide customized solutions, and implement risk and capital management solutions. Cedants, especially larger ones, have been consolidating their reinsurance panels. Their preferences are changing in favor of dealing with fewer reinsurers that are more-strongly capitalized, and those with good product expertise and a broad product offering.

SCALE AND DIVERSIFICATION WILL INCREASINGLY DEFINE COMPETITIVE POSITION

With business models being tested, limited organic growth opportunities, and returns under pressure, reinsurers are looking for ways to stay relevant. Those that have the scale, breadth, and depth of products; strong underwriting capabilities; and the ability to build partnerships with their clients will fare best. Scale and diversification can also help bring capital and operating efficiencies that partially offset margin pressures. These factors inform reinsurers' varied strategies, which include the acquisition of teams to enter new lines, the undertaking of bolt-on transactions, and transformative mergers and acquisitions (M&A).

We have monitored a lot of deal activity over the past couple of years which highlights carriers' desire to diversify into complementary insurance or reinsurance businesses (and, in a few cases, into noninsurance operations as well), a trend we expect to continue. As a result, there could be even fewer pure play reinsurers than the handful that currently exist.

Historically, reinsurers, particularly those based in Bermuda, have expanded primarily into the high-severity commercial lines, including excess casualty. Some have established or acquired Lloyd's syndicates to access the Lloyd's market's global distribution channels. As a result, only a few stand-alone specialist writers with most of their business emanating from Lloyd's remain.

Various small-to-midsize players have acquired insurance carriers and managing general agents to accelerate their growth in primary markets. Even the large players have been emphasizing their primary business. We believe that reinsurers are likely to continue increasing their share of primary business, including via M&A.

One of the main objectives of groups that move to a dual platform (insurance and reinsurance) or seek to broaden their product base and geographic presence within those platforms, is to improve their ability to properly manage the underwriting cycle, based on prevalent pricing conditions within the various business lines in their specific portfolios.

CONSOLIDATION CAN HELP, BUT RISKS ABOUND

From a credit perspective, although M&A have failed to improve buyers' creditworthiness at the outset, they have generally helped buyers and their targets to maintain ratings. A strategic merger or acquisition can provide benefits such as growth opportunities through combined platforms, a stronger position in chosen products and regions, increased diversification, and potential expense synergies that could improve the earnings profile. A well-executed deal can protect creditworthiness and improve shareholder value.

However, M&A inevitably results in various risks, particularly for larger deals. In any transaction, there is always a risk of overpaying, which may reflect an overly optimistic view of the strategic benefits and of expense and capital efficiencies. In addition, execution risk is paramount because these transactions generally involve integration of teams that may have very different cultures, separate books that might have an overlapping customer base and distribution channels, underwriting and technology platforms, and other infrastructure. We place heavy emphasis on management's ability to execute on strategic objectives after the transaction closes, to manage flight risk of key customers and employees (both management and underwriters), and to develop a combined comprehensive framework for enterprise risk management from two very distinct groups.

BULKING UP FOR THE LONG SLOG

M&A will remain part of the changing landscape as reinsurers refine their business models and adapt to a difficult operating environment. While the level of deal activity will depend in part on the market valuations - many players are wary of the high costs and risks involved - the potential strategic benefits in the face of continued market pressure may ultimately push a few to take the plunge.

Therefore, we expect M&A activity to continue over the next few years, leading to increasing consolidation. In our view, consolidation is unlikely to significantly change near-term market dynamics, given the abundance of reinsurance capacity and fragmented nature of the sector. However, a well-executed M&A that has a sound rationale can improve the competitive standing of the combined entity. We maintain a broadly neutral view, but given the inherent risks, especially those in transformative deals, we have a slight negative bias to M&A.

Barring any unexpected developments, the pressures on market participants are likely to continue unabated. Therefore, we expect reinsurers to seek to 'bulk up' to endure the marathon ahead. Those that have the scale, broad product suite, geographic presence, and strong balance sheet, as well as offering more than just capacity, will likely make it to the finish line. ■

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