Volume 2 | Issue 3

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ViewPoint

Analyzing Industry Issues from an Independent Perspective

Market Outlook 2017

A Summary of the Rating Agencies' View

In advance of Monte Carlo Rendezvous and the unofficial "kick-off" to the 2017 renewal season, A.M. Best and S&P each hosted webinars to offer their outlook on the reinsurance industry. Although both have similar observations, A.M. Best maintains its "Negative" industry outlook, while S&P indicates the industry is "Stable."

In short, expect more of the same.

Remaining Relevant

With record-level capital, reduced demand, low interest rates and reserve development pressuring reinsurer growth prospects, competition to remain relevant is intensifying. Reinsurers are looking at all options to gain scale and innovate – both with a focus of being relevant to their cedents.

Among reinsurer strategies to remain "relevant" in the current market are: offering new products (e.g., terror, cyber, flood), establishing strategic partnerships and adding primary operations. Reinsurers that develop their own unique view of risk can create opportunity to exploit mispricing or model deficiencies. For the traditional reinsurer, there is also a trend toward medium-tail casualty lines to diversify.

This pursuit of relevance has seen large organizations getting larger, spawning the 2015 M&A flurry. More recently, TransRe and GenRe partnered to provide increased capacity, two strong balance sheets and scale.

Size Matters…but that's not all

In its annual ranking of the Top 50 Reinsurers, Best's notes that the Top 10 control over 70% of the market, or $140Bn in premium. It is a top heavy industry. To that end, the Top 2 (Munich Re & Swiss Re) control 30% of global premium. The pressure to grow in size and scope is strong. While the minimum capitalization size used to be $500Mn, it is now $1Bn (and growing). S&P similarly notes the chasm between the large and small reinsurers continues to widen. While there is a trend to consolidated panels on larger covers, Best's observes that a diversified panel/syndicated placements are still most often the preferred route for cedents.

In this regard, smaller markets can compete with the "giants," Best's indicated. The key is focusing on specific markets with a local specialty and concentrating on niche opportunities. Moreover, it is still a relationship business. Smaller organizations are able to be more innovative and responsive to clients' needs and maintain strong relationships between the executive management of both organizations. Service, responsiveness and lower cost structure all support these efforts – creating a true trust-based partnership.

More M&A to come

A place in the market remains for pure reinsurers; however both S&P and Best's believe more M&A is on the horizon, with prospects seen as compelling. Current macroeconomic uncertainties such as stock market volatility, interest rate uncertainty and the U.S. election may be delaying combinations otherwise already in the works. In addition, with price-to-book ratios near 1:1 and the desire for product capability, geographic reach and access to capital, the sense is there is a lot of discussion happening among reinsurers, with investment bankers "working very hard."

Emergence of Convergence (Capital)

Other influences include the continued growth of convergence capital, which now contributes 20% of total industry capacity ($70Bn) – including ILS, collateralized, sidecars and ILW's. Collateralized markets are quickly growing with $50Bn of capacity, of which 60% is controlled by the top five or six providers.

Much of the capitalization is from Pension Funds, as opposed to Hedge Funds, and the jury is still out, as to whether Hedge Fund-backed reinsurers will thrive. Their involvement in the industry is still in its infancy and results have been volatile and inconsistent (both underwriting and investment). Expense ratios are higher (7 points on average), and with no redundant loss reserves left to release, profitability will be further pressured going forward. As a whole, it's too early to judge the success.

Pension Funds are more prevalent capital providers today than in the past. They tend to have a longer-term return expectation, are more comfortable with the risk and see reinsurance as uncorrelated with other asset risks. Analysts see this capital as "stickier" expecting the long-term orientation of these funds to be tolerant of lower returns in the short-run.

The existence of this non-traditional capital spurs innovation and synergies with the traditional market via side cars and a growing retro market, as well as the already expanding collateralized market. Movement beyond Property Catastrophe to some casualty lines will also occur (and has already begun). There is no slowing of this market segment, with investors having a menu of choices for their capital, based on preference and risk tolerance.

2017 Outlook

Overall, market rates will continue to soften but at a slower rate. The need to balance staying relevant in the market with underwriting discipline will continue to put pressure on reinsurers. S&P predicts overall price reductions of 0 – 5%, with modest softening continuing into 2017. Similarly, Best's believes January 1, 2017 will be challenging for reinsurers. In the end, reinsurers' capital should be sufficient to absorb continued price declines, catastrophe shock loss, earnings deterioration or increased asset risk.

How much further to the bottom is anyone's guess.

Holborn Corporation is an independent reinsurance brokerage firm, which was founded in 1920 and is headquartered in New York. Through the adoption of an Employee Stock Ownership Plan (ESOP) in 1998, it became exclusively owned by its employees. For additional information, please visit our website at www.holborn.com.