Post-Monte Carlo Reinsurance Market Update

October 2015

Executive Summary:

- Alternative is now mainstream
- Growth prospects remain
- The pricing cycle is likely not dead
- M&A activity anticipated to continue

The 2015 edition of the Reinsurance Rendezvous, while devoid of significant debate regarding either catastrophe loss events or January 1 price levels, still managed to provide some intriguing conversation. What is most striking is the pace of change in the market, which continues to accelerate, creating challenges and opportunities for market participants. As with all change, we believe it is important to assess whether this change is driven by sustainable factors, such as improved efficiencies, or if it is driven by temporal factors (e.g., excess capital in a soft market). Change for change's sake is not always good, and at times it was hard to keep your balance without getting knocked over by all the style drift afoot in Monte Carlo.

Alternative is Now Mainstream

It is very apparent to us that the pace of change in this market will continue to accelerate at a dramatic pace. Reinsurers may be positioning themselves to more directly compete for institutional capital by buying or building out asset management businesses (e.g. Markel and CatCo[1]). Both insurers and reinsurers appear to be looking to access capital more directly by creating hedge fund reinsurers or looking to replicate the captive hedge fund reinsurer model adopted by Ace-BlackRock[2] (see Axis[3], XL[4], Aspen[5]). We are also witnessing convergence from the investor side with ILS investors establishing rated vehicles or partnering to assume business from non-traditional sources such as Lloyds.

Of course the real danger is overgeneralizing these changes and treating them as homogeneous. The market often speaks about the global pension community as a single entity that will move in lockstep, digest these moves with acceptance, and have perennial interest in the asset class irrespective of market dynamics. The reality of course is far different, with each organization having different objectives, perspectives, and decision-making frameworks. Likewise, the "traditional reinsurance market" is not a monolithic entity that moves in synchronous fashion. The players within the traditional reinsurance market will likely evolve and adapt in a heterogeneous way.

Brokers are responding to the changing landscape as well. Captive hedge fund reinsurer models threaten brokers' revenue streams, and it is conceivable they could alter their business models. Guy Carpenter announced a joint venture with Vario whereby they will seek to bring non-catastrophe risk to investors.[6] At first, it is anticipated this risk will be placed with dedicated ILS/reinsurance funds, but they also acknowledge that they may eventually raise a stand-alone fund.

One interesting aspect of the term transactions is that no one is talking about how such vehicles will be valued and how the exit would conceivably work from such vehicles, which could pose significant challenges for longer tail lines of business. It seems most of the liquidity is expected to come via an IPO, but that is far from certain and largely dependent on the state of the equity markets.

As the saying goes…just because you can, doesn't mean you should.

Growth Prospects Remain

Swiss Re's latest Sigma report focuses on the growing insurance gap. Economic losses from natural disaster events have averaged $180B per annum over the last 10 years with 70% ($127B) of that uninsured. Taking into account modeling of potential future events, Swiss Re estimates $217B of annual economic losses, $153B of which would be uninsured. We know what you are thinking: it's the China story again. Actually, while China is the country with the third largest insurance gap, the gaps in the U.S. and Japan are greater, largely due to low take-up rates for earthquake protection. Willis Re made similar comments, pointing out that almost half of the $101B in global economic losses in 2014 stemmed from floods and cyclones in Asia, where insurance penetration is only 8%.[7]

Aon Benfield pointed to several areas of growth:

- continued privatization from government cat pools (e.g. Florida Citizens)[8]
- potential growth in areas where insurance penetration is high but certain perils not widely covered (e.g., U.S. flood, California earthquake, and Netherlands flood)[8]
- increased capital requirements from A.M. Best in the U.S. for hurricane and storm surge-exposed insurers, leading to increased demand[9]
- transfer of $3B of credit default risk from Fannie and Freddie to the (re) insurance market (including alternative capital). Aon estimates an additional $20B to $40B of annuity could be transferred to the (re)insurance market over the next six to seven years. Aon has developed a modeling platform (Pathwise) to assess the risk[9]

On the supply side, Aon is estimating global reinsurance capital at $565B, down 2% since year-end, but up 66% since the end of 2008.[8] Aon estimates "alternative capital" at $68B.[9] Guy Carpenter similarly estimates "convergence capital" at $66B, but its estimate of reinsurance capital is $400B (GC claims their method is more precise than Aon's aggregation of all capital at companies that write reinsurance). More specifically, GC estimates that the property catastrophe reinsurance limit has grown by 8% YOY to $352B.[10]

In addition, we are starting to see the impact of Solvency II, which has led a number of European insurers to increase reinsurance purchased and to issue sub-debt and equity to meet the new capital requirements.[11]

There are also ongoing public and private initiatives in Australia to address a lack of cyclone capacity in northern Australia. Elementum is evaluating a number of potential solutions in this region.

The Pricing Cycle is Likely Not Dead

It is also becoming more apparent, in Elementum's opinion, that the reinsurance pricing cycle is not dead and there are a couple reasons for this. First, there appears to be an almost universal belief that there is excess capital in the market and enough capital on the sidelines to ensure that current spread levels are the "new norm." One thing that history has taught us is that groupthink and herd mentality can lead to unexpected outcomes contrary to what the masses believe. As more uniform thinking abounds, we have witnessed circumstances of behavioral change – and, in our opinion, the more people relax terms and conditions, chase income, and engage in passive investing, the more likely it is that there will be a surprise loss that could lead to market corrections.

Second, what we believe to be a mini-correction in the Florida reinsurance market at the end of May is interesting. Specifically, several insurers with less stable operations came to the market late and experienced difficulty getting their reinsurance purchases completed at their desired levels. The main impetus for this appears to be some incremental demand for reinsurance (approximately $3 to 4B[12]) plus the purchase of approximately $600mm of ILWs. If such activity can disrupt the market, perhaps the levels of excess capital, at least for peak U.S. risks, are overstated?

This is not to suggest that future cycles will be the same as what we have witnessed in the past. We believe that the presence of more flexible capital should mean that the disruptions will be more localized and shorter lived. In addition, given there is still a fair amount of inefficiency in the market, we believe there continue to be localized disruptions/ opportunities even in a softer market environment like we are in now.

Whether it be changing delivery mechanisms or different pricing cycles, Elementum views itself as well positioned for this environment. In this regard:

- we have developed supplemental investment technology to enable our investors to deploy capital quickly to take advantage of potential short-term opportunities
- our investment approach is consultative – we have direct relationships and develop bespoke solutions for our counterparties, which we believe makes us less susceptible to disintermediation from brokers and other market participants

M&A Activity Anticipated to Continue

According to SNL Financial, the year-to-date (thru September 9th) aggregate value of insurance M&A totals $62.2B, which "comfortably exceeds" the combined value of such transactions from January 2011 thru December 2014.[13]

We believe the trend will continue, though not necessarily for the same reasons as some market participants. Reasons cited include:

- *You need to be big to control flow* – yes, size matters, however, we have always contended that relationships and structuring are equally important to securing attractive deal flow and that there is a bell curve to sourcing – too big, and you have to accept less to maintain your share, too small and it is difficult to be meaningful. Importantly, what is meaningful to a regional insurance company is different than what is meaningful to a global insurance company – again, there is a need to avoid overgeneralizing the market.

- *You need to combine to diversify business lines* – in the context of a rated balance sheet, there is some truth here in that diversification can increase leverage and provide more stable profits. Then again, leverage does not turn bad business into good business, and if you are an institutional allocator looking to the asset category for diversification, second order diversification within the asset class generally has marginal benefit. Perhaps it is better for end allocators to determine the suitability of diversification?

The principal reason we believe M&A will continue is a function of the other side of the income statement – the expense side. Like many industries, the reinsurance industry, particularly catastrophe reinsurance, is evolving from a brick-and-mortar industry to one that has a more efficient delivery mechanism and cost basis. Thus there is the potential for significant economies of scale by combining operations for those entities that have less efficient infrastructure.

What about Rates?

While admittedly rate changes were not a big topic of discussion, we would be remiss not to at least summarize where things appear to be headed. Most market participants are anticipating rates on non-loss affected programs to be off 5-10%, which is supported by some early renewal pricing that we have seen in the U.S. and Australia. Retrocessional rates are slightly more difficult to predict given M&A activity amongst reinsurers that is expected to eventually suppress demand.[12]

Conclusion:

The interactions we had and information we amassed in Monte Carlo heavily revolved around an industry in flux. The debate on whether alternative is mainstream or if mainstream is alternative was omnipresent. The evaluation and focus on legacy pricing cycles being behind us is something where we believe our opinion has diverged from the broader market. Relative to history, our market has had levels of change in legacy business models, M&A activity, and new capacity access points that are unmatched.

Given these observations and inputs, we believe it is now more important than ever that Elementum continue to evolve our business, while remaining true to our style, to continue to meet the evolving objectives of our investors and counterparties. This does not mean that we follow the market or drift from our incumbent style.

Footnotes:

[1] Source: Trading Risk, "Markel Plans for Catco Build-out" (September 16, 2015)
[2] Source: Insurance Insider, "Ace and BlackRock Launch ABR Re After $800mn Fund Raise" (April 1, 2015)
[3] Source: Insurance Insider, "Axis Reboots Casualty-focused Hedge Fund Re Project" (September 10, 2015)
[4] Source: Insurance Insider, "XL Catlin and Oaktree Targeting Hedge Fund Start-up" (September 14, 2015)
[5] Source: Trading Risk, "Aspen and Goldman Sachs Fundraise for Hedge Fund Re" (September 22, 2015)
[6] Source: Trading Risk, "Guy Carp Partners with Vario to Launch Non-cat ILS Manager" (September 10, 2015)
[7] Source: Swiss Re Sigma Report; 2015, No. 5
[8] Source: Insurance Day, "Reinsurers Must Seize Opportunity to Bring New Risks to Markets (Issue 4,436; September 14, 2015)
[9] Source: Insurance Day. "US Mortgage and Annuity Risks 'Present $80bn Opportunity for Reinsurance Capacity" (Issue 4,436; September 14, 2015)
[10] Source: Guy Carpenter, "The (Re)insurance Landscape: Mid-Year (Re)insurance Report" (July 2015)
[11] Source: Reactions Rendez-vous Reporter, "Capital Solutions for the Solvency II Era" (September 14, 2015)
[12] Source: Estimates are the subjective views of Elementum Advisors, LLC and are based on Elementum's direct experience, reflects our views of general market trends, and a variety of reinsurance broker publications, contain significant assumptions and are subject to change. These estimates accordingly do not reflect all market conditions.
[13] Source: SNL, "Insurance M&A to Roll On, Top Brokers Say" (September 16, 2015)