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INNOVATION AND EFFICIENCY

Technological Solutions to Address Low Capital Return for Reinsurers

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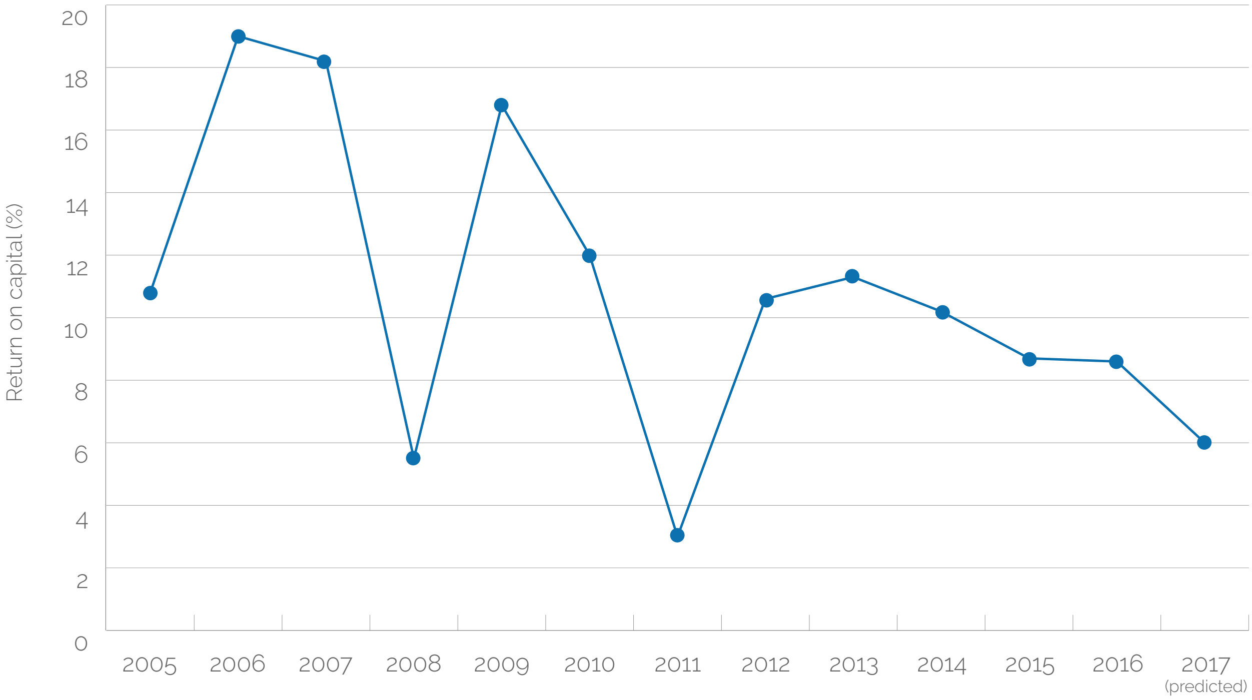
Abstract

With market conditions remaining tough for reinsurers and current return on capital at its lowest for a decade and approaching the cost of capital[1] itself, this whitepaper looks at the options available to reinsurers from a technological perspective. In particular, looking at the ability of technology solutions to drive innovation and efficiency, reducing operational costs and improving return on capital. The paper identifies the importance of a strategic collaboration between reinsurers and technology providers to meet the goals to increase sales through innovation, and reduce costs through efficiency.

fig.1 - Return on capital for reinsurers between 2005 - 2017

source: S&P Global ratings



1 - Reported by Bermuda Reinsurance Magazine (5th Septemeber 2017) based on S&P report "Global Reinsurers' Returns Dwindle Ever Closer To Their Cost Of Capital"

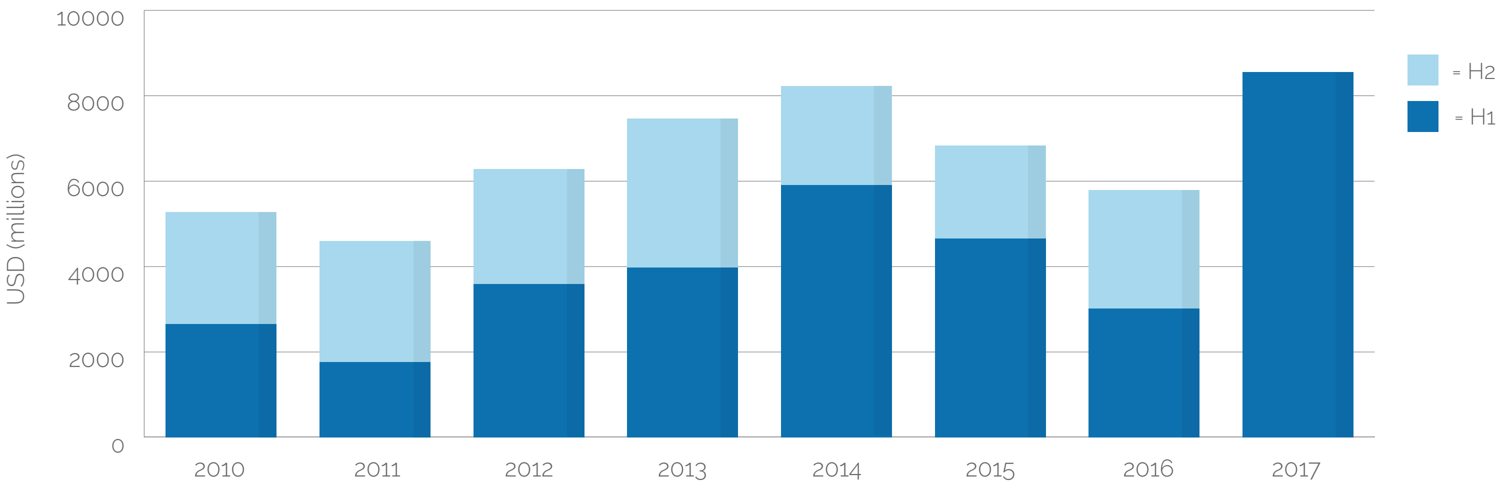
Introduction

S&P's recent report – "Global Reinsurers' Returns Dwindle Ever Closer To Their Cost Of Capital"[2] painted a somewhat gloomy picture of the current state of the financial landscape for reinsurers. It shows the reinsurers return on capital falling to not much above the cost of capital, and predicts it will fall further.

The difference in the return on and cost of capital obviously has significant implications for profitability. Reinsurers have been cushioned somewhat by the favourable impact of prior-year reserve releases, but the recent spate of high-profile Natural Catastrophes suggests that it cannot be guaranteed in the future.

Ordinarily, losses on this scale might see a hardening of the soft market that has contributed so much to the tough situation reinsurers find themselves in. Certainly, AllianceBernstein are predicting that US Natural Catastrophe Reinsurance rates will rise 4-5% in response to Hurricanes Harvey and Irma and associated reduction in ILS Capital[3]. However, Sompo Canopius form an interesting counter to AllianceBernstein's assumption, as it is actually accelerating its plans to launch an ILS fund in response to Harvey and Irma[4].

fig.2 - Catastrophe Bond Issuance



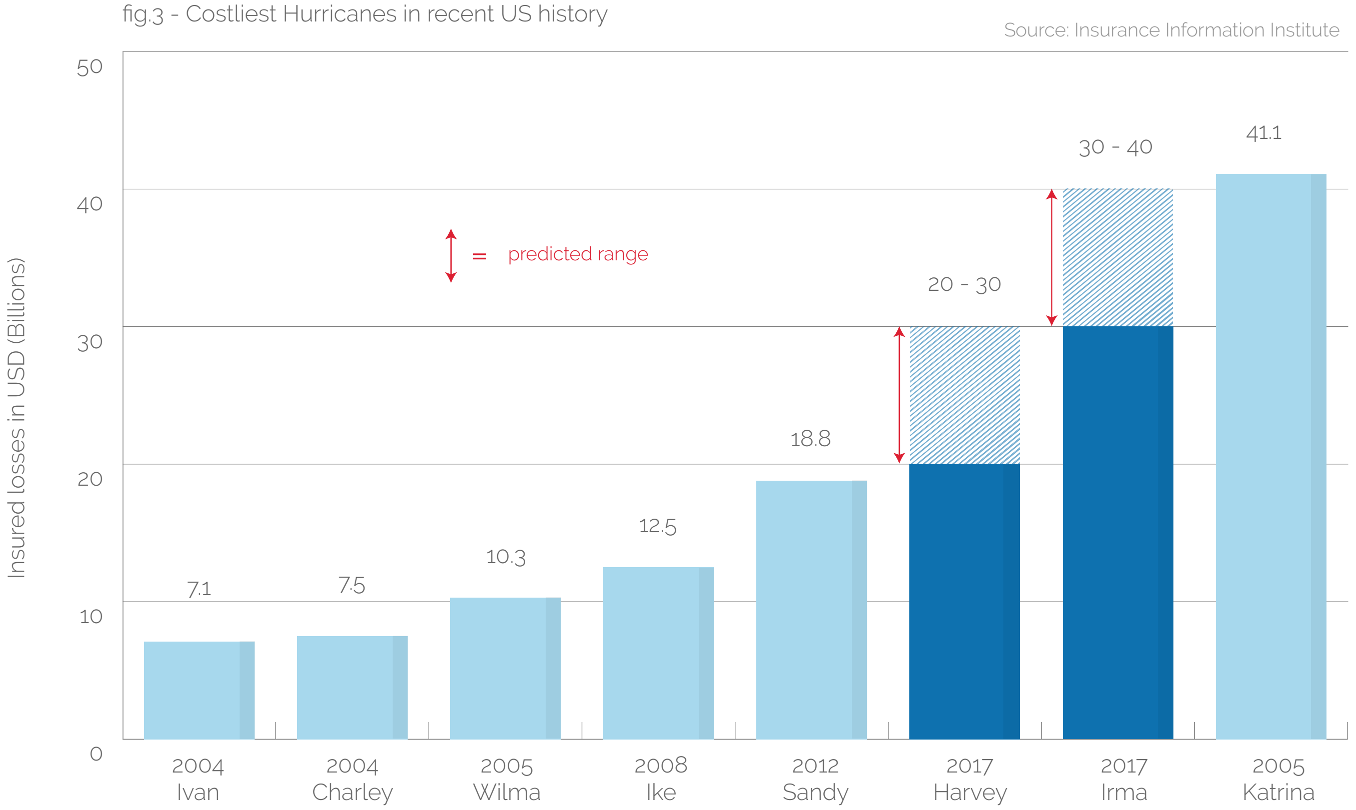
2 - Ibid
3 - Reported by Intelligent Insurer (14 September 2017)
4 - Reported by Insurance Insider (13 September 2017)

This, and the fact that Global Interest rates are remaining low, a reversal of the 2016 surge of Capital into ILS Funds (a 7% increase in the year according to Willis Re[5]) is not certain, so the scope to harden rates may be limited.

AM Best's recent report "Down But Not Out: Reinsurers Look to Reposition Amid Market Disruption"[6] notes that despite a relatively benign Catastrophe experience, the sector still booked an underwriting loss in 2016. The profits warning issued by Munich Re in response to the recent Hurricanes, has come as no great surprise and may not be the last[7].

In a sector where returns are already low, scope for increasing rates may be limited, and active year claims experience is deteriorating. So, what action can reinsurers take to improve their profitability?

fig.3 - Costliest Hurricanes in recent US history



5 - Reported by Artemis.bm (20 April 2017)
6 - AM Best Special Report, "Down But Not Out: Reinsurrers Look to Reposition Amid Market Disruption" p1
7 - Reported by Financial Times (13 September 2017)

Improving Returns

Two of the classic responses to a low differential between return on and cost of capital are to cut costs or increase sales (or combine both). For the Reinsurance Sector, technology is both an aid and a challenge in achieving these objectives.

Increased Sales

The ability to increase sales will certainly be challenged by technology. The InsurTech revolution offers a challenge to reinsurers – by giving the primary insurer access to better information in the underwriting process, and changing the risk profile of the primary insurer, which in turn may result in the need to purchase less reinsurance, or purchase different types of reinsurance[8].

As the nature of the underlying risk data changes – e.g through data gathered by wearable technology, sensors on property (personal and commercial) – this will see two changes in primary insurance that will impact reinsurers.

Firstly, the primary insurer may be able to take (or encourage the insured to take) action that prevents or minimises loss. Reduced loss accumulation or size at the primary level will obviously lead to less need to purchase reinsurance.

Secondly, the different nature of the data available to the primary underwriter, and the different loss profile may also change not only the amount but the nature of the reinsurance required, in particular loss triggers. Parametric triggers are already common in Natural Catastrophe Reinsurance and ILS (where for example, a Hurricane may have to reach a certain wind-speed in order to trigger a recovery) and this type of trigger may reach into other classes of business.

8 - Reported by Intelligent Insurer (10 September 2017)

These challenges will require reinsurers to themselves innovate, and put challenges on their own technology to make that innovation viable. Legacy systems and inefficient practices that slow down product changes will not be sustainable. End-to-End systems from a single provider able to control the entire lifecycle of a risk would also be more attractive: if a reinsurance product was changed or new line of business introduced, a simpler process with less parties involved would be crucial to allowing the reinsurer to respond to challenges quickly and efficiently.

Technology also offers other opportunities to reinsurers for increased sales, by introducing new classes of business or changing existing classes of business.

Cyber Risk is certainly the most topical and high-profile example of this. As the understanding of Cyber Risk continues to evolve, the primary and reinsurance products that serve the risk will also need to continue to evolve. Additionally, it remains a class of business that is considered to be significantly underinsured with an insurance gap quantified by Lloyd's as being tens of billions of dollars[9]. As the understanding of this risk increases, and the insurance gap closes, the scope for increasing sales into this class of business is significant.

Similarly, the spread of Artifical Intelligence, Machine learning, Robotics, and Automation into new areas of the economy is sure to change existing classes of business or introduce new flavours of these classes.

Once again, the onus will be on reinsurers to innovate to meet these new opportunities created by technology, and it will be incumbent on their own technology solutions to rise to the challenge. Speed of innovation will be key, and a consultative and flexible partnership with technology providers will be an important part of this innovation challenge.

"Currently, the global cyber insurance market is estimated to be $3 billion to $4 billion in gross written premiums. The market is dominated by North America, and we expect it to grow to about $14 billion by 2022"

S&P

9 - Lloyd's Report "Counting the costs" (10 July 2017)

Reduce costs

Organisations in many sectors often look to technology to reduce costs, and the results can be mixed. This highlights the importance of selection of a trusted technology partner with a strategic view of the market and a vision of the benefits that technology can realise and how these will be achieved. For reinsurers, there are several key areas that technology can address to increase efficiency and reduce costs.

In some areas, especially underwriting and claims, technology advances in AI and Blockchain will certainly add efficiency and remove costs in the medium term. They also require both initial investment and patience to realise the benefit. The same applies to automation by machine learning.

Reducing costs in the shorter term is likely to involve the identification of "quick-win" efficiencies that require low initial investment and where savings can be quickly realised.

One of these methods will be in a better use of data. Quickly understanding and analysing new types of data available from connected devices is essential, as primary insurers will be able to use this information to reduce claim costs and reinsurers will need to understand how to do the same.

While the scope for avoiding claims is not the same for the reinsurer as for the Insurer, the availability of information should provide scope for a reduction in Adjustment Fees and Expenses.

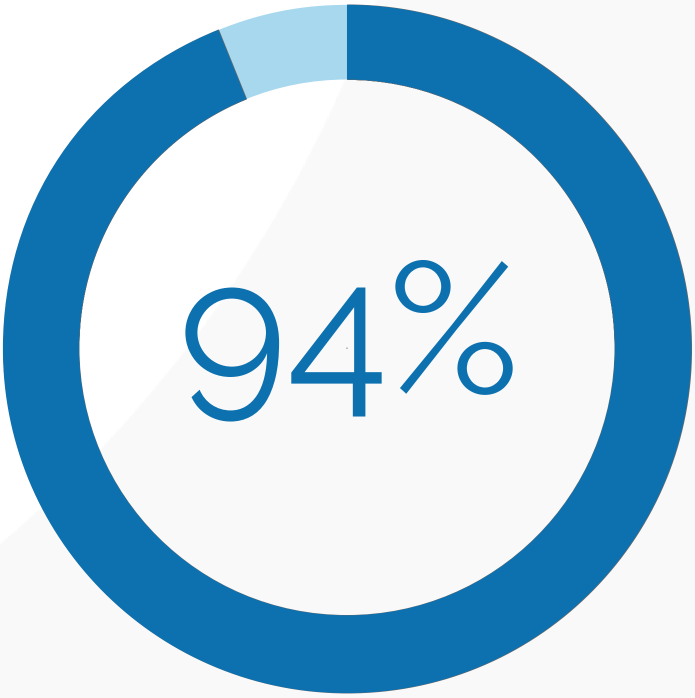
There is also the possibility, working with technology partners, to assess existing operations for "rulesbased, repeatable processes" that are ripe for speedy automation. These are manual operations that nevertheless do not allow for discretion on the part of the user: if a condition is met, the same action is always taken. This is particularly prevalent for reinsurers in appointing TPAs or Lawyers and credit control.

Introducing automation in these sorts of areas and any others where rule-based, repeatable processes are identified is a painless way to improve efficiency and reduce costs.

Another way to reduce costs and increase efficiency, and one that particularly supports the goal of increasing sales through innovation, is with reducing the number of parties supplying technology and working with one strategic technology partner.

By reducing the number of parties providing technology, reinsurers can realise an immediate benefit in reduced license and support fees. While the preference to identify individual "best of breed" solutions is understandable, the reality is that this introduces unnecessary costs and challenges. The necessity of integration during implementation, can lead to "pass the blame" scenarios and makes the management and administration of the technology more time consuming and expensive.

Further, when reinsurers need to be able to innovate and respond to changes in primary insurance to increase sales, the greater the number of parties required to respond to that innovation, the slower, more complicated and more expensive any response will be.



94% of respondents are priortising better risk insights and customer engagment

source: PwC Global InsurTech report -2017

Conclusion

Identifying a strategic technology partner to supply multiple elements of its technology landscape, allows reinsurers to reduce costs and increase sales through responding to innovation challenges.

Consultative partnerships are the key to realising the benefits available from technological changes and responding to the particular challenges reinsurers currently face in the form of their low (and reducing) returns on capital.

While there is no painless solution to the attack that reinsurers are under from a soft market, (alternative capital, natural catastrophe losses and the changing needs of primary insurers) it is clear that although technology is the cause of some of these challenges it also provides an opportunity for the reinsurers to address them. Forming a strategic relationship with a technology provider that has a clear vision of the path reinsurers can take and the benefits it will realise is key.

Reinsurers who position themselves with the ability to embrace the opportunities for innovation and efficiency that technology brings, alongside expertise provided by the strategic partnership of their technology partners, will be best placed to overcome the current challenges and improve return on capital.

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