# EFFECTS OF RECENT DEVELOPMENTS IN THE REINSURANCE MARKET

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## Introduction

The international reinsurance market has undergone dramatic changes in the last decade. We take an overview of the trends and the structure of the world reinsurance market and its effects on the East Asian and Pacific Region.

## Growth of Reinsurance Business

The following table, based on SIGMA, shows the volume of non-life direct premiums and reinsurance premiums in 1997.

Amounts in billions

| Region | Direct Premiums In US Dollars | Direct Premiums As % of total | Reinsurance Premiums In US Dollars | Reinsurance Premiums As % of total | Cessions Rate in % |
|---|---|---|---|---|---|
| North America | 317.7 | 43.4% | 39.9 | 38.9% | 12.6% |
| Western Europe | 247.5 | 33.8% | 36.1 | 35.1% | 14.6% |
| Japan | 65.2 | 8.9% | 4.3 | 4.2% | 6.6% |
| Asia/Pacific | 54.9 | 7.5% | 12.4 | 12.1% | 22.6% |
| Latin America | 21.7 | 3.0% | 3.3 | 3.2% | 15.1% |
| Eastern Europe | 10.3 | 1.4% | 1.7 | 1.6% | 16.4% |
| Rest of the world | 15.4 | 2.1% | 5.0 | 4.9% | 32.6% |
| Total world | 732.6 | 100% | 102.6 | 100% | 14.0% |

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Direct premiums in Asia/Pacific (excluding Japan) is only 7.5% of world premiums, but the cessions rate is high at 22.6% making the volume of ceded reinsurance premiums in this region next to North America and Western Europe. Local direct insurers of the region typically have small capital base and the retention capacity is low. The portfolios of insurers also have a high mix of industrial and commercial risks due to under development of personal lines of business. This requires more reinsurance.

SIGMA data also shows that over the period 1970-1997 global non-life reinsurance market rose by 2.6% per annum on average in local currency terms, after adjustment for inflation. This was substantially higher than the 1.7% annual growth recorded in direct insurance.

Data also indicates that the real growth rate of direct premiums in the Asia/Pacific region has been higher than in other regions, and significantly the cession rate also increased faster.

**The Changing Structure of International Reinsurance Market**

The reinsurers (the suppliers), the insurers (the consumers) and the brokers (the intermediaries) are the three main constituents of the international market. Over the period, the market has been changing. The following are the noteworthy aspects of the changing structure of the international reinsurance market:

***Growing use of Excess of Loss Covers***

In most markets there is a shift from proportional towards non-proportional, or excess of loss reinsurance. Retention capacity of insurers has increased and the emphasis has shifted from 'sharing of risks' to 'transfer of peak risks'. Continuing soft conditions, larger retention capacities of insurers and preoccupation in many markets with retention of premiums within the country has helped the growing use of excess of loss.

Since the insurers now generally retain more of risks with high frequency but low severity losses, the premium volume of *reinsurance programmes* is generally lower. This has, however, not led to a decline in total volume of reinsurance business internationally, since a large number of high value risks have come into picture requiring excess of loss protection.

Another aspect of greater use of excess of loss reinsurance deserves notice. Since the performance of excess of loss contracts is more volatile than that of proportional contracts, the business has to be supported by a higher capital base. This underscores the need of enhancement of capital adequacy requirement of reinsurers. Emphasis on solvency of reinsurers, has increased.

*The Liability Crisis in the United States*

Since the early eighties, the US insurance industry has seen loss ratios rocket in the liability business due to higher claims associated with asbestos and environmental impairment losses. The situation was exacerbated by the general trend in US court rulings to grant increasingly higher compensation to injured parties. This forced insurers to increase their loss reserves, and the legal uncertainties in the writing of new business led to severe capacity shortage in the US insurance market and in the reinsurance market especially. This prompted a massive increase in premium rates on the one hand and the restricted availability of liability coverage on the other. At the same time the capacity crisis provided a catalyst for a fundamental overhaul of the insurance industry, with liability covers switching to claims made policies, more captives being set up and the advent of financial reinsurance.

The liability crisis in the US did not directly affect this region. But indirect effects have been felt, in as far as it led to considerable shortage of capacity and a hardened market for a while. It also highlights the necessity of better risk management of exposures in the region.

*Emergence of Bermuda as an Important Market*

Bermuda is a newcomer as a reinsurance center. One of the main factors contributing to Bermuda's rapid rise was the shortage of worldwide liability reinsurance capacity during the mid-eighties. Another contributory factor was the accumulation of natural catastrophe losses at the end of the eighties and start of the nineties.

Now Bermuda plays an important role in the provision of innovative insurance and reinsurance solutions. The overall advantages provided by Bermuda's tax and regulatory framework allow attractive finite risk reinsurance solutions to be offered from this location.

Several regional reinsurance centers have also grown, particularly at Singapore, Hong Kong, Australia and South Africa. Development of these new markets has affected the gravitational pull of London as the world's most important reinsurance market.

*Lesser Catastrophe Losses during Last Few Years*

Another dominant feature of the late eighties and early nineties was the increase in major catastrophe losses. This hit the reinsurance industry just as it was recovering from the liability insurance crisis. Lloyd's reinsurance market also experienced problems. The incidence of catastrophe losses has mercifully been much less in the late nineties. This has given a much needed respite.

None the less, possible increase in catastrophe losses continues to haunt the reinsurance markets. It is become clear that one of the keys to the success of a reinsurance player or a market, is its capacity to respond and offer solutions to catastrophe protection.

*Improved Results of Reinsurers*

Reinsurers work on a very thin margin, mostly relying on volume. But in the last few decades they have been incurring underwriting losses and have been surviving on investment income on reserves historically created. In recent years there has been some improvement in the 'combined ratio' Initially the improvement was due to higher reinsurance prices. In the last few years, however, the strong increase in global capacity has forced reinsurance prices down again. The combined ratio is currently hovering around 100 percent, That the combined ratio has remained under control is due to the combination of special factors:

1. Low natural catastrophe losses
2. Generally good results in direct insurance business
3. Good run-off results in the USA by liquidation of loss reserves that had been estimated too high in response to the liability crisis.

Failures still take place, for example, that of GIO in recent days. Unfavourable days may come back, particularly if higher incidence of catastrophe losses is encountered. Management of those dealing with reinsurance business, therefore, have to be highly focused.

*Consolidation in the World Insurance Market*

Mergers and acquisitions are natural phenomena of the modern day economy. Corporate entities are bought over or merge with others for a variety of reasons, vertical or horizontal integration, improving market share, elimination of competitor, injecting new technology, and etceteras. The insurance sector could not remain sheltered, and during the last few years there has been a market shakedown. A large number of mergers and acquisitions have taken place.

The market share of the top four reinsurers increased from 22% in 1990 to 29% in 1997. (If the recent acquisitions are taken into account as well, this group has enhanced its market share to around 34%). The following were the market share of the top ten reinsurers during 1997:

| Reinsurer | Market Share | Reinsurer | Market Share |
|---|---|---|---|
| Munich Re | 10% | Employer Re | 5% |
| Swiss Re | 8% | Hanover Re | 3% |
| General Re | 5% | Gerling Re | 2% |
| Scor | 2% | Axa Re | 1% |
| Zurich Re | 2% | Generali | 1% |

## *Factors Leading to Consolidation*

It will be simplistic to attribute a single factor. Each case has its background in terms of business and financial considerations. However, we can generally identify the following as the motivational factors:

- Better geographical spread of business
- Diversification of activities
- Improvement in underwriting expertise
- Enhanced service capacity
- Trend towards disintermediation
- World wide presence
- Ability to invest more in research and development

## *A Noteworthy Feature of Mergers and Acquisitions*

It is obvious that in most of the cases the prime motive has been other than immediate enhancement of value to shareholders, or expanding the premium or the asset base. The price paid for the acquisition often did not match the gain in premium or assets acquired. It is also noteworthy that contrary to early 90s, no additional capital has been garnered from the market by the acquirer to finance the takeover. The acquisitions have been mostly managed through internal resources, made possible through large retained earnings because of:

1. Absence of huge catastrophe losses
2. Good technical results
3. Capital gains due to booming international equity markets and decline in interest rates

It would seem that the financial markets and the shareholders have been quite tolerant to diminishing return-on-capital also known as (ROE), and poor performance in the sector.

*The Changing Roles*

Mergers and acquisitions take a long time to settle down and truly integrate. Persons are displaced, and corporate cultural adjustments have to be made. It appears that this phase is still not over. From a long-term point of view, however, as players become larger and endowed with more resources and better technical capabilities, new strategies get evolved. The following are some of the discernible likely developments:

- Large players will compete less on price and conditions, and more on quality and service
- They will try to present themselves as small, personal client-oriented service providers with the back-up facilities of a large world wide reinsurer
- They will try to be "multi-specialist"
- Many are exploring and talking of ART mechanism and financial reinsurance - although soft market conditions are not conducive for these
- Strategic alliances will take place between large insurers/reinsurers/brokers and investment banks
- Emphasis on technology will increase
- Services as Risk Management and client-specific reinsurance : special solutions will be provided to respond to changing requirements of large clients
- Change will gradually take place from selling transactional capabilities to selling advice, expertise and knowledge
- Markets will get increasingly polarised between international players with global network and smaller players with focus on niche markets
- Insurers of this region have not felt any significant effect so far, but may be squeezed when the market hardens

*Reinsurance Brokers*

A few issues related to consolidation amongst reinsurance brokers may be noted:

- Large brokers widening their activities into fields such as treasury risk management consultancy
- Large brokers moving away from commission to fee system
- The huge placing power of mega-brokers should be capable of producing price advantage for their clients; in practice, the effect is likely to be marginalised
- More consolidation can be expected amongst the middle-size brokers
- Second and third tier brokers will have to create capabilities differentiated from large brokers in areas such as client focus and service

## The East Asian and Pacific Markets

The changing structure of the international reinsurance market has many implications for the East Asian and Pacific insurance markets. Two other important developments have, however, intervened. First, the economic crisis witnessed during the last few years, and secondly, the movement towards liberalisation.

### *Economic Crisis Witnessed During Last Few Years*

We will not consider here the reasons for what happened, nor the efforts made by various countries to overcome the setback. From the insurance point of view, however, the following general observations (needless to say, with exceptions) may be made:

- Investments in shares, bonds and property depreciated
- Consequently, the shareholders' fund suffered to varying degrees
- Stagnation, in many cases fall in premium growth, increase in costs
- Increase in claims ratios in many instances due to
- - Many large infrastructure and industrial projects were abandoned
- - Decline in exports, leading to decline in marine business
- - As a cost cutting measure, insurance outlay was reduced wherever possible
- Fierce competition for available business, rate erosion
- The value of the capital eroded, particularly in foreign currency terms
- Attempts of takeover by foreign interests did not generally succeed, due to
  1. Price demanded was perceived to be too high
  2. Protection provided by regulatory environment

The following general observations may be made in respect of reinsurance:

- Increasing attempts by market to retain more premium in the country
- Volume of reinsurance business reduced
- Nevertheless, new entrants keeping in view long term prospects
- Reinsurers adopting strategy of providing value added service to their clients
- Attempts to promote indigenous mega-reinsurance in the region was put on hold
- Reinsurance requirements of insurers are now lower in terms of currencies of reinsurers
- This, coupled with general soft condition of the market made reinsurance placement easy
- Volume of reinsurance business derived from the region has shrunk in terms of reinsurers' currencies

*Liberalisation Process*

We will not consider here the general advantages or otherwise of a liberalised set up in the insurance sector of the region. Perceptions differ from country to country, and also the side of the coin being looked at. Very broadly speaking, however, it can be said that the insurance sector would like a slower pace of liberalisation. However, at the government and macro level, it is being increasingly realised that there is no other option but to liberalise, and earlier this is achieved, albeit in a phased manner the better. The fact is that while governments are overtly resisting pressures from external agencies, steps are nevertheless being taken internally to adjust to what is inevitable.

To foreign interests liberalisation means freer access to a market. From a country's point of view, however, it also means institutional reforms. In particular, the need of some sort of consolidation in the primary market is being widely felt. A large number of indigenous insurers in the region are either family owned or linked to banks or some other financial institution. It is being increasingly realised that, while on the one hand, advantage can be taken of the linkages, e.g., promotion of bancassurance, on the other hand, ways and means must be found to have players with larger resources in the field so that the new emerging insurance needs of the community could be better served.

Malaysia has adopted the policy of consolidation in the primary insurance sector. An incentive package to promote mergers and acquisitions has been announced. It has been stated that the aim is create 10 to 15 "financially strong insurers" by the year 2003. A strategic alliance between 12 local general insurance firms has been formed in Singapore (known as Singapore Insurance Group) to underwrite large industrial risks and compete with big foreign insurers.

***Possibilities of more mergers and acquisitions in the future***

It has been noted that bye and large, there have been only a few instances of mergers and acquisitions amongst local companies, and in particular, take over by foreign interests. There could be greater activities in this direction in the future due to the following factors:

- Need to increase capital base, and non-availability of additional capital from local sources
- Increasing emphasis on professionalism in the industry
- Pressure from international agencies

## Globalisation

Globalisation goes a step beyond liberalisation. It means ability and opportunity to operate globally, or at least, in a wider international field. Globalisation is an economic phenomenon and most economies are moving in this direction, albeit at varying speed.

Globalisation certainly marks an improvement in insurance services. However, the immediate beneficiaries are the elite and top echelons of the clients. There is also the concern that the adjustment cost of globalisation should not be high and should be phased so that the economic equilibrium of the society is not unduly disturbed. As far as the insurance sector of the Asia/Pacific region is concerned, it appears that in the short run it is a one-way process. Consequently, greater emphasis is being placed on evolving more effective ways of re-regulation; it is realised that it is not a simple matter of deregulation but of changing the basis of regulation. This has to precede a greater degree of globalsiation.

There is another aspect that deserves a mention. As a prelude to worldwide globalisation, steps need to be taken towards regionalisation of insurance services, to begin with in the ASEAN countries. A lot can be learnt from the beneficial features of the European economic integration. Undoubtedly, it is a long haul, but efforts must begin.

## The Future

Without attempting to look into a crystal ball, it would appear that the process of liberalisation and consolidation would continue. Mergers and acquisitions are taking place in other sectors as well, e.g., the banking sector and there is no reason for insurance to be an exception. At the same time, those who are overawed by the recent developments will realise that bigger is not always better.

We are living in an exciting era. It is becoming difficult to keep pace with changes taking place. It is hoped that in the coming days the insurance industry will progressively organise itself in a much more refined way with opportunity for all to play a role in serving the insuring public.