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Reinsurers' Shopping Spree Won't Slow Down Falling Rates

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Global reinsurers have seen the future, and it requires greater scale. Already, some major proposed acquisitions or mergers have roiled the sector over the past few months in a consolidation wave that Standard & Poor's Ratings Services had anticipated. It confirms the challenges that management teams at global reinsurers face in the current soft market, marked by an ongoing downtrend in pricing and underwriting conditions combined with an influx of third-party capital that poses an additional threat to the traditional players in reinsurance.

Standard & Poor's believes competitive pressures will remain heightened in reinsurance, and we don't expect the recent spate of consolidation will alleviate that burden. In fact, we believe this trend toward greater scale highlights how hard it will be for management teams to defend their market positions. As the remaining cast of reinsurers look to adapt their business models to fit the current market conditions, the newly merged reinsurance groups that fail to profitably use their new size and scale or others that fail to adequately defend their business positions could see their competitive position scores--and ultimately their ratings--deteriorate.

Overview

- The soft market remains as pricing during the January renewals continued its declining trend, and terms and conditions are showing signs of further widening.
- A string of mergers and acquisitions (M&A) announcements highlight the limited options that many reinsurers have in defending their market positions.
- Reinsurers' risk-adjusted profitability will continue to underperform recent history as pricing keeps declining in almost all global lines, investment returns remain relatively low, and the benefit of reserve releases likely diminishes.
- Diversified product offerings, larger balance sheets, global scope, and expertise will continue to be differentiating factors for successful reinsurers.

Credit Trends Remain Negative

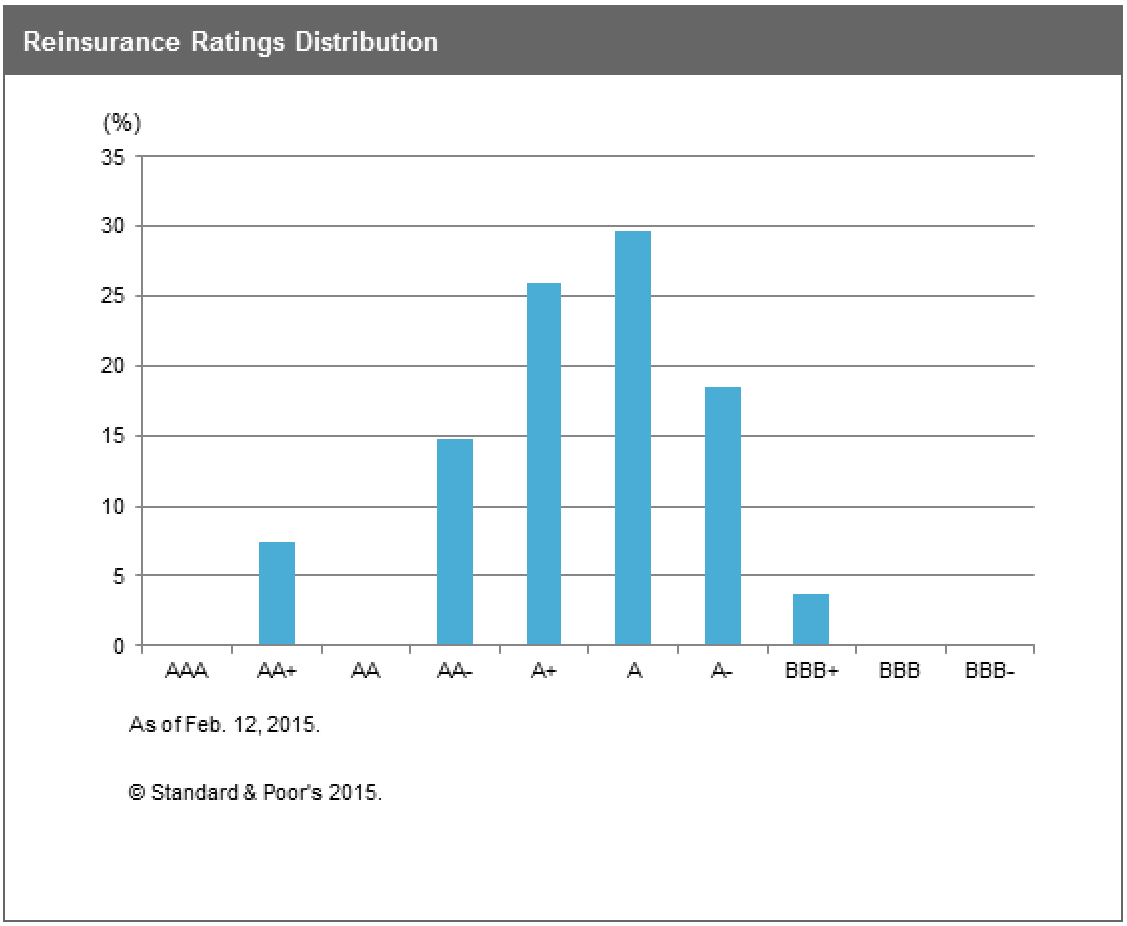
We are maintaining our negative outlook on the global reinsurance sector because we believe current market conditions mean credit quality in 2015 and 2016 will continue the downtrend we saw in 2014. We expect capital levels will remain at or near all-time highs, and pricing will keep declining during the major renewals in 2015, forcing risk-adjusted returns to continue to deteriorate beyond the slippage in 2014. When the dust settles from the consolidation land grab, fewer traditional players will be fighting for a seat at the table. Nevertheless, competition will remain fierce as the new entrants in the top 10 look to grow into their enlarged capital bases, third-party capital continues to expand, and the members of the old guard keep trying to defend their long-standing positions.

We base our negative outlook on the reinsurance sector largely on the prevailing negative trends we have observed in the competitive landscape: material price reductions; our expectation for earnings to fall to levels that may not meet investors' return targets; and, to a lesser extent, integration and execution risks associated with any announced or future M&A. We anticipate that some cedants may reduce their combined share of exposure to the merged entities, which would result in a loss of business for those reinsurers.

Reinsurers' strong balance sheets with strong capital adequacy, a track record of robust earnings, and disciplined risk management and underwriting have largely enabled them to withstand much of the pricing pressure and competition seen to date. Without this balance-sheet resilience and discipline, we would likely have already taken negative rating actions on some weaker reinsurers. However, the prevailing negative trends (covered in more detail below) could lead to changes in our assessments of reinsurers' competitive positions or capital and earnings. In many cases, downward revisions of these assessments could lead to negative rating actions.

The average rating for the 27 companies in the global reinsurance peer group is 'A' (see chart 1).

Chart 1



Competitive Pressures Are Shifting, Not Abating

Premium rates for reinsurance contracts have continued to decline. During the January 2015 renewal season, brokers reported pricing for excess-of-loss treaties fell by 10%-15% across most business lines and regions. We don't see any relief in 2015 because we expect rates to keep declining by 5%-10% across most lines, unless the industry suffers a major loss.

Pricing for primary insurance has flattened out in the U.S. in January, according to Marketscout. Standard & Poor's expects U.S. primary pricing momentum in 2015 to be subdued and multidirectional, ranging from negative 5% to plus 5%. Rates in some lines of business (excess liability, workers compensation, commercial auto) are modestly rising, and others (commercial property) are down. U.S. rates are treading water relative to loss-cost trends. Similar trends are occurring in other developed countries. A softening market for the primary insurers would most likely lead them to increase risk retention and cede less coverage to reinsurers. This reduction in demand will only compound top-line pressure for reinsurers.

The role of alternative capital (also referred to as convergence capacity, third-party capital, and collateralized reinsurance) in the catastrophe reinsurance segment increased in 2014. The insurance industry issued a record $8.8 billion in catastrophe bonds (of which Standard & Poor's rated $4.1 billion) and collateralized reinsurance rose to nearly $30 billion, according to estimates from broker Aon Benfield. Aon also estimates that all alternative capital vehicles, which take the form of sidecars, insurance-linked securities, and catastrophe funds, now represent $62 billion, or 18% of global catastrophe capacity. As the supply of catastrophe protection rises, pricing is naturally pushed down. Traditional catastrophe reinsurance premiums are seeing the most severe rate declines, and catastrophe bonds' return on expected losses (the measure of pricing in this market) is near all-time lows.

As margins in this historically profitable line of business are squeezed, traditional reinsurers have begun to look at other regions and lines of business to deploy their capital and diversify their exposure. This will have obvious consequences for pricing in those lines of business. In fact, some large reinsurers are already renewing their interest in long-tailed casualty business, particularly in the U.S. This line of business has typically been a no-go segment for many due to the unprofitable margins resulting from today's low interest rates and its sensitivity to changes in claims experience over years. This is an example of the industry looking to deploy excess capital by exploring less-profitable segments. Without prudent risk management and measured decision-making, this could be a slippery slope.

An Arms Race To Find Consolidation Partners

Standard & Poor's expected that consolidation would be a likely outcome for some companies in the face of the continued soft market and competitive pressures. Despite claims that the recent wave of M&A would yield material cost-savings or potential benefits from diversifying into new regions or lines of business, we believe each proposed transaction largely reflects the reinsurers' need for scale to compete in the current market. If these transactions get integrated smoothly, we recognize that the newfound scale and scope should benefit these new groups because the companies will be able to benefit from greater product diversification by offering larger capacity to cedants. However, during the next couple of years these new large players will likely raise the competitive pressures for the remaining small players and for the incumbent larger reinsurers that now face new direct competition.

We expect to see an arms race for the remaining small and midsize reinsurers to find consolidation partners. At the same time, as these newly merged reinsurance groups grow into their capital bases, they could push pricing down further in many lines and regions. A more substantial capital base and better diversification may allow larger companies to lower prices even more than before, especially as they look to expand into new regions and deploy capital. In addition, their clients' preference for diversity in their reinsurance panels and potential churn of business and key personnel as companies integrate will pose natural challenges for the companies in play. As ever, reinsurers that can maintain stringent underwriting discipline and demonstrate their relevance to existing clients will be well positioned to navigate the reconfigured market.

Can't Give It Away!

Few of these competitive pressures will abate as long as capital remains at or near all-time highs. Significant capital is unlikely to leave the market in the coming 12-24 months, which reduces chances for rate hardening in lines not affected by losses and will extend the period of earnings pressure for the sector. Reinsurers' discipline will continue to be tested, not only on price, but also on the terms and conditions they are willing to concede--we see further evidence of terms and conditions widening in the market.

Reinsurers will likely post strong results in 2014 on the back of benign natural catastrophe losses and continued favorable reserve releases. We expect to see an average combined ratio (a key metric of insurers' underwriting profitability, with a ratio below 100% indicating an underwriting profit) of 86%-88% and an return on equity (ROE) of around 12% for the year. But as pricing continues to fall, we forecast a combined ratio in the range of 97% to 102% for 2015, assuming average historical catastrophe losses. We expect shareholders' equity for the peer group to remain broadly flat in aggregate because capital returns via dividends and share repurchases should consume most of the earnings for the year. Overall capacity will continue to increase as alternative capital keeps growing. We anticipate that catastrophe bond issuance in 2015 will be in line with 2014's $8.8 billion or perhaps slightly outpace it, while other forms of collateralized reinsurance will continue to grow.

The current round of consolidation will not result in a meaningful reduction of industry capital, reflecting our belief that the primary motivation for these transactions is to achieve a scale that managements deem necessary to compete in the global market. Thus, significant capital returns are unlikely in these deals. In fact, from the three large tie-ups announced in the last few months, we estimate a maximum cash return to shareholders of $4.3 billion (see table 1), which is less than 1% of aggregate shareholders' equity for the top 40 global reinsurers. And even some of that return is to be financed by raising additional debt, rather than paying it out of existing equity.

Table 1

Mergers And Acquisitions: Cash Considerations

Deal	Cash consideration	Cash outlay (Mil. $)
RenaissanceRe/Platinum	$10 per share special dividend plus shareholders' choice of either:	248
	a) $66 in cash or 0.6504 shares in RenaissanceRe per share in Platinum; or	1,639
	b) $35.96 in cash and 0.296 shares in RenaissanceRe per share in Platinum	893
	Range	1,141 - 1,887
XL Group/Catlin Group	410p in cash and 0.13 as shares in XL per Catlin share	2,400
PartnerRe/AXIS	None	0
	Total	3,541 - 4,287

Profitability Pain Prolonged

We believe underlying earnings in the sector will continue to suffer in 2015-2016 because of this excess capital, soft pricing, sluggish growth in new markets, and low investment returns.

While we expect reinsurers' headline earnings to be strong in 2014, and in line with historical averages (see table 2), these results benefited greatly from benign catastrophe losses and favorable reserve releases. Catastrophes and large losses accounted for an average of three percentage points drag on the combined ratio, while reserve releases aided reinsurers' results by nine percentage points on the combined ratio, and nearly five percentage points on the ROE through the first nine months of 2014. Looking through to the underlying combined ratio (that is, the accident year combined ratio) shows that at 93%, it is as high as it has been since the nearly 92% seen in 2009 (see table 3) and in line with the results we forecasted for 2014 in January of that year (91%-96%).

Table 2

Standard & Poor's Global Reinsurance Earnings Forecasts

(%)	2016f	2015f	2014e*	2013	2012	2011	2010	2009	Avg. 2009-2013
Combined ratio	99-104	97-102	86-88	86.4	88.1	105.6	92.6	86.8	91.9
Return on equity	7-9	7-9	12.0	14.1	14.4	5.2	14.1	22.2	14.0

*As of Feb. 12, 2015. e--Estimated. f--Forecast.

Table 3

Sector Combined Ratio Breakdown

(%)	2014*	2013	2012	2011	2010	2009
Reported combined ratio	86.9	86.4	88.1	105.6	92.6	86.8
Reserve release benefit	9.0	5.5	7.7	8.4	8.7	7.2
Catastrophe losses	2.9	9.6	10.4	30.1	12.5	2.3
Underlying combined ratio	93.0	82.3	85.4	83.9	88.8	91.7

*First nine months data.

We expect to see ongoing rate deterioration in the major reinsurance lines, coupled with rising ceding commissions. Therefore, we also expect to see underwriting performance continuing to tail off in 2015 and 2016. Unfortunately for the sector, it will not get any significant relief from investment income over that time frame, either. We expect interest rates to remain low in developed markets, where most reinsurers' investments are focused. Resurgent uncertainty about deflationary trends and eurozone stability following the Greek elections, falling oil prices, rising geopolitical tensions in the Middle East and Eastern Europe, and slowing economic growth in emerging markets all make for risky bets in today's market. There is some temptation to look for yield in alternative investments and some reinsurers have begun to increase their allocation to equities and other alternative investments, but only at the margins and in line with their stated risk tolerances. The current market uncertainty means pushing the limits further is unlikely, and it may lead to a flight to quality in many cases. We anticipate that yields for the sector will be flat in 2015 and increase in 2016 (see chart 1), beginning to somewhat offset the impact of premium pricing declines on companies' ROEs and returns on revenue.

Table 4

Long-Term Interest Rate Forecasts (%)								
	2016f	**2015f**	**2014e**	**2013**	**2012**	**2011**	**2010**	**2009**
World	6.0	5.6	5.7	5.6	6.1	6.8	7.0	7.9
G20	4.6	4.2	4.5	4.6	5.3	5.8	5.5	6.2
Emerging Markets	6.2	5.9	5.8	5.0	5.5	6.0	6.1	7.0
U.S.	3.3	2.5	2.5	2.4	1.8	2.8	3.2	3.3
France	1.8	1.6	1.7	2.2	2.5	3.3	3.1	3.6
Germany	1.2	1.1	1.3	1.6	1.6	2.7	2.8	3.3
U.K.	3.2	2.8	2.7	2.5	1.9	3.1	3.6	3.6
Eurozone	2.0	1.8	2.1	3.0	3.9	4.4	3.6	3.8

As of Feb. 12, 2015. Source: Standard & Poor's. e--Estimated. f--Forecast.

Chart 2

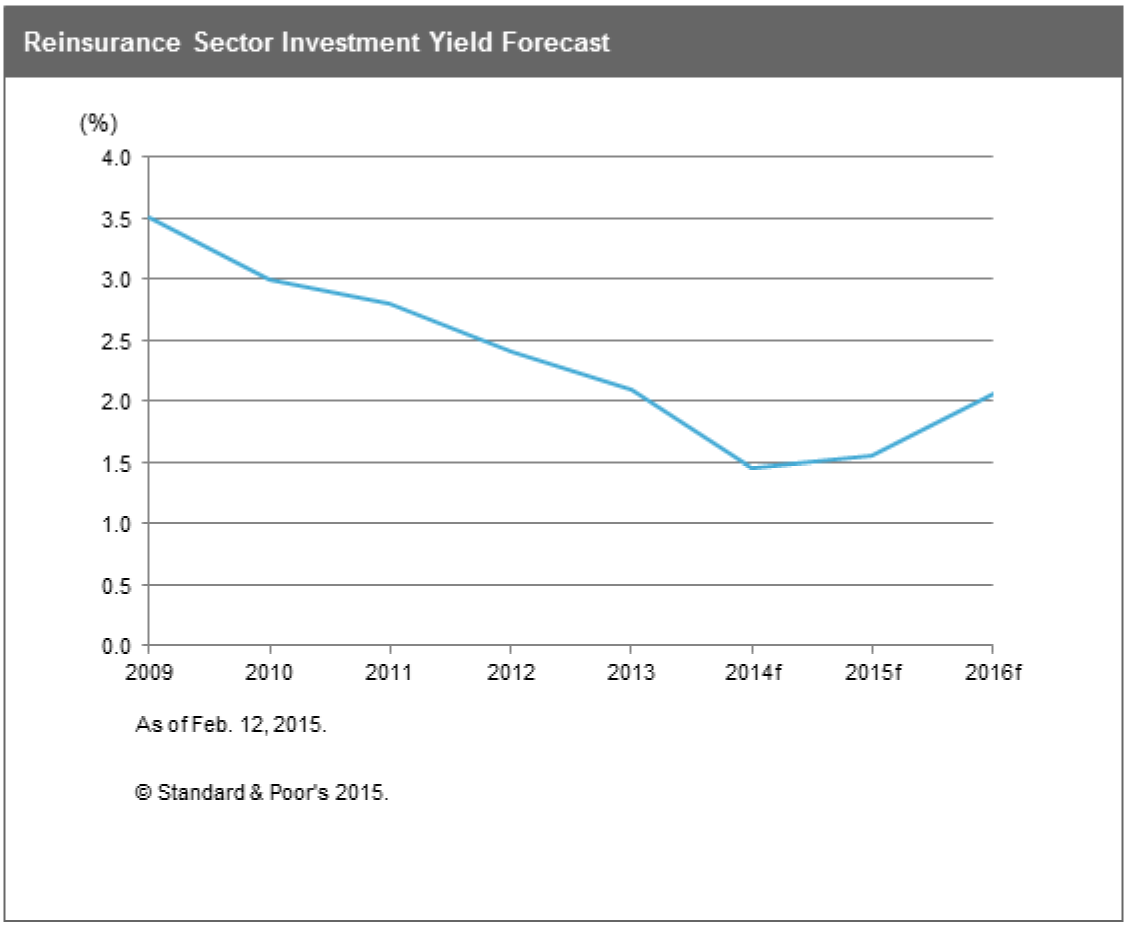


Table 5

GDP Growth Forecasts (%)								
	2016f	**2015f**	**2014e**	**2013**	**2012**	**2011**	**2010**	**2009**
World	3.8	3.6	3.2	3.1	3.2	3.9	5.1	(0.2)
G20	3.6	3.4	3.1	3.0	2.9	3.9	5.0	(0.6)

Table 5

GDP Growth Forecasts (%) (cont.)								
Emerging Markets	5.3	4.8	4.8	5.0	5.1	6.5	8.1	3.6
U.S.	2.9	3.3	2.4	2.2	2.3	1.6	2.5	(2.8)
France	1.2	0.7	0.4	0.4	0.4	2.1	1.9	(2.9)
Germany	1.6	1.1	1.4	0.2	0.6	3.7	3.9	(5.6)
U.K.	2.5	2.7	3.1	1.7	0.7	1.6	1.9	(4.3)
Eurozone	1.4	1.0	0.8	(0.4)	(0.6)	1.6	1.9	(4.4)

As of Feb. 12, 2015. Source: Standard & Poor's. e--Estimated. f--Forecast.

Scale Is Good, But Reinsurers Must Use It Wisely

As the industry keeps adapting its business model to meet the current market's demands, we believe earnings will continue to deteriorate as competitive pressures build. We expect successful companies to defend their competitive positions by leveraging diversified product offerings, global scope, and expertise, and by exercising disciplined underwriting to protect their margins, potentially at the expense of top-line growth.

The trend in M&A highlights players' need for scale and diversification because cedants are increasingly looking to partner with reinsurers that can offer large capacity across many geographies and have expertise to write tailored products. We anticipate further consolidation in the market as smaller monoline reinsurers are likely to be squeezed more than globally diversified groups and will look to gain scale to compete.

The industry is undergoing a reconfiguration that will result in fewer, larger reinsurers. The path to that result is strewn with challenges in executing and integrating new transactions, growing into new capital bases, and competing against a different set of peers. Profitability and capital preservation will be difficult to achieve as pricing declines and investment yields are slow to rise.

We foresee another competitive and difficult year for the sector, and thus maintain our negative outlook. It is unlikely in the next 12 to 24 months that we will see profitability return to the strong levels seen over the past five years, that pricing will improve enough to turn the market across the board, or that competition will subside. We could revise our view on the sector to stable if pricing and demand for reinsurance protection were to plateau at levels that allowed for an adequate risk-adjusted return and if the contribution from investment yields returned to historical levels. This would be characterized by combined ratios of around 95% and ROEs of at least 12%.

In the meantime, for reinsurers, the game seems likely to remain eat or get eaten.

Under Standard & Poor's policies, only a Rating Committee can determine a Credit Rating Action (including a Credit Rating change, affirmation or withdrawal, Rating Outlook change, or CreditWatch action). This commentary and its subject matter have not been the subject of Rating Committee action and should not be interpreted as a change to, or affirmation of, a Credit Rating or Rating Outlook.

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