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The best is yet to be

If there was one thing the financial crisis did to the Asian insurance markets, it was to highlight their immense opportunities. And this is nowhere more evident than in the number of global players looking away from the developed markets of the US and Europe and at Asia.

But there is much the region's reinsurance industry needs to do to develop the market. The reality is that, despite much trumpeting of the Asian growth, reinsurers are falling short of capitalising on this – and along with primary insurers, have yet to pave a clearer way to developing the region's insurance market.

A starting point

Industry-wide, there remains a need to strengthen reinsurance's role as a cornerstone for developing economic and social infrastructure, and to have a greater appreciation by its stakeholders of this role.

Asia Pacific's Nat CAT experience this year should serve as a starting point for doing this. While the region accounted for 40%-50% of aggregate global insured losses in 1H 2011, its total insured losses, fortunately as some would say with relief, was a tiny fraction of the total economic losses. This shows an extremely low insurance penetration. And the same thing can be said of the reinsurance penetration, as demonstrated, for example, by the relatively low penetration rate of earthquake reinsurance in Japan compared to that in New Zealand.

Will the growing number of reinsurers and reinsurance brokers in the region improve the penetration rate, or will they compete on the same turf? Will brokers and reinsurers focus on developing new market segments through innovation and by educating insurers? Will there be new products launched? Will reinsurers be able to differentiate themselves?

Leading the market?

Reinsurers' greatest lure is their additional capacity to domestic insurers in Asia's emerging markets. They must go beyond just providing capacity, though. There is much more they can do by using their technical expertise to help companies develop competitiveness through innovation, to guide them in managing portfolios, and to offer advice on business planning and product development. They must nurture risk-conscious players among ceding communities – not just risk-traders.

Be entrenched in the market

Reinsurers going after growth in Asia's emerging markets have to better understand these markets. While readily exploiting the opportunities that can bring them good returns, they must be mindful of the demands and pitfalls linked to the not-so-rosy areas, so that they will not be accused of cherry-picking as they select risks carefully. They will need to offer products and services that respond to the triple needs of clients, market and regulators.

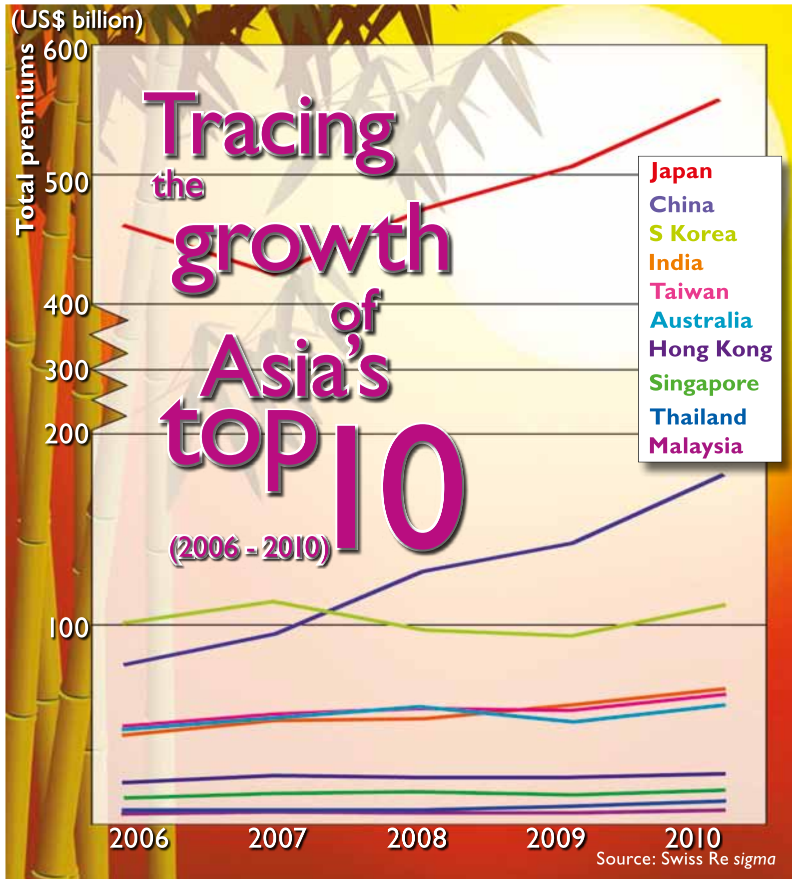
Then there is the more pressing need to develop a larger pool of local talent, particularly technical experts, as the number of reinsurers and reinsurance brokers increase. The game of musical chairs in the same pool of professionals continues to play, underscoring the urgency of this need.

Get the best out of it

With Asia, including Australia, accounting for less than 10% of global reinsurance premiums, there is a wide imbalance between reinsurance coverage in the region and its economies' contribution to global GDP and immense potential.

Opportunities for reinsurers to tap into the region's potential are, needless to say, vast. But the question is: Are reinsurers doing enough and doing the right thing to capitalise on these opportunities?

Today's executive panel discussion will offer insights on what the reinsurance industry should really be doing to get the best out of Asia's growth – and to bring the best of its capacity and expertise to the region.



Source: Swiss Re *sigma*

Rates on the rise

After two years of rate softening, given the record levels of excess capacity available, finally there are signs of a hardening of the market in the wake of an eventful 2011 so far, as well as changes in CAT models.

A catastrophic 2011

With the spate of catastrophes in 2011, estimates of this year's insured losses stand at US$70 billion thus far second only to 2005, the year of Hurricane Katrina and have already surpassed the total losses of 2010 and 2009.

This has put a dent in the industry's excess capacity position, reducing it by half from $20 billion at the start of the year to $10 billion, after taking into account losses, premiums and investment income.

Looking at Asia, in markets hit hard by catastrophe losses this year – Japan, New Zealand and Australia – rate increases have been estimated to be up to 100% on the topmost excess-of-loss layers of renewing reinsurance programmes. For the rest of the region, no significant across-the-board price hardening has been seen, given the low market penetration and excess capacity available.

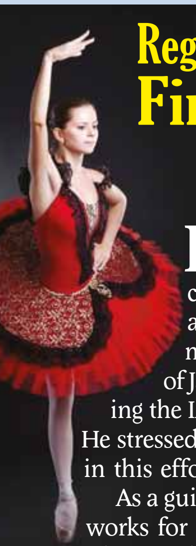
Revamped CAT models unleash changes

2011 has also seen new releases of CAT models, specifically for wind-related risks and earthquakes. Changes to the models have been significant, impacting risk perceptions and estimated loss amounts. RMS, for example, issued a substantial update to its US hurricane model, triggering material increases in risk estimates to many insurers with exposure to hurricane states.

As insurers and reinsurers alike grapple with the changes, it is likely that the demand for reinsurance protection will rise. This is as the new model slants towards increased risk perception, and companies will require a greater amount of capital than before for the same level of CAT exposure.

With the 2012 renewals almost upon the industry and the 2011 hurricane season yet to be over, another major catastrophe will certainly put the industry's capital position under greater strain, likely resulting in a higher demand for cover and a rate firming.

Regulation: Finding the right balance is key



Reforming frameworks for financial regulation and supervision is becoming an extremely challenging task as financial transactions have become more complex and globalised, said Bank of Japan Governor Masaaki Shirakawa, during the IAIS Conference in Seoul this September. He stressed that getting the balance right is crucial in this effort.

As a guiding principle for reforming the frameworks for international financial regulation and supervision, the emphasis should be on finding the right balance in various respects without relying too much on any specific methodology.

He in particular noted that insurance practitioners' and regulators' knowledge is still quite limited with respect to the intrinsically complex mechanisms of the financial system.

"The need for humility is obvious when we look back on how bubbles have developed and burst in the past and how financial crises have followed thereafter," he said.

Although financial institutions' business models differ by country and institution, against the backdrop of financial globalisation and advances in information and communication technology, individual financial institutions must flexibly adjust to changing business environments.

Given this, enforcing "one-size-fits-all" regulations for various types of financial institutions could increase the likelihood of adverse side-effects.

To avoid this, there should be a greater reliance on supervision than there is right now, said Mr Shirakawa. "We must design a comprehensive framework that better combines regulation and supervision."

Cost of capital 101

Reinsurance comes with a cost, but not many practitioners realise what the cost of capital (CoC) really means. Here, we bring you a textbook research on what CoC is, hoping to help create a better understanding for the coming renewal negotiations.

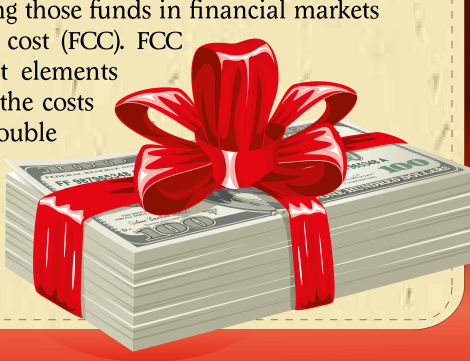
CoC is directly related to the size and type of risks assumed by an enterprise. For insurers, since they assume insurance and financial market risks, their CoC should reflect exposure to both.

The common models used to evaluate CoC include the Capital Asset Pricing Model (CAPM), Market Consistent Pricing Model (MCPM), Arbitrage Pricing Theory (APT) and Dividend Growth Model (DGM). CAPM is most commonly used for CoC estimates for its computational simplicity and the fact that it requires only publicly available information.

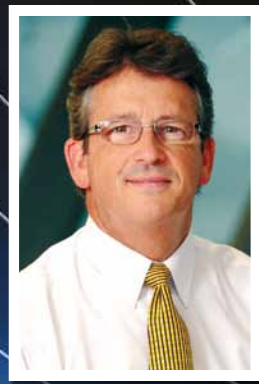
Experience suggests caution, though, in applying CoC estimates based on CAPM for decision making in insurance. This is because beta estimates have been proven unstable, and splitting the overall CoC down to individual lines of business, which is essential for company steering, is difficult.

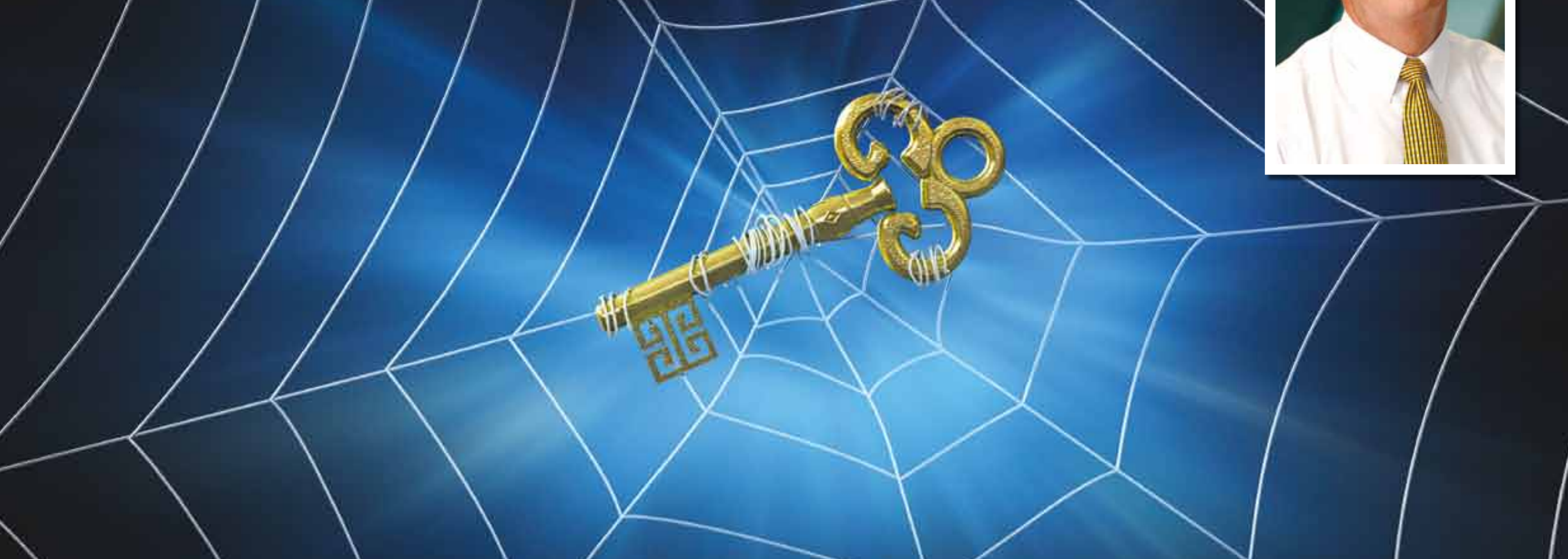
In general, CoC depends on the returns expected by shareholders – which are composed of the base cost of capital (the return that investors could have obtained by investing those funds in financial markets directly) and frictional capital cost (FCC). FCC can encompass many different elements of CoC and generally includes the costs of regulatory capital, agency, double taxation and financial distress.

Compared to insurers, reinsurers have higher CoC and FCC because of the higher volatility of their results.



Swiss Re well positioned to capture growth opportunities





Despite the challenges of the current economic environment in Asia, **Mr Martyn Parker**, Division Head Client Markets Asia, **Swiss Re**, says that his company is well positioned to capture future growth opportunities in the region with its strong capitalisation, robust underwriting discipline and ability to innovate.

After an extended soft cycle, reinsurance rates have gradually begun to improve, though pockets of soft pricing remain. Moreover, protracted record low interest rates are a real shock to the industry. Swiss Re, said Mr Martyn Parker, the company's Division Head Client Markets Asia, is well placed to capture future growth opportunities, due to its excellent capitalisation, the benefits of its strict underwriting discipline, its proven track record of innovation and a very strong client franchise.

"The current economic environment in Asia, with low interest rates, volatile stock markets, and uncertainties around future inflation expectations, poses a significant challenge to our industry today," he said. "In this situation, diversification, size and agility, founded on disciplined underwriting and low-risk asset management, are key pillars of a successful strategy for tomorrow. Our value proposition to cedants and clients remains intact and is as strong as ever."

Swiss Re is well on track in implementing its new group structure that aims to optimally capture growth opportunities across the (re)insurance market.

Nat CATs and low interest rates

Given the series of major Nat CATs that hit Asia in 2010-2011, including severe earthquakes in New Zealand and Japan, as well as floods in Australia, Nat CAT prices increased in April and July 2011, notes Mr Parker. "Underwriting terms for P&C business have improved significantly, particularly for exposures in loss affected areas or where modeling uncertainties exist," he said.

Casualty, on the other hand, shows less sign of change. Players continue to release reserves, and there has been sufficient capacity in the market to keep prices flat. However, the reality of low interest rates will be felt, and at some point, the bubble will burst.

Low interest rates have been a shock to the industry over the last three years. If not compensated by significantly lower combined ratios, the earnings capacity of the industry will erode over time.

Swiss Re expects a modest, broad market turnover over the next three to 15 months.

Innovation power

The company, shared Mr Parker, has always been an innovator. It pioneered an innovative index-based insurance programme for the Vietnam Agribank Insurance Joint Stock Co to insure rice farmers in up to 10 provinces of Vietnam, against the inability to make loan repayments due to low yields from natural catastrophes.

In Australia and New Zealand, Swiss Re took a leadership role in public-private partnerships for better disaster risk management and funding, such as engaging key ministers and government stakeholders at the federal and state levels in constructive dialogue, and advocating pre-emptive disaster financing through media.

Likewise, it successfully initiated a pilot project in Kunming, China to support environmental pollution liability business by providing reinsurance protection and technical support. The project is now being extended to other Chinese provinces. In addition, Swiss Re initiated the first-ever Geneva Association Liability Regimes conference in Asia, discussing environment pollution, which took place in Beijing.

The company also transferred specific risks to the capital markets through innovative insurance-linked securities, including a unique CAT bond combining Japan earthquake, Japan typhoon, North Atlantic hurricane, European windstorm and California earthquake; and a CAT bond combining Australia earthquake with US peak Nat CAT risks.

Strong capitalisation

In terms of capitalisation, Swiss Re holds a comfortable buffer in excess of the level required for an AA rating by S&P. In combination with a prudent asset management strategy, the company had also applied strict underwriting discipline over the soft cycle, forgoing market share if price adequacy was not met in previous years. In 2011, it saw successful renewals, with its P&C treaty portfolio growing by 20%, while price adequacy was maintained.

Mr Parker concluded: "We have a proprietary, deep understanding of risk and underwriting; we have an asset strategy in place to navigate through difficult markets; and we have a track record of innovation. On top of this, our capitalisation is excellent. All this positions us ideally for capturing exciting new business opportunities with our clients."

SIRC kicks off in *style* at MBS

The 11th SIRC kicked off in style yesterday in a night of warm chatter and catching up over copious food and drinks. Munich Re's cocktail party not only offered an evening of arts and other surprises, but also reminded delegates of the need to conquer the high seas of risks and returns through a guided tour of the Titanic artifact exhibition at the ArtScience Museum of the Marina Bay Sands.

ArtScience Museum, Marina Bay Sands

Editor-in-Chief: Sivam Subramaniam • Journalists: Manuelita Contreras, Min Yong, Benjamin Ang & Seow Kai Lun • Design & Layout: Angeline Tsen & Charles Chau