INSURANCE AND RISK ADVISORY SERVICES

Is Now the Time for Reinsurers to Diversify? Companies May Consider Entering the Primary Market

Executive Summary

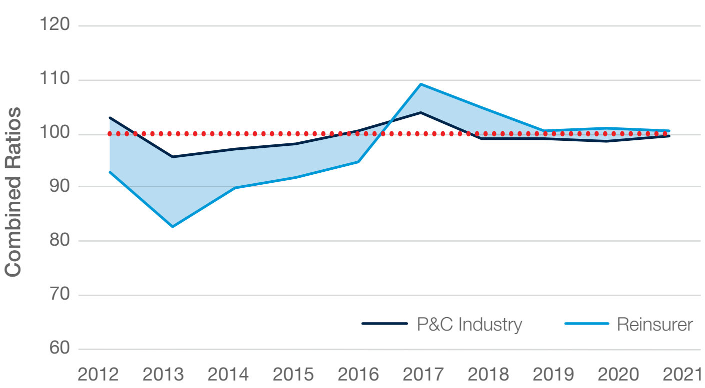
Economic uncertainty continues to bear heavily on the mind of business leaders across industries. The insurance industry is no different, where the economic downturn can impact all aspects of a company's value chain, from products to investment return to insured losses.

Market Changes: Executives in the Property & Casualty (P&C) Reinsurance area, which has exhibited historically attractive business performance, are seeing their business margins diminish or disappear, primarily due to disappointing or deteriorating underwriting results. This deterioration can be due to the increased severity of their catastrophe-prone books of business. As Reinsurers evaluate their risk profiles, pricing, and performance metrics, the capital providers are seeing desirable pockets of primary insurance carrier performance in the U.S.

Industry Response: The shorter-tailed primary writers in the U.S. have been recording relatively desirable return measures, generating results that have not gone unnoticed by their reinsurance partners. Some reinsurers have noted this trend and are considering the tradeoffs and benefits of possibly entering non-correlated lines of business. Companies are beginning to enter several new insurance markets, providing desirable business characteristics, risk profiles, and return metrics.

Key to Success: For many historically catastrophe-exposed reinsurers, the primary market offers attractive non-correlated risk business profiles exhibiting favorable return metrics. However, to effectively capture desirable returns, organizations must understand that real risks and opportunities require a structured, focused, and informed approach to participate in the new areas. These require consideration of operational elements that are very different than what reinsurers have historically housed within their operating companies.

Chart 1:
US P&C Industry vs. US Reinsurers
Calendar Year Combined Ratios



Drivers for Change

The U.S. based Reinsurer segment of the industry has exhibited disappointing underwriting performance over the past five years. Unrelenting losses from natural catastrophes to COVID-19 has battered performance.

The deteriorating profitability trends of reinsurers in recent years has spurred some reinsurance companies to explore expanded operating models, (Chart 1). Product diversification is one of the leading strategies being considered to normalize underwriting earnings while increasing investment returns with more predictable business portfolio outcomes.

Reinsurance companies have taken note of the more favorable Net Loss & LAE performance measures primary carriers have posted since 2017, with some traditional P&C reinsurers starting to underwrite primary lines in their portfolio as one of the ways to address these strategic concerns, (Chart 2).

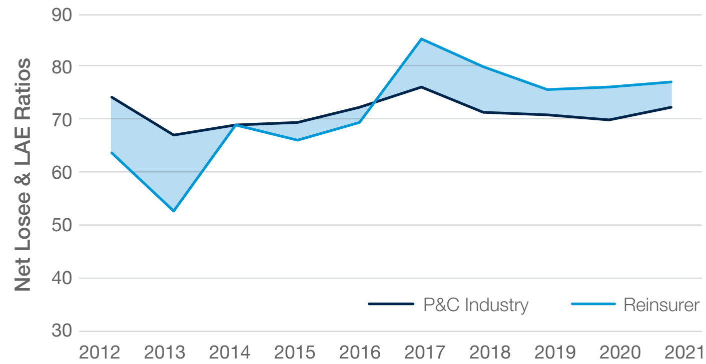
Product Considerations

As Reinsurers look at new opportunities in U.S. primary insurance markets, there are several variables that must be considered. For example:

- Will the carrier write on an Admitted or Excess basis?
- What barriers of entry exist for catastrophe writing reinsurers to move into non-catastrophe exposed lines (i.e., private passenger auto), where these reinsurers can add non correlated risks to their risk profile?
- How will the organization utilize automation to capture, store, analyze and report on the new data being gathered?

Chart 2:

US P&C Industry vs. US Reinsurers
Calendar Year - Net Loss & LAE Ratios



Lower rating agency capital requirement(s) for certain, more predictable lines of business, (such as private passenger personal auto), makes entry into these non-correlated lines appear attractive compared to other, longer tailed or catastrophe exposed lines of business. However, fierce competition amongst established competitors dominating the less catastrophe prone private passenger auto space results in razor-thin, but more predictable profit margins, largely driven by operating efficiency-based competition, making this a difficult space for new entrants to succeed without proper planning.

The required investment necessary to effectively establish and manage distribution sources, develop appropriately priced sets of customizable and versatile products offerings in a highly price sensitive space requires the development of sustainable technological advantages where long established players make this a challenging space to enter, let alone attract market share as well as succeed.

Why would any company look to enter areas such as private passenger auto, for example? For starters, the arena is the opposite of many P&C reinsurers business profiles are today, where Cat exposed businesses dominates their current books of business. Further, the auto space, as an example, is largely driven by relative operating efficiency where the average loss event tends to be smaller, with an extremely short tail, often represented with shorter policy periods that allows insurers to adjust pricing to each states' unique market conditions with semi-annual rate hikes.

According to data provided by A.M. Best, the Private Passenger Auto Composite has generated a sub one hundred five-year average Combined Ratio that outperforms the aggregated underwriting performance statistics for all companies writing all lines of business by approximately 2.0 points. In addition, traditional Return on Revenue measures outperform all company composite performance measures by roughly four full points over a similar time frame.

Regulatory Considerations

Reinsurers looking to enter the primary market will face a regulatory environment that is much more complex than what they've been accustomed to. Direct writers are subject to a very broad range of state laws and regulations that impact virtually every aspect of the company's business. Those laws include of course, not only the company's state of domicile, but also every other state in which the company is licensed to conduct business.

While the states have come a long way in recent years to achieve a greater level of uniformity, critical differences exist among different jurisdictions. This is particularly the case with personal lines coverages where product design, rating, marketing and sales, distribution, claims, among others are heavily regulated. Companies doing business in multiple states are expected to know these differences and be prepared to comply with them. Building and maintaining the infrastructure, personnel and systems needed to manage the company's regulatory and compliance risks is among the most difficult challenges encountered by primary writers doing business in the U.S.

For a company considering entering the primary market, regulatory considerations should be part of the planning and decision-making process from the earliest stages. Every major decision should be evaluated considering the potential regulatory or compliance ramifications. Optimally, that planning process contemplates an "end operational state" for the company and the regulatory and compliance infrastructure designed to ensure that operational state is ready on Day 1.

Strengthening Operational Foundation

Strengthening operations before a move into primary lines business is of paramount importance. Reinsurers should consider how primary business operations differ from reinsurance operations and what that means in terms of infrastructure (e.g., systems), personnel and process.

Primary lines underwriting is significantly different in several ways from reinsurance underwriting, particularly for things like submission volumes and data detail levels. Some reinsurers may not be prepared for dealing with the increased volume and workload including the sheer increase in data volume.

Simply put, reinsurers will generally be shifting from a low policy count with large average limits to high policy counts with small average limits. This also means dealing with a much greater number of submissions each with more detailed data. Thus, it is likely that a reinsurer seeking entry into primary lines business would seek to gain primary lines underwriting capabilities would do so through acquisition or outsourcing to an MGU/MGA.

Like underwriting, primary insurance claim operations are very different than reinsurance claim operations. Any Reinsurer seeking to enter the primary lines business will have to decide between bringing on new talent expertise or farming out their claims handling, as they might choose to do for underwriting. To directly retain and develop a sufficient claim staff to manage primary lines claim volumes would be time consuming and costly. Contracting with an outsourced claim handling firm is a much faster means to establish this capability.

For some reinsurers, depending on their current capabilities and excess capacity, building up their current operations may prove more attractive. The decision of build vs. buy should be made with careful analysis and consideration of cost and benefits, both near-term and long-term.

Table 1:

Industry – Underwriting Expenses Ratio							
	Net Commissions	*Other*					Total
		Premium Taxes	Manager/Agent Allowances	Salaries	Rent/ Equipment	All Other	
2021	11.0	2.1	0.4	7.2	1.7	4.1	26.5
2020	11.2	2.2	0.4	7.4	1.8	4.4	27.4
2019	11.0	2.2	0.4	7.4	1.8	4.4	27.2
2018	11.2	2.2	0.5	7.4	1.8	4.1	27.2
2017	10.3	2.3	0.5	7.9	1.9	4.5	27.4

Even outsourcing the underwriting and claim operations, although likely faster and less costly (initially) than acquiring or building from scratch, will still require Reinsurers to develop an enhanced ability to oversee individual primary underwriting and claims operations of outsourced service providers, particularly for the purposes of making significant decisions on things like large individual claims regarding acceptance/rejection of FNOL, settlement offers, litigation strategy, etc. These activities go beyond the typical reinsurer monitoring of claims reported by their primary customers and require more active decision making and reporting.

Table 2:

Reinsurers – Underwriting Expenses Ratio							
	Net Commissions	***Other***					Total
		Premium Taxes	Manager/Agent Allowances	Salaries	Rent/ Equipment	All Other	
2021	21.0	0.1	(0.1)	1.5	0.3	0.4	23.2
2020	22.6	0.1	(0.1)	1.7	0.3	0.4	25.0
2019	22.1	0.1	(0.1)	2.0	0.3	0.4	24.9
2018	21.7	0.1	(0.1)	2.2	0.3	0.5	24.7
2017	20.5	0.1	(0.1)	2.6	0.4	0.6	24.1

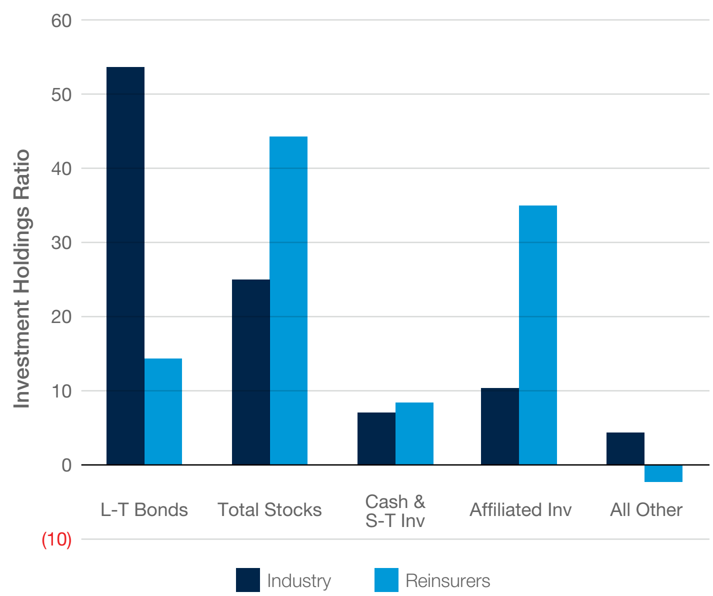
Systems will also prove to be a challenge if not appropriately considered in any plan to move into primary lines. Most reinsurance systems are designed to handle more aggregated levels of data than is required for primary line business. Even if a reinsurer successfully farms out the underwriting and claims operations of their primary lines business, they will still need to be able to accept a much greater volume of data in much finer levels of detail than they currently can. The reporting they currently receive as a reinsurer from their primary lines clients is very different than the data they will need to collect and manage to successfully own a primary lines business. Reinsurers will likely need to improve/change their ability to collect, analyze, manage, and report in ways their current systems cannot.

Investment Holdings

Reinsurers have recently suffered a setback relative to the rest of the insurance industry due to economic events unrelated to the underlying insurance business. Reinsurers tend to have investment portfolios structured more toward shorter-term investments than does the insurance industry overall. This is likely the result of the need for most reinsurers to maintain higher liquidity in their investment portfolios to respond quickly to catastrophic events. The recent shift to higher interest rates driven by central banks, especially the Fed, to battle inflation, has driven interest rates on treasuries from historic lows to highs not seen in decades. The insurance industry, generally, has benefited from this increase in interest rates due to the considerable capital tied up in loss reserves and invested in things like treasuries and other low risk investments. For years the returns on this capital were negligible. Now those returns have increased considerably thus helping insurers' bottom lines.

Chart 3:

US P&C Industry vs. US Reinsurers Investment Holdings 2021 Year-End



Unfortunately for reinsurers, the group has not benefited as much as the rest of the industry (primary insurers) from the rise in interest rates. Although reinsurers tend to have investment portfolios with shorter maturity investments than primary insurers, their having a higher proportion of investments in equities and affiliated investments, may have worked against them as interest rates increased and the value of equity holdings declined, (Charts 4 & 5).

Chart 4:

US P&C Industry vs. US Reinsurers Bond Portfolio Average Investment Maturities

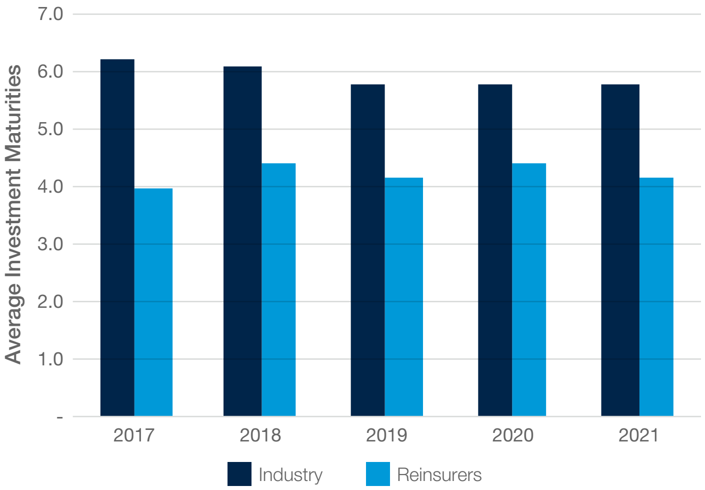
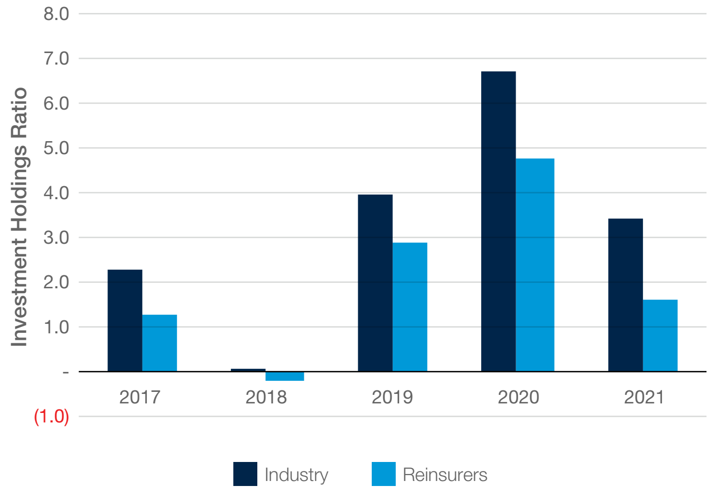


Chart 5:

US P&C Industry vs. US Reinsurers Bond Portfolio Market Value to Statement Value



As reinsurers and their capital partners consider their strategic alternatives to enter into unfamiliar spaces such as primary lines, a host of considerations from the line characteristics, legal environment, product offering, pricing flexibility, systems requirements and just entering a new operating frontier, (with very different business characteristics), can provide potentially attractive returns, but are also fraught with a host of very different risk profiles than the space reinsurers have been used to operating in. A careful, well thought out strategy is of utmost importance to both survive and succeed in this new world.

Authors:

James McDermott
Managing Director
+1 212 763 1873
jmcdermott@alvarezandmarsal.com

Tamseel Butt
Managing Director
+1 646 259 0046
tbutt@alvarezandmarsal.com

Scott Harrison
Senior Advisor
srharrison@alvarezandmarsal.com

Greg Hoeg
Senior Advisor
ghoeg@alvarezandmarsal.com

Henry Mikrut
Senior Advisor
hmikrut@alvarezandmarsal.com

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