Reinsurance News Monte Carlo Executive Roundtable

2019

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FOREWORD

Welcome to the first ever Reinsurance News Monte Carlo Rendezvous Roundtable, in which participants discussed industry disruption, the state of catastrophe modelling, and an array of key fundamental shifts currently taking place across the market.

With a wide range of challenges and drivers influencing the state of the reinsurance marketplace at this time, our panel was not short on topics to pick apart and discuss.

Conversation first touched on the reaction to record catastrophe years in 2017 and 2018, capital market behavior, and whether the changes currently taking place are structural or cyclical.

With technology's role constantly expanding and evolving, participants discussed how the barriers to entry and exit to the reinsurance market are being altered, as well as the way underwriting decisions are being shaped.

Also touched upon was the way market psychology and collective assumptions in the face of catastrophes influence sector behavior.

Looking forward, the panel considered how these transformational drivers will affect specific markets like Lloyd's. With the world-famous marketplace undergoing the biggest modernisation drive in its history, these steps could prove vital to its future success.

With significant global issues such as cyber and climate change still looming large, it will be interesting to see how the reinsurance market adapts to and copes with such unpredictable and volatile risks. It seems likely that collaborative efforts powered by bleeding edge technology and analytics will prove invaluable moving forward.

Steve Evans
Owner and Editor in Chief, Reinsurance News

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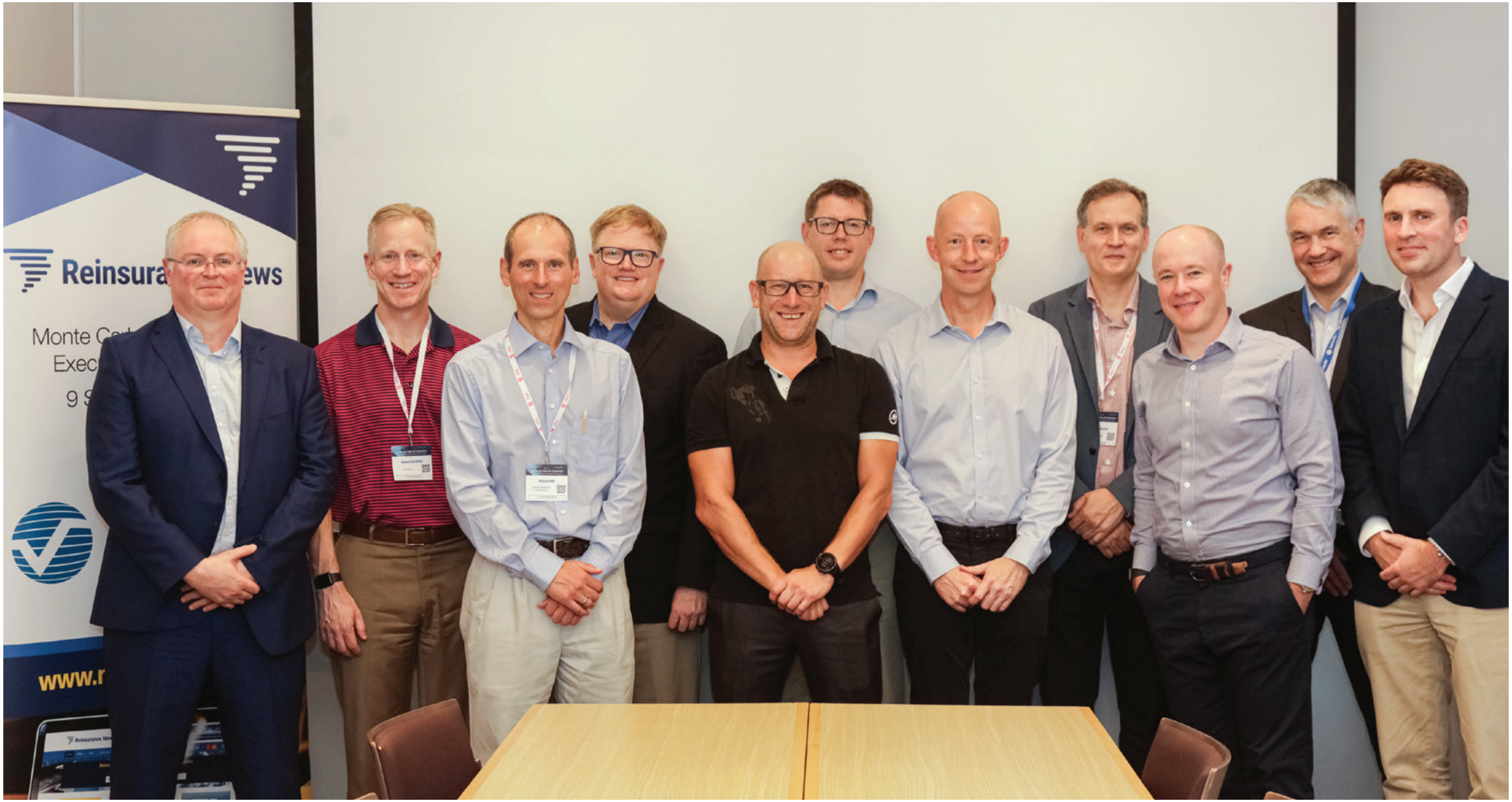

FROM LEFT TO RIGHT, BACK ROW:
Ed Hochberg – *Guy Carpenter*, David Flandro – *Hyperion X*, Mike van Slooten – *Aon Reinsurance Solutions*, Sean Bourgeois – *Tremor*, Mike Mitchell – *Swiss Re*, Darren Bailey – *R&Q*

FROM LEFT TO RIGHT, FRONT ROW:
Stephen Netherway – *Devonshires*, Michael Hinz – *Korean Re*, Tom Johansmeyer – *PCS*, Steve Evans – *Artemis*, Steven Beard – *RFIB*

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PARTICIPANT INDEX

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Mike Mitchell, Head of Property & Specialty Underwriting, Swiss Re

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Darren Bailey, Business Development, R&Q

Mike van Slooten, Head of Market Analysis, Aon Reinsurance Solutions

Stephen Netherway, Partner, Devonshires

STEVE EVANS

So, let's begin by talking about reinsurance renewals, current conditions, whether you feel the market has improved enough and expectations beyond that?

DAVID FLANDRO

I can tell you that in all seriousness, I think the reinsurance market is going through its most acute level of disruption since the wake of the financial crisis.

This is down to a combination of things, including the two largest consecutive catastrophe loss years ever in 2017 and 2018, both in real and nominal terms.

And with reserves, we are now starting to see as many net deficiencies as net redundancies on a weighted basis, and that hasn't been the case since the mid 2000's.

Then there's what's happening in the capital markets in terms of the reaction that we had at the end of 2017 and 2018 versus 2018 to 2019. There was an obvious change in the way capital flowed into the sector. For third-party capital providers, when you look at the non-correlative aspect of cat versus the expected return on cat, it is just isn't as sexy as it was back in 2012 or 2013. It's nothing personal; they just aren't pouring into the sector with progressively higher levels of investment in the way they did before.

David Flandro – **I think the reinsurance market is going through its most acute level of disruption since the wake of the financial crisis**

You add all of this up and reinsurers have one lever left to pull, and that's price. We saw that at 1/6 and we will wait and see what happens at 1/1 2020, but it won't be until next year that we will start to be able to see whether what's happening now merely cyclical or whether it's secular and structural.

TOM JOHANSMEYER

You look at a market that's 400 years old, 400 years of tradition unimpeded by progress and eventually somethings got to change.

STEVEN BEARD

I would say the changes are structural and will require different business models, talent and flexible capital to address. Those waiting for a hard market and a contraction of capital will be disappointed in the coming years.

MIKE MITCHELL

I think what we have seen is a somewhat slavish enthrallment to the cat model. I've been a massive proponent of the need to understand and underwrite risk in the most sophisticated and technical way possible. I do think that the loss experience that we've seen has started to test some of the assumptions of those models and have generated some dramatic learning experiences for capital and individuals that are new to the space; specifically how much variation there is between modelled loss and actual loss outcome from a client by client perspective.

What I anticipate seeing is a much stronger return towards a more technical basis of underwriting so the models are used in the way they were designed, which is to be supportive of sound underwriting and to be one part of the overall underwriting process, rather than replacing it.

Mike Mitchell –
I think what we have seen is a somewhat slavish enthrallment to the cat model

DAVID FLANDRO

I think it's an excellent point, the models are a tool, a common language; they are not the whole answer and they require the feedback and underwriter scrutiny using learned experience.

STEVEN BEARD

I'd agree, there is an over reliance on models and risk management. Underwriting's entrepreneurial roots and risk-taking means that there is too much capital chasing marginal returns. There are still break-out returns for risk-takers and innovators.

SEAN BOURGEOIS

While Tremor isn't in the business of pricing risk portfolios directly, it's my impression that the major cat models do a good job with sparse data - but as the data is sparse to begin with cat models can only be so accurate for a given year. I also believe the market overall accounts for the high standard deviation of expected loss data when pricing property cat treaties.

For me, the cat models when properly used deliver a really rich and robust picture of loss distribution. As long as you are building a diversified portfolio with a clear understanding of how adding risk contributes to your portfolio, changes the shape of your portfolio, your tail risk exposure, etc., cat models can take you very far - and capture the lion's share of technical underwriting considerations probably better than people can.

MICHAEL HINZ

The model output is pretty much looking at the same data but the conclusions we've seen in the last three or four years were surprising in a sense that model outcomes might have been overridden or internally re-calibrated to meet market prices.

Sean Bourgeois –
For me, the cat models when properly used deliver a really rich and robust picture of loss distribution

I think what we've seen in the last year was return on equity which has been reducing from year to year for various reasons, especially low interest rates, rate erosion, drying out reserve redundancies, loss creep and large non-modeled losses.

I'm really quite optimistic that the market now feels a certain need to continue what was started around a year ago and that we draw again more technical conclusions from the model outputs.

Ed Hochberg – **Somewhere in the future there will be a big loss that recalibrates everything**

ED HOCHBERG

I've asked various people at the conference so far what year it feels like, and almost to a person they've said 2000. It feels very much like we've come after a time where we've had a run of property losses as well as everyone realising that actually their reserves weren't so redundant and starting to see things like social inflation creeping back in and reminding everybody that actually this casualty business has a tail to it and the assumptions you make at the outset can't necessarily withstand underpricing for a long time. So it feels like that and it feels a little bit like the way the market was responding back then, too.

Somewhere in the future there will be a big loss that recalibrates everything and that's typical to the market. But right now, I think the market is responding the way you would hope it would, I don't see any knee jerk reactions or massive withdrawals of capacity. The underlying rates are going up, that helps, there are increases but the increases aren't put at a point where it's starting to scare buyers away. The trouble with a truly hard market is that buyers learn to do without and then when that happens, they don't come back.

MIKE MITCHELL

I completely agree, it's a question of sustainability and ensuring you have a sustainable value proposition in your product which is valuable to both counterparties. The reality is that the amount of capacity available in the marketplace has driven rating in a number of areas, and terms and conditions let's not forget that, to unsustainably low levels. What I think adds to the gentle pressure we had in 2000 is how we're at an unbelievably low level of yield and that systemic difference has a double-edged effect. Our need to make underwriting profit is even more enhanced than it was in 2000, so from that perspective I do feel a greater sense of urgency.

STEPHEN NETHERWAY

What struck me this year was that there was a real drive to improve pricing across the market. Particularly, people want to make pricing reflective of risk, which will mean that some risk classes and regions will see more of a hardening than others.

DAVID FLANDRO

This is a completely different market now than the one of 18 months ago. All lines, not just reinsurance but energy, marine, aviation, property and casualty are bouncing off the bottom. The question is whether the longer-term decline in rates is cyclical or structural. If it's been cyclical and the factors driving this new upward phase of the cycle are significant, then we're going to move back up and stay there for a while. But if the structural changes which drove rates lower between 2013 and 2017 remain in place and there's nothing more to counteract them, then we're going to bounce along the bottom. That's the question we have to answer. We won't know the answer for another year, but it will become evident as we go through this next stage.

STEVE EVANS

Do you think it's also timing? For example you're seeing reserve deficiencies, issues in a lot of casualty lines, and a low rate environment as well. It seems like a lot of things coming together at once?

DARREN BAILEY

From a casualty perspective it is perceived that the class of 2019 underwriters hide behind their actuaries and for property natural catastrophe the market has become far too reliant on models. Whether that's true or not, the next generation of underwriters need to embrace innovation, but certainly not solely rely upon benchmarks and technology to underwrite their portfolios.

DAVID FLANDRO

Are we just going to go back to a normal economic cycle where all of a sudden we have 3% inflation in Germany? Or is there something structural that's happening where we're never going back there again? Really, Western Europe is now turning Japanese, as it were, in its demography. Unless something really changes in the global economy we could have disinflationary interest rates for a very long time. I made the mistake 10 years ago when analysing industry reserves of assuming yields and inflation in the West would eventually return to historically normal levels. They haven't.

ED HOCHBERG

I think we're often biased in thinking that the way things are today is the way things will always be. I think the amplitudes of the cycles get gradually pushed down and one of the reasons for that is if you look back at the reserving crisis that existed in the late 90s, part of the issue was very poor information. You thought as an underwriter you were taking on an exposure equal to ten but actually the underlying exposure was 15 because the information related to the underlying exposure units was so poor and you were making such a guess. You actually had to correct for the fact that you didn't have the right starting point. I don't think we have that problem today; the information flow is much more transparent and we also have other forms of social inflation that are worrying and it's those things which are causing the change in the pricing cycle.

DAVID FLANDRO

I don't think that 3% interest rates are coming back to Europe, not during our working lifetimes at least. But there are new, non-core, emerging inflationary factors that are going to affect casualty and there will be no yield to compensate for that.

ED HOCHBERG

There's no advantage to holding on to liabilities anymore, there used to be a time that holding insurance liabilities was something you wanted to do.

STEVE EVANS

So in this environment where you're getting pressure from both sides of the balance sheet, there's obviously a need to get as much as they can out of the risk, is that what's instilled more determination in rate discussions?

MIKE MITCHELL

I think systemically, whether it's a cyclical or a structural shift in the marketplace, the reality is that the capital that has been deployed hasn't been making returns that justify the volatility of the underlying business we're in. What we've seen is a slow bleed into that realisation, driven by individual pockets of loss activity. So, while there's clearly a need for a broader reset across the system, in the absence of a loss trigger it's becoming pretty hard for underwriters to drive rates into a sustainable level of profitability.

I was actually talking to someone recently within the energy space, which is clearly a space where the practitioners in the market are saying that pricing has come down too low, but there's no losses so it has been one of the best performers in terms of classes of businesses. I think we're going to see a continuation of responses to underestimated loss and that new loss information coming into the system will create a step of gradual rate improvements in classes of business that are under stress. Whether that combination is enough to outstrip the pain that triggers the activity is probably

the key question, because if it's not and we're relying on rate movements to be preceded by something that's eroding profitability, it's going to continue to be difficult for us in the industry to make a sustainable return.

TOM JOHANSMEYER

Jebi's a great example of something nobody was thinking about 18 months ago. Once you solve the Jebi problem, there's the Adnoc problem, and the Jubile problem, and as an industry we have to get our act together around consistent real flow of actual information otherwise you're going to keep relying on whispers and gossip. It's not just an issue of development going out of control, be it in Japan or Florida, it's also the flow of mis- or dis-information which influences the release of collateral, which impacts the amount of capacity that's in the market.

DAVID FLANDRO

Having monitored as much information as I can on the development of Irma, Maria Harvey, Michael and Jebi, it seems to me that it's not just a data flow that's causing the problem with trapped collateral it's the underlying factors like AOB and lack of loss adjusters.

ED HOCHBERG

I always wonder whether we'll get to an agent-based modelling approach where you overlay a loss in a place like Florida and what really happens. The models have a job as a common language but what they don't do is say what really happens when you have a category 3 hurricane slam into palm beach. Like we saw when Sandy hit, when you don't have power, you don't have fuel, civilisation breaks down, basically.

MIKE MITCHELL

The ingredients are different but what I've started to observe is that, particularly in the catastrophe situation which is very widespread and systemic in terms of the impact, the large events are the ones which seem to have the biggest deviation from expectations, and in every loss that I've looked at it's a different situation. The ingredients of how that tail of experience emerges are all different but there seems to be a common theme that suggests we have an underestimation bias towards the really large events.

TOM JOHANSMEYER

I think we need to talk to social scientists in this industry a lot more than we have been. We have no idea what rain or flood or rocks falling through the sky does to humanity, and these are things we need to understand better.

MIKE MITCHELL

I think you're absolutely bang on, Swiss Re has always talked about the four-box underwriting model for cat models. Now the latest thinking, at least from Swiss Re's perspective, takes it to the fifth box: what are the intangible inflation factors, the intangible loss drivers; these things appear to be an increasingly significant proportion of loss activity.

MIKE VAN SLOOTEN

I think there has been a structural shift. One of the challenges for the industry is that the lower the interest rates go the more capital seems to enter our sector. There is a lot of capacity out there at the moment and if we get into a recessionary environment and interest rates continue to track lower, assuming we work though some of the issues that have emerged over the last couple of years, over the long term you're going to see even more capital coming into the industry.

Tom Johansmeyer –
I think we need to talk to social scientists in this industry a lot more than we have been

SEAN BOURGEOIS

I definitely think it's a structural change. For me why it's a structural change is that it's really moving the market from risk selection to sophistication of portfolio construction. For capital providers that are really good at portfolio construction the benefits you get for completely uncorrelated investments are amazing, and they have a lower hurdle to get over in terms of their target. Tremor operates a marketplace, I'm not actually pricing the risk itself, but it's always a curious thing to me that if you have a predicted loss distribution and you have a loss that's in the catalogue, why should rates go up?

ED HOCHBERG

There's a market psychology which really is the overlay and we sometimes forget about it. When there hasn't been a loss in a while, the market psychology relaxes and it starts to act like that loss isn't going to happen again, until it does, and then suddenly it's always going to happen. Now there are people pricing Florida like we're going to have a hurricane every year, but we didn't have one for ten years and people forgot that actually that shouldn't happen. So that market psychology is the reason why what you said shouldn't happen does happen and that will continue.

TOM JOHANSMEYER

It's not just the insurance market, just look at cyber: for a long time all anybody cared about were breaches, then NotPetya hits and Maersk gets obliterated on their property program and everyone comes out and says it's not breaches that are the problem it's Business Interruption, then not even six months later Mariot is hit and all of a sudden the focus goes back to breaches. It is a primal market psychology.

MIKE MITCHELL

The barriers of entry and exit to our business have been structurally altered by the financial technology that's represented by ILS. I think the sensitivity of that capital to avoidable error has to increase as experience comes through. What I hope to see is a stronger definition of generation of alpha value in that portfolio management structure because it's critically important to get as close to the predictability of risk outcomes as you can when constructing a portfolio.

STEVE EVANS

What do we think these transformational challenges we've discussed affects specific markets, Lloyd's for example?

MIKE MITCHELL

I think what I've observed in Lloyd's over the last couple of years is that, while for everyone involved in the process it has been quite painful, it has been fundamentally healthy. The decile 10 review process, trying to identify where the portfolios and segments are that are not generating value and the process of reducing the amount of capital that is deployed into those segments has had a very beneficial effect in bringing some of those market segments back into a more sustainable proposition.

In some areas there's still more work to be done, but to me if Lloyd's continues on the track of actually steering capacity towards businesses that are demonstrating their capability to deploy that in a long-term sustainable way, and generate real shareholder value I think that's going to cement Lloyd's place in the discussion.

Steven Beard –
I think Lloyd's will prosper if it focuses on its historical strengths

STEVEN BEARD

I think Lloyd's will prosper if it focuses on its historical strengths as a market of last rest resort and a leader in highly specialist and innovative risk transfer. Its cost base is misaligned for commodity and fiercely competed for business.

SEAN BOURGEOIS

Lloyd's as a marketplace is now embracing its biggest modernization push ever. Almost half of the initiatives include introducing forms of electronic trading. I think everyone knows that Lloyd's is going to look really different in a few years' time at this point. We are in the very first innings of what has happened broadly in financial services, but the game has definitely started for re/insurance.

In Tremor's view, Lloyd's will continue to be an important market and it will adopt many of the initiatives outlined in its blueprint and as it does it will likely look and operate quite differently from today - we believe that it will need to be welcoming to technology companies that are fast, nimble and very good at building software vs. trying to build and own everything themselves. We're looking forward to working with the corporation as it embarks on this journey next year.

ED HOCHBERG

I think over the course of the last 350 years the epitaph of Lloyd's has been prematurely written several times and I would say that this feels no different to me, Lloyd's is at a bit of a crossroads but they've been at worse crossroads and has always somehow managed to reinvent itself to demonstrate the value in the marketplace. It is a high-touch high intellect marketplace and almost by definition it's a higher cost environment, therefore commodity business doesn't fit well within Lloyd's. It's expensive because you have to high smart people to make it work. I'm pretty bullish on Lloyd's in the long run, it's good to take stock and ask yourself some serious questions, but I would not bet against Lloyd's.


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