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“Global Trends of the Reinsurance Market”

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Ladies and Gentlemen

Good Morning


When I was asked to talk to you on the occasion of this meeting, it was a pleasure and honor for me to accept this invitation.
Introduction

• Firstly because in times of fast moving inter-dependence of markets a regular and intensive dialogue between regulatory bodies and the insurance and reinsurance industry is indispensable for guiding markets towards stable growth.

• Secondly: China has been a most important trading partner already before its access into WTO and is now a member we all do not want to miss. My company, the Munich Re, attaches great importance to a long-lasting stable development of the Chinese insurance market. Therefore, I am very much looking forward to a lively and beneficial exchange of views during the 2 days of this meeting. Let me also thank the CIRC and OECD to join forces and organize this important event again!
In the *first part* of my presentation I have picked a few trends (of short term and long term nature) which appear to me essential for describing past as well as prevailing developments which led to the present state of affairs of the global reinsurance market. I will also risk to look ahead to where we may go from here.

In *parts 2 and 3*, I try to build a bridge to the Chinese market, high-lighting some thoughts which may hopefully help to kick off and fuel a lively discussion amongst all participants during the 2 days here in the beautiful city of Suzhou.
**Part 1: What has happened – happens – may happen?**

*Trend Cycle 1:*

As a consequence of unprecedented high nominal and real interest rates (over the past 20 years) the income of insurers from investing their underwriting reserves grew to unexpected dimensions. The reserves, particularly in liability insurance grew faster than in the lower reserved property insurance. This trend changed the balance between underwriting results and the investment returns and had considerable impact on our industry’s business:
• Insurers could incur higher negative underwriting results but still showing positive operating results. Underwriting results almost everywhere developed permanently negative with combined ratios for above 100%.

• To increase the bottom line by writing as much business as possible resulted in insurers and reinsurers increasingly neglecting line profitability in favor of across the board overall profits (after costs and investment returns and after reinsurance or retrocession).
More than before, higher or lower investment earnings potentials of different classes of insurance decided upon how much to retain or to reinsure. Highly reserved -after investment income - still profitable lines where retained, lines not profitable - after investment income - were reinsured.

The likely investment income from a reinsured portfolio has increasingly been taken into account for reinsurance pricing.
In view of the over weighing – beyond an acceptable level of prudent business conduct? – of investment results as compared with underwriting results, the focus was put purely on “operating (results) cycles” for guidance as to where the industry stands. This judgment was supported by the fact that soft downward cycles turn only hard once operating results, not just underwriting results, become negative.

Since the cyclical (underwriting) downward phases became longer, upward underwriting cycles shorter, whilst operating result cycles still stayed positive the policy to focus on one parameter – investment returns – became the trend of the last decade.
With the *shareholder value concept* firmly in place the management of global reinsurers (and insurers alike) are under at least quarterly (USA monthly) observation of shareholders and the capital markets to guarantee that positive operating result cycles will be sustained to meet their annual and multi-annual return on equity expectations.

*The pressure on the reinsurers/insurers managers, is of course, rising, once measured against the benchmark of alternative investment options for shareholders on the capital markets, and once upward operating result cycles are not strong enough to generate the RoE expected by investors.*
Subsequently it is easy to understand why after at least a decade of an extremely soft underwriting market cycle - increasingly downward, even negative operating results - the financial safety and security of a whole market is about to lose balance (*unless* …? Consequences are drawn).

It was obvious that the sudden implosion of the capital markets with depreciated assets of a magnitude never experienced before and eventually the tragic September 11th event – to which I will revert later – had quite dramatic consequences for the reinsurance industry.
The drastic reaction taken by global reinsurers during portfolio renewal to re-underwrite their portfolios gearing towards a longer-lasting, upward underwriting result cycle (long-term trend? – yes) should be a healthy measure for the global insurance community as a whole.

At the same time, global reinsurers will sophisticate their return on equity objectives (risk based capital allocation models) to cope with the increasing challenges to financial management and control. Risk-based-capital-oriented models are increasingly used in the reinsurance industry to gear portfolio strategies towards an optimization of return on equity targets and market segmentation.
**Trend Cycle 2:**
The second fundamental phase, by now lasting almost a decade and accelerating during the last few years, is globalization, bringing about rapid changes and challenges to the insurance and reinsurance industry in the long-term. “Risk”, “frequency” and “accumulation” are concepts that have taken on a new quality:

- Up to a few years ago the need for reinsurance was increasingly questioned, one of its core-functions - to balance fluctuations by spreading risk - appeared to be doomed towards extinction due to the ever-increasing capitalization of primary insurers.
Mergers/acquisition increased the capital base and thereby the retention levels of global MEGA insurers. The latter of which on the one side eroded the spread of reinsurers’ client base; on the other side, primary insurers reinsured more and more anti-selective, high risk and volatile segments of their portfolios.

- Portfolio optimization geographically through global operations is achievable as regards catastrophes. However, portfolio optimization through geographical diversification was becoming difficult. The interdependence of growing economies produces increasingly parallel developments of truly global classes of business with global cycles, but also impacts parallel cyclical behavior of classes of more local character. Therefore, in many fields
reinsurance is behaving cyclically in a global way which makes the balance over markets less likely or feasible.

- Due to e-commerce distribution complex risks might be purchased/offered in the future amongst global risk partners (captives, insurers, reinsurers) directly.

Reinsurers are subject to smaller risks are reinsured to a lesser extent – reducing the advantage of the larger number principle. On the other hand, large risks on which an increasingly larger number of mega direct insurers compete, not necessarily continue to be offered by the insured but through their captives also to reinsurers directly. Therefore, international reinsurers operate increasingly client-segment oriented in their strategy to offer products and services.
**Trend Cycle 3:**

Another important phase is brought about by the rapidly progressing liberalization in the wake of deregulation in the financial services industry and markets as a whole. Whilst regulatory authorities worldwide understand the global approach of reinsurers, deregulation in the sense of freedom of reinsurance has always existed - with a decreasing number of countries still requiring from reinsurers licenses, deposits or minimum local investments:
• Deregulation also in the direct markets today, in the wake of WTO, amongst others allows consumers to benefit from increasingly free pricing and unrestricted product designs. However, competition reduces profit margins of insurers, at the same time erode their ability to absorb fluctuations in their results, and increases reinsurance demand to generate optimal results for shareholders and capital markets. The market economy principles to which deregulation leads, is therefore an environment conducive to reinsurers.
In a deregulated market insurers pursue their very individual strategy irrespective of the interests of their competitors which has implications for underwriting and operating results. These market economy driven characteristics produce another significant consequence: Reinsurers’ pricing increasingly detaches from general market rate levels and focus on the assessment/pricing of the specific risk segments reinsured by direct insurers.
Deregulation of any trade such as insurance in the overall context of financial services (Banks, Securities, Insurers, Reinsurance ..) means that traditional border lines amongst industries are blurred. The convergence of the markets have only just begun and the developments are too complex; but investors are potentially interested in diversifying their investment risk as a means to optimize returns. Reinsurers have understood that potentially the capital markets will provide at least supplementary protection for risks that are very large.
Allow me to make a view remarks on New York September 11th, 2001:

The impact of this tragic event was not only a catastrophe in terms of loss of human life. It also made transparent the new orders of magnitude when it comes to risk assessment. When you consider that frequency is as yet an unknown variable, then the challenges to our industry are clear. In the context of this tragic loss it has to be mentioned that the global financial system has been tested as never before. As the managers and carriers of risks the global insurance and reinsurance industry is of course in the front line and the impact with insured losses of potentially US$ 60 bio. Or more are no small matter, even for the global network of insurers
and reinsurers. Large global reinsurers include loss events of even greater magnitude in their risk models which, however, does not imply that it is “business as usual” but to immediately address these new exposures. Companies and Governments are really put to the test when particular risks are by their nature uninsurable/not re-insurable, or when it is impossible to achieve a balance of risks by spreading liabilities geographically or otherwise. Therefore, professional reinsurers, as business people, must take primary responsibility for monitoring developments in their markets closely and for reacting to them in the proper way.
As a result also of this loss but also as a consequence of the implosion of the capital markets and immediate enormous depreciation of assets, the last important trend I like to highlight is the flight to financial security & quality.

The inherent volatility of reinsurance business has up to now been compounded by more severe loss trends as well as swings in the financial markets which makes it imperative that insurers increasingly treasure again financial security & quality. Aspects such as the reinsurer’s overall standards – see below-

- standing in international reinsurance
- experience and expertise
• quality, reputation and integrity of management
• technical and management skills
• stability and continuity
• corporate responsibility and corporate structure
• legal and economic background in its country of origin
• sound investment policy
• asset/liability matching

become again important also for regulatory authorities. On top the reinsurer’s attitude to reinsurance business – see below -
• professional conduct of business
Flight To Financial Security And Quality

- general market behavior and services rendered
- risk responsibility and retention policy
- suitable spread of risks
- due diligence in underwriting

is measured too.

That is why looking at the development of reinsurance today, the 4 top reinsurers increased their market share to approximately 35% (1990: 22%).
As a result of the aforementioned a conclusion with regard to the immediate and most likely long-term development of the global reinsurance market could be drawn/risked:

- Even major (MEGA) global reinsurers cannot provide their risk capacity, more specifically their capital, at lesser conditions than other capital market players; to the contrary: reinsurers due to the nature of the increasing volatility of their business need more risk capital and therefore have to achieve even higher returns to attract their shareholders.
Significant upward price adjustments in the future will be necessary to maintain profitable, longer lasting underwriting result phases to cater for the permanently increasing high risk exposure in reinsurers’ portfolios. (For instance for natural catastrophe coverages the PMLS for a whole range of accumulation zones worldwide now amount to several times the figure upon which price calculations were based just a few years ago.)

The growing volatility in the portfolios of reinsurers will force change and along with dramatic shrinkage of retrocession capacity reinsurers have become net underwriters of risk. This will call for the need to diversify into other types of business to allow successful balance of the exposure.
Strongly advocating the view that the reinsurance industry performs the function of risk assessment, risk management and risk carrying in a most efficient, capital saving way, new risk modeling tools will be developing, at the same time supervisory regulations will have to be adjusted to assure that a truly free trade and function of reinsurers as the ultimate risk managers can be maintained.

The reinsurance industry is second to none in terms of expertise in identifying and evaluating risk, in loss prevention and minimization of risk as well as risk financing. There is very good reason to believe that the global insurance and reinsurance industry will be able to continue their superior role of risk managers for commerce and industry, eventually for the global society.
Parts 2 & 3:

Let me now risk a few comments on the future of the Chinese reinsurance market and the relationship between Chinese insurers and the global reinsurance market:

Given the tremendous growth potential of the, in global comparison practically untapped direct insurance market, the chances for sustainable growth of the Chinese reinsurance market appear to be good.
Given the ever increasing progress of China’s socio economic development, the country’s - I call it - risk profile pattern will be developing towards one of the most complex high risk environments in the world. The relation - increasing urbanization, megalo-polisis, industrialization, accumulation of people and high values - indicates the growing dimension of mega risks and the future demand for catastrophe and risk management in the decades to come.
Given the tremendous need and importance to establish superior risk managers in China to sustain stable economic progress, the chances that Chinese insurers and the global reinsurance community join in a long-term risk partnership are high and from my point of view indispensable.

Obviously one would have to conclude that the Chinese (re-)insurance market has to *increase its capital base* to meet the competition, their liabilities and stay financially sound. To provide for a stronger capital base of the whole market will be a pre-requisite:
• to meet the growing complex demand for protection against high risk scenarios of any kind (natural catastrophes, etc.);
• to guarantee financial stability and security (consumer protection) of all insurance market participants;
• to establish a permanent critical amount of market momentum to progress best practices by way of healthy competition.

In my view, the huge dimension of the tasks to be fulfilled in one go but needs a kind of natural evolution of the forces driving the market to maturity. It is, therefore, of utmost importance that the CIRC is guiding the market most
Professionally. Over the last years, ever since the establishment of CIRC in 1997, we have seen a tremendous effort and progress of the Chinese insurance market. The regulatory framework is under permanent screening by CIRC to meet the demands. I am confident that CIRC will successfully achieve adjustments where and when needed.

With regard to Chinese Reinsurance market I may say that there are well known obstacles why the market in comparison to its potential and in acknowledgement of the primary insurers needs is not mature. One of the outstanding issues to be developed is a reinsurance regulation which allows reinsurers to pursue their function as professional risk managers. They may provide their risk partnership with the Chinese Insurance to the maximum benefit if the following important criteria are met:
Growing Interdependence Of Chinese Insurance/Global Reinsurance Market

- Guarantee unrestricted free global reinsurance trade:
  - insurers are free to select their reinsurers
  - global reinsurers have unrestricted access
  - reinsurers are guaranteed free exchange of settlement of balances
  - reinsurers are unrestricted in their investments

- Guarantee the financial security of reinsurers
Reinsurers, in view of their high risk capital need, may only be able to perform their function as prime risk managers if they are unrestricted in the broadest sense. Only the free transfer of balances, the access to all business lines and unrestricted global investment of funds will enable them to professionally conduct their low margin business.

In this context I am confident that global reinsurers will be able to play a vital role as risk managers also in the People’s Republic of China and provide their capacity as a substitute for a lack of capital base of direct insurers.

I thank you for your attention.