Winter 2019

THE INSURANCE Insider

BERMUDA ROUNDTABLE 2019

Through the looking glass

With Lloyd's having ventured down a rabbit hole of reinvention, does Bermuda stand to benefit?

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Feeling fractious

Bermuda has certainly been a hotspot of activity in recent years, with the island bearing witness to numerous mergers and acquisitions, start-ups and closures.

The island remains a destination of choice for many looking to establish new (re)insurance businesses, while it continues to be the pre-eminent domicile for both captives and the ILS industry.

That it remains such a hotspot for the ILS market, even when faced with aggressive competition in the wake of newly minted rules and legislation in jurisdictions such as the UK and Singapore, is testament to Bermuda's regulator as well as those on the island who are widely regarded as innovators and pioneers.

At the same time, Bermuda continues to be the go-to destination for property catastrophe business, and it has enjoyed even more success due to the difficulties and shifts taking place in other (re)insurance markets in the world such as Lloyd's and the US.

These topics are just some of the points of discussion that came up during a roundtable that *The Insurance Insider* hosted in partnership with Lloyd's Bank in Bermuda at the start of November.

Other topics that came up included the dislocation that has occurred in the wholesale market between client expectations and carrier's aspirations.

With risk managers struggling to take on board the reversal in pricing as a hardening market gathers pace, brokers are under the cosh to both sell rate increases and continue to articulate the value of the reinsurance product.

Meanwhile, in the ILS market, trapped capital – or 'trapital' as it is fast becoming known – is a continuing issue, while loss creep from 2018 events continues to concern existing and prospective investors in the space.

But of equal concern to the industry currently is the growing crisis in the casualty market, with social inflation threatening to overwhelm carriers who haven't sufficiently reserved for the rising tide of claims.

That said, it's not doom and gloom for every sector of the market. The legacy segment has a huge opportunity, with continuing remediation in Lloyd's and re-underwriting of portfolios in the company market.

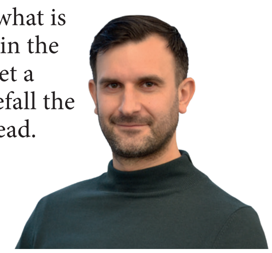
As Premia's Scott Maries notes: "Outside Lloyd's we've only seen the tip of the iceberg in the US."

Elsewhere, as reinsurers contend with rising retro prices alongside the above challenges, the industry as a whole is seeking ways to make conducting business more efficient.

For some this implies withdrawing capacity from volatile business and diversifying into areas with better returns.

For others it involves divesting themselves of entire segments in order to concentrate on core business. And the issue of which technological innovations are likely to improve underwriting and distribution models is as keenly debated as ever.

Read on to discover what is exercising participants in the Bermuda market and get a glimpse of what may befall the industry in the year ahead.



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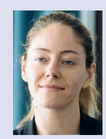

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Bermuda
Roundtable 2019

Christopher Munro
Welcome to this Bermuda roundtable. The first question is how would you describe the state of the global wholesale, specialty and reinsurance markets?

Ben Savill
Whether it's dislocated or dislocating, it's certainly fractious. There's a realisation of the gross-to-net leverage and how heavily geared entities have been across the most recent five or perhaps even slightly longer than years or so. The questions that are being asked by heads of ceded re and other trading partners as to how those gross lines are managed and what that net-line position looks like are questions that, as we start to get to those more fractious discussions, are becoming more prevalent as people understand that gross-to-net position.

"In the wholesale world, there's a dislocation in terms of client expectation and what the market is doing managing those messages"

Chris Bonard

Chris Bonard
In the wholesale world, there's a dislocation in terms of client expectation and what the market is doing managing those messages. Risk managers are still struggling with a change in the prices that have been delivered to them. In the retro market, we'll see what happens this year. It's definitely going to have some change, whereas the reinsurance market seems to be somewhere stuck in the middle.

If you look at the US, that's a different story to Asia. There's an abundance of capacity out in China for local business. And we're starting to see some influx of that coming into our marketplace. It is a market that's going through flux.

Anup Seth
From Aon's perspective the direct market is firming, particularly on the specialty side. You look at Lloyd's, combined ratios north of 100 percent in both 2017 and 2018. Then when you look at the retro market, that is hardening – certainly on the back of the 2017/2018 losses. Something like over $200bn of insured losses in those two years and then we've got the typhoon again in Japan, Californian wildfires this year. We're expecting a tough renewals season when it comes to the retro market. The reinsurance market is stuck in the middle. That bow-tie shape is what we're seeing. There's a big crunch in the middle and those rates should move so that we can have some level of underwriting profit within that sector.

Andre Perez
From an ILS perspective you have a few forces that we're dealing with. One is the trapped capital, which has been an issue for the past couple of years. We now have the Japan typhoons, we have the Californian wildfires, we've had a couple of hurricanes. That's an issue that seems to be compounding a bit. But investors are better understanding the mechanics.

We have some capital flowing in and it's been very divergent. Some existing funds have been able to raise a lot more capital, while others have had a real struggle to raise money. So it's not uniform but we're seeing a couple of new retro funds and vehicles being set up to capitalise on that capacity. It's going to be a very interesting renewals season.

Tom Horrell
It feels like there is enough capacity in the reinsurance market that everything will get placed, although across many classes there will be price increases. In the retro market, there's going to be a point at which some companies will choose to retain risk. ILS funds are suggesting that flat AuM to deploy at 1 January will be a good position, which means that they are focusing on renewal business first and new opportunities later.

Jeff Sangster
It hasn't taken an enormous loss of capital to shift a lot of the market. Three or four years ago, we would have said it would take hundreds and hundreds of billions of dollars of industry loss because the industry is overcapitalised by so many billions. Now we've had some big, but not market-changing losses, and we are seeing real change. The ILS market needed a shake out because everybody was making money in ILS for so long, it didn't matter if you were smart or lucky. Now there's been some differentiation. That's knocked on into the capital investors are putting behind the ILS managers. They're pulling it from pure cat plays, especially pure cat plays that have done poorly, and redirecting it into more diverse insurance strategies. Capital has shifted more quickly and in a lot more ways than we'd have predicted in, say, 2015.

Ian Thompson
The elephant in the room is probably casualty. We're seeing significant rate increases in certain areas but it's going to get a lot worse before it gets better. We're hearing almost daily reserves strengthening across multiple years. It's such a huge cause of loss to the industry so that's a concern we have to address and it's going to get worse.

There's an acceptance that things need to change which wasn't there 12 months ago. That's why we're going to see those rate increases and that's the positive that I can take from this. But I don't think people are going to be making too much more money because we're going to have to address those reserves in the next year or two, or longer.

Christopher Munro
I'd be interested to hear from brokers about price increases. Are clients generally as accepting as they are going to be?

Chris Bonard
Definitely not. People don't want to pay for other people's losses. People in Canada aren't interested in typhoons in Asia and hurricanes in Florida. Every case has got to be managed whether it be risk-managed business, reinsurance-buying business, they're all interested in their own portfolio and what they spend.

Anup Seth
There are particular sectors of the industry where we are seeing some wholesale changes. Companies that have captives are utilising those captives as the "underwriters of choice". Aviation is a good example where, across the board, rates have moved and so we've seen a big uptick in the utilisation of aviation-based captives. That cliché that your captive is your underwriter of choice is coming back to reality, particularly as certain markets are hardening more than others.

Chris Bonard
If you take, say, US habitational risks, the real-estate investors have been using insurance as a maintenance product. That's got to change and it will change.

Christopher Munro
Looking at Q3 results there are still cat losses from prior-year losses, and other casualty issues are coming to the fore. Is there a sense of optimism though in the market?

"We're expecting a tough renewals season when it comes to the retro market. The reinsurance market is stuck in the middle"

Anup Seth

Bill Wharton
There's no sense of optimism on the underwriting floor and if optimism does rear its head, it's quickly dismissed at the next meeting with senior management. We're very concerned that inflation – social inflation, cat losses – is still outpacing rate increases and will probably do so for the foreseeable future.

Tracey Gibbons
Even if you get 20 percent, 30 percent, 40 percent rate increases they will be short-lived, because of the excess capacity in the market and the erosion of capital barriers to entry. It's the same model the industry has had all along; rates go up and more capacity comes in, it just comes in much quicker now due to the ability to raise just in time versus permanent capital.

Chris Bonard
It reminds me a bit of building up to 2001, there was all the talk about the market changing and people saying enough is enough but it took a terrible event to impact the market.

Jeff Sangster
It's going to be a good retro market at 1 January. There are several different groups trying to raise capital for retro who haven't got there. Over time it will happen, but it doesn't happen overnight. There are many pockets of opportunity for incumbents who have the capital to play.

"Both Lloyd's and the Prudential Regulation Authority are increasing their scrutiny of companies they think may be fudging the reserves"

Tracey Gibbons

Andre Perez
I hear there are massive rate increases on the casualty reinsurance side, or is that just street talk?

Tracey Gibbons
It's certainly not across all lines; it's in certain lines of business where there is an acceptance that change needs to happen. One of the big issues is the development of prior-year losses. Companies have become used to consistent reserve releases. That was how companies showed higher margins, they were making a small calendar-year margin, but enjoying reserve releases to increase their margin, supplemented with modest investment income given the low-interest rate environment.

Both Lloyd's and the Prudential Regulation Authority in the UK are increasing their scrutiny of companies they think may be fudging the reserves to ensure they are adequately reserved for past years, which might cause reserves to be pushed up.

In certain areas of the market there will be rate increases, but are you getting back to where you need to be? We've been getting 5 percent and 10 percent rate reductions for 16, 17 years now; a 40 percent increase doesn't get you back to where you need to be. In some cases you may need 100 percent or more.

Scott Maries
There is a lot of opportunity in run-off. There is a tremendous amount in Lloyd's because the various syndicates are trying to get their balance sheet shipshape for the next year, so that pushes a lot of deals into the market.

You now have a lot of parties in Lloyd's that in the past wouldn't have considered talking to the run-off market but are now considering such transactions. That is in large part because their core business is under stress. They can't necessarily get the rate they need on the inwards business so the way they make the maths work for their RoE is to get off their balance sheet reserves that are sucking up capital.

Outside Lloyd's we've only seen the tip of the iceberg in the US. US companies don't think of finality, they think of LPTs and ADCs and that's just fine for them. But when you have very well known, analytically minded brand-name companies getting caught sideways with reserving, you know the game is changing a bit.

We see a lot of opportunity across a variety of non-property lines of business – workers' compensation, general liability, commercial auto, professional liability etc. And we think the quality of the opportunities is higher than a couple of years ago.

Christopher Munro
With the amount of deals around, is that making the run-off market more competitive?

Scott Maries
The run-off market has fewer competitors than the traditional market, but it is still very competitive as run-off is a winner-take-all mentality – i.e. a run-off company takes 100 percent of a transaction, it does not syndicate alongside others. There are significantly higher barriers to entry than the traditional reinsurance market. For example: (1) there are few credible teams on the sidelines who are capable of raising capital, (2) run-off is infrastructurally intensive which takes considerable resources to build out, and (3) run-off economics are typically recognised over the life of a transaction, and as transactions are often longer dated this causes a more gradual incline in RoE.

Caroline Oehm
Could you see entrants that maybe don't know how to price those deals, and they're being mispriced?

Scott Maries
There's that in the existing insurance and reinsurance market. There will be some capital that comes in that gets it wrong because the run-off deals now are bigger and more complex. If you get it wrong, you're likely to get it wrong bigger and in a more extreme fashion than you would have done a few years ago. There were very few $500mn to $1bn dollar run-off deals a few years ago – today they are more commonplace.

Jeff Sangster
We're seeing that in life. There's private-equity money that all want to try and be Apollo and Blackstone chasing any kind of life deal. If you're trying to do an operational life deal where you want the operations, you're getting priced out because they're just chasing the AuM.

Caroline Oehm
So when does that blow up?

Jeff Sangster
It takes a while for that to come home to roost. I guess their maths is that they get AuM and they invest it because they've seen others doing it but they're not focused on potential operational challenges.

Christopher Munro
How long do you think the ILS and retro squeeze will last?

Jeff Sangster
Everybody believed retro was going to continue to be strong this year and now we've added Japanese typhoons. So you have to draw a line under that, when it is combined with loss creep and some investors taking a step back to reassess their understanding of how the market works and trapped capital works. It has scared off most of the investors that might step in on the opportunity. So it's probably takes a loss-free year, plus one. If we are loss free next year I don't think there'll be a lot of new participants at 1 January 2021. If you go another year, probably we'll see a little more.

Some traditional investors are having a rethink – they sold the board of their pension fund [on the idea] that they're getting insurance risk and the board was fine with that. They're now realising they have cat risk, and these are two different things. They're looking for the diversity that insurance risk brings and having a rethink. Those conversations and decisions don't happen quickly, so it's going to be slow-moving.

Tracey Gibbons
It's two things – continuing losses and then the loss creep from prior events and capital coming in to fill the void left by the reduction of ILS capital, plus the trapped capital. So either/or a combination of additional losses or development of prior years and the speed of new capital coming in to specifically write retro, could shorten the window or lengthen it.

Ian Thompson
The ILS market does spend on the relationships the individual carriers have with people who are going to replenish the pot. It's very different to the retro market which, in my experience, has been the first thing to go. It could be pretty ugly at 1 January because if you've got a choice of where you're going to put your capital, it won't be retro.

Anup Seth
We're seeing a more robust reserving philosophy, reserving policies, feeding into the valuation policies. So that's encouraging. On the investor pause, it's about understanding that real risk-adjusted return, especially in a low-interest rate environment. The discussions we're having with potential investors is: show us the distribution of the expected returns and what's my potential downside, what is the risk-adjusted return versus say a negative interest rate environment in Europe?

It's the relative return now. If you come up with a new fund with a relative return of 600 basis points above Libor, that is considered more attractive than it was three years ago.

The paradigm is changing as we're entering a period of economic slowdown and prolonged low interest rates.

Chris Bonard
According to a recent Morgan Stanley report, both bonds' and equities' long-term outlook looks poor. Eventually new investors are going to look at insurance given the amount of liquidity it offers and find a better way of doing it. Some of the perceived issues have been around transparency of what they're getting into. You're going to see different products unavailable and I would question how much worldwide agg will be left. If you look at the long-term outlook there's still a lot of capital around the world and it's got to find ways to invest and get those bps above Libor from different sources.

Tom Horrell
As a market we misjudged the size of Jebi; there hadn't been a wind loss like that in Japan for a number of years. From an ILS perspective, several funds were initially criticised by their investors because they went out with fairly hefty loss-reserve estimates. Those funds that were conservative, grew investor confidence over time and are now reaping the benefits as the capital flow appears to be moving in their direction.

You're going to start seeing some of the buyers become sellers. We're finding more rated paper markets are increasing their retro offering, and although it is not going to replace the quantum of capital that has left the market, been lost or trapped, it is going to have an effect on the amount of capacity available and the length of time retro is squeezed.

"If we are loss free next year I don't think there'll be a lot of new participants at 1 January 2021"

Jeff Sangster

"As a market we misjudged the size of Jebi; there hadn't been a wind loss like that in Japan for a number of years"

Tom Horrell

Ben Savill
In terms of the potential new entrants, the people who have been heading up these propositions are not new entrants. They have a long track record of doing this business. So if they can't get traction, or they've decided that they have to pull up stumps because they're not getting the investor traction, that tells you where we are. It's just investor confidence and questioning surrounding the returns which the managers' respective new funds are offering. There's too much variability around or they can't answer the questions with sufficient transparency or accuracy to alleviate fears from the investor base.

Andre Perez
We can't look at the ILS market as one monolithic market. Those who have been investing for a while are certainly a lot more demanding in terms of disclosure, transparency, independence.

For a lot of those pension funds and sovereign funds, it's a minute part of their assets that they're investing. This is not going to tip the balance and if they've made the strategic decision or strategic allocation they're probably going to continue. The ones who are probably leaving are those who were purely opportunistic and then first loss, second loss happens and they run for the hills. Then you have brand new investors, whether they're institutional investors, we're seeing family offices and some other sovereign funds we haven't seen before.

The loss creep and the trapped collateral were a learning process for them. Catco was a learning process for some of them. But you can't throw the baby out with the bath water; you need to look at what is the differentiation.

Christopher Munro
Have big losses from property cat events dented long-term confidence in the property cat class?

Ben Savill
It depends which side of the capital fence you're sitting on – whether it's rated balance sheet or ILS. You go through this process and it is influenced by the volume of retro that has been available historically, and understanding and backing those clients that have a greater trading longevity. They've been through the cycles of prior losses, they know how to navigate the respective legal jurisdictions in their territories, they understand the basis of the risk they're then transferring to you as a reinsurance partner.

We saw in 2019 in the 1 June, 1 July renewals within the Florida market, there was true differentiation between the carriers that performed better with their loss creep and have the infrastructure in place than those that have just traded off the back of freely available capacity. So that dented confidence, maybe. It's certainly made people more circumspect about the risk they're bringing on board.

Christopher Munro
How are incumbent specialty insurers and reinsurers realigning their businesses to be more efficient conduits of capital and risk?

Bill Wharton
I'm at the field level, where underwriters have more data. We get a lot better insight as to how our portfolio of risk is performing and maturing a lot quicker. So you can make changes on the fly. No longer can you hide behind a long-tail book and say oh, there's no development; oh, my goodness, year five has a lot of development. There's much better data but I don't think that it's particularly novel, technical or unique. It's just that it's there for all to see and you're questioned. You're challenged by senior management much more rigorously, quickly and frequently.

Ian Thompson
Incumbent is an important word in this question because it's a heck of a lot easier if you're playing your own hand. There are a number of new players who won't have that ability. So that's going to have an impact.

We're going to see more carriers looking for more balanced portfolios. You're seeing them already. The most obvious way you do that is by cutting your limit. So those days of $100mn, $150mn limits particularly on long-tail classes are gone.

We'll look for more balance. There'll be an element of stripping out classes within composite placements. Public D&O, do you want that? No. Well move it on to a distressed platform, because if it's polluting the greater whole I don't think you can have that.

People will have a more limited 1 January cat appetite. If the pricing isn't there, and it doesn't look like it's going to be there, people will look for other things.

Tracey Gibbons
A lot of companies are investing in technology. In Bermuda there's the new RICAP platform. It's a blockchain-based technology used to place business which is getting some momentum. That's going to cut out a lot of inefficiencies, and cut expenses by eliminating repetitive inputting of data at all the different stages along the value chain.

There's a renewed focus driven by small margins on the underwriting side leading to companies looking at their investment returns and to ensure that they're optimising returns from both underwriting and investments. With reduced underwriting leverage for rated balance sheets, all companies need to be total-return focused, whether they admit it or not.

The companies that will flourish in the next few years will be the ones that optimise capital and return on equity, and which will require the resources and skill sets to think more broadly than underwriting and investing in fixed income.

Outsourcing is also becoming a larger component as companies try to minimise fixed expenses and maintain flexibility.

Anup Seth
Companies are focusing on what is core and what is non-core. Anything that is non-core they're not just leaving it on their balance sheet. They're now calling the legacy companies and saying we'd like to get this off our balance sheets because it's a big drag on our capital. And we'd like to redeploy that capital to grow our core businesses.

Tom Horrell
We talked about moving away from cat and one of the points is diversification. We have found over several years in Bermuda that the type of reinsurance and retro opportunities we are working on have changed. Our pipeline used to be focused on cat and whilst cat is still the largest component, after all, in Bermuda we sit in the largest cat market in the world; we now have legacy, cyber, marine and energy and casualty coming through our Bermuda office as the reinsurance marketplace here has become more diversified.

Andre Perez
10 years ago you'd have a conversation with CEOs about starting an ILS platform, and it was like you're crazy, why would I want to do that? I write the risk and I like the risk, I want to retain the risk, I don't need the fee income. It's a shift of mentality from a lot of reinsurers saying there is a part that's going to service third-party capital and whether it's ILS, whether it's run-off business, we've seen a couple of the large players setting up run-off business in conjunction with the large institutional PE funds. They're much more open in diversifying that source.

Tracey Gibbons
I don't think there's such a thing as "alternative capital" any more. There's risk and there's capital that's going to come together in whatever is the most efficient way.

Scott Maries
We'd give a lot of credit to the broking community in developing the additional business that's hitting the run-off market.

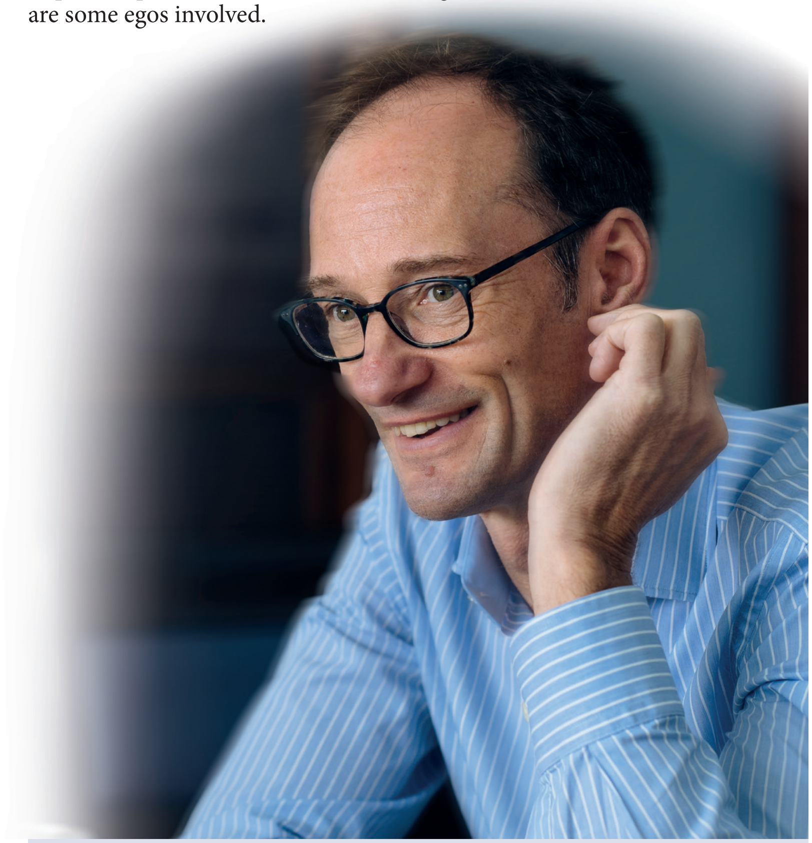
We have seen a big push from both the big three brokers and the more specialist brokers, to better educate their clientele on the benefits of run-off. It has led to more opportunities and better-quality opportunities.

Christopher Munro
What factors will drive M&A in 2020 and has the rationale for M&A changed in the last few years?

Chris Bonard
I read an article recently that said there's a freight train of M&A coming. It's not abating. If you now look at the big three, it's the big one with two and three behind. I don't see a change and the abundance of sovereign wealth funds or major family offices spending money. It's very buoyant and it will continue.

Ian Thompson
Things have slowed a little in the last few months. Whether that is a trend I don't know. We all know it's out there, the search for scale goes on. The problem is that so many of the good ones have been taken and those that remain might not want to be purchased.

The stock market has a massive play on this. It's been hugely inflated; that's changing a little bit so that will have an impact on prices. The bar has been set high as well and there are some egos involved.



"There's significant diverse capital for debt investment, not just investors in the ILS space"

Richard Askey

"The Lloyd's market is full of pessimism, while the domestic market has much more optimism – the answer is somewhere in the middle"

Ian Thompson

You see it at 2.5 times multiple and I want three. I suspect the rationale hasn't changed: big is beautiful and the ego factor is going to have massive play. There will be significantly more to come, particularly if the market continues to show good rate rises.

Anup Seth

If you look at the significant amount of long-tail reserves just within Lloyd's waiting for a home, we'll continue to see more run-off companies buying Lloyd's syndicates to facilitate reinsure-to-close (RITC) transactions.

Ben Savill

There is more coming from a corporate M&A perspective but also there are a lot of very good teams who are quite disenfranchised in their respective operations. So rather than go M&A for the corporate position, it could be cheaper to pick up those teams and bring them in, and you don't have all of the noise that comes with a larger corporate acquisition.

Richard Askey

I've got more opportunities on my desk which are relevant to Scott's world than anything else currently. A number of varieties, some linked to Lloyd's transactions with partial break-ups and others with brand new investors as examples. The other aspect I would mention about M&A and capital markets currently from our perspective is that there is strong demand from debt investors.

Despite the fact that there's been a significant number of catastrophes, some of magnitude, we undertook subordinated debt issuance for a client in September, right in the midst of all this. A market-leading name, but they achieved a tighter price than expected and were around five times oversubscribed. It went out to a more diverse investor base, both in terms of geography and entity. These included private bank, high-net-worth investors. Granted, it is a top-quartile name, but interestingly while there was focus on catastrophe activity, they were probably more interested in the yield and the quality of that business. There's significant diverse capital for debt investment, not just investors in the ILS space and so forth. It will be interesting as we move into 2020, to say the least.

Tracey Gibbons

Although we've seen a lot of consolidation, it's encouraging to see the re-emergence of the boutique brokers enabling an element of choice and to service the niche areas. The Capsicums, Tysers, Eds, Beaches and the McGills of this world building up their brand is encouraging. The large brokers have a lot of leverage and resources, but competition will drive creativity and deliver value, which will benefit clients, capital providers, and ultimately the broker market in the end.

Christopher Munro

I imagine there are probably some opportunities coming out to Bermuda that have potentially gone to Lloyd's in recent times. Bill, are you seeing more business coming to Bermuda?

Bill Wharton

We're seeing quite a bit of business coming to Bermuda. It has to be business that we find acceptable. Sometimes we go back to the broker and say is your client aware of and will they be accepting of Bermuda rates. Compared to what they got invoiced last year, don't look at it as a rate increase, look at it as that market is no longer able to support you and this is a new world.

And also on the insurance side, a lot of our books are 80 percent to 90 percent, 95 percent renewal books so we're looking at that client on more of a relationship basis. Is this going to be a client that we're going to have five years from now, 10 years from now, because most of our clients we've had that long. We're not jumping in on 'oh we can get a high rate this year and we expect that business to go away next year'. That's of no interest to us.

Ian Thompson

It feels like Lloyd's is being hard on itself. If you go to the Lloyd's market, it's just full of pessimism, while the domestic market has much more optimism, and the answer is probably somewhere in the middle.

Lloyd's is a looking glass. I always feel it has about a year, to a year and a half head start on some of the domestics because it's self-regulating. I wonder whether all the pain that Lloyd's is being very public about at the moment is going to come out in lots of other places in the near future.

Christopher Munro

That might be as good a time as any to come to an end. Thank you very much, everybody.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