



**The soft market is still
with us...**

**...and may be for some time
to come**

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- Still too much supply (capacity)
- Soft R/I market reaches two years at 1/1
- True rate discipline is largely a hope, not a reality (even if the line is held on the headline price, weakening of T&C's persists)
- R/I capacity leaking into primary market...and that will continue

M&A is part of the pricing problem (for carriers) not part of the solution

- We see 3 types of 'buyer' for 'traditional' R/I players
 - Investor/Entrant
 - Diversifier
 - Consolidator
- All 3 typically increase capacity – even if the last two may reduce 'available capital '

Recent Transaction List

Buyer	Target	Type
ACE Ltd	Chubb Corp	Consolidator
TokioMarine Holdings, Inc	HCC Insurance Holdings, Inc	Diversifier
Fosun International, Ltd*	Ironshore, Inc	Investor/Entrant
EXOR SpA	PartnerRe, Ltd	Investor/Entrant
Endurance Specialty Holdings, Ltd	Montpelier Re Holdings, Ltd	Consolidator
Fairfax Financial Holdings, Ltd*	Brit PLC	Investor/Entrant
XL Group PLC	Catlin Group, Ltd	Consolidator
RenaissanceRe Holdings, Ltd	Platinum Underwriters Holdings, Ltd	Diversifier
Validus Holdings, Ltd	Western World Insurance Group Inc	Diversifier
Mitsui Sumitomo Insurance Co Ltd	Amlin PLC	Diversifier
China Minsheng Investment Corp	Sirius International Insurance Group Ltd	Investor/Entrant

*We view these groups as 'Investors' despite their significant existing R/I operations given the groups' apparent strategy for their R/I business

- Capital is not the same as capacity (at least not in isolation)
- Capacity derives from capital models

$$\frac{\text{'Available Capital'}}{\text{'Required Capital'}}$$

- E.g. an SCR of 100% means

$$\text{Available Capital} = \text{Required Capital}$$

- Thus....capacity reduces when capital is reduced ONLY if required capital does not also similarly shrink (not a given in M&A transactions, as we will see)

- Why not just buy shares in Munich & Swiss?
 - ‘We want to create a float’
 - ‘We want to create our own ‘market leader’
 - ‘We can have a lower cost of capital’ (the ‘non-traditional ‘ capital provision rationale in a soft market)

None suggest ‘shrinking’ capacity. All suggest ‘expansion’.

Plus...why pay more than book for something and then shrink it?

- Growth opportunities in core business are limited
- Expand into R/I with a long term view
- Deploy excess capital*
- Get a diversification pick-up

Again there is no 'shrinkage' logic and lots of 'expansion' logic...

*A rationale for paying a premium to book using current excess capital is that they are therefore purchasing future profits greater than the cost of that capital.

- Serve large cedants better – global, one stop shop
- Eat or be eaten
- Enhance diversification

But also....

- Pay back surplus capital

At last capacity shrinks.....

Well, not necessarily, no.

Two + Two Equals Three and a Half

- Reinsurer A writes £2bn NWP on £2bn available capital
- So does Reinsurer B
- A buys B
- Because of diversification 'AB' now only needs £3.5bn of capital to write £4bn of net premium
- AB pays back £500m of capital BUT capacity remains £4bn

- A will have bought B telling its shareholders a **growth** story and/or a **diversification/capital efficiency** story and/or a **cost reduction** story

Growth = Increased capacity

Diversification = Increased capacity for a given amount of capital

Cost reduction = Ability to write same business at lower price

All three = Downwards pressure on rates

Increased inflation/interest rates

Why?

- Excess capacity exits due to healthy 'returns' elsewhere
 - Traditional
 - Non-traditional
- Loss cost inflation requires reserve increases reducing available capital

Why not?

- Higher investment returns encourage even further price-based competition for premiums

Major CAT loss

Why?

- Traditional players required to hike rates to compensate shareholders for 'loss' year
- Alternative capacity exits 'spooked' by reality of a loss

Why not?

- Traditional players have to stay 'in the game' limiting price flexibility
- Alternative capacity sees 'opportunity'

It's risk Jim, but not as we know it

- Emerging risks cause step change in industry risk/return map and opportunities
 - VW?
 - Talk Talk?
- Buyers develop asymmetric views of insurable risk/return
 - Pay what it takes to lay-off the risk
- Knowledge advantage returns to the carriers - for now

Arguably the main 'structural' source of a return to systemic healthy pricing for the R/I industry, though obviously in return for accepting less well defined risks.

Even de-risking does not necessarily reduce capacity

De-risking might be driven by

- Seeking higher regulatory capital ratios (e.g. for S2)
- Enhancing/defending a credit rating
- Strategic choice of a lower risk appetite

But...it is an easier and a more straightforward strategic choice to de-risk the investment portfolio rather than the underwriting portfolio

- No loss of core business franchise or client relationships
- No tail (so no legacy costs or capital charges)
- Near instant execution for traded investments



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 **LITMUS ANALYSIS**