CONSOLIDATED RISK TO REINSURERS

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A shake-out is predicted in the European insurance industry over the next five years, a transformation deeper and more rapid than any in living memory. The driving force is deregulation, which is opening up the industry to new entrants, both domestic and foreign. These changes are leading to a contraction in the number of major players in each country as companies react to the pressure on profitability created by increasing competition.

These are some of the conclusions of a recent large-scale investigation into the major issues facing executives of insurance companies in Europe over the next five years. The conclusions are the result of questions put to 420 senior insurance executives in 15 countries using the Delphi technique. The companies covered by the survey account for about 80% of the European market.

The survey was concerned with the primary market for insurance and did not analyse the reinsurance market as such. However, the trends set out below will clearly be of interest to the reinsurance market since they have a major impact on that market's buyers.

The shake-out takes place against a background of continued growth, albeit somewhat less rapid than in recent years. In the life and pensions market, growth in Europe has recently exceeded 15% per year in nominal terms. The forecast is that this will fall to between 5% and 9% per annum in the years 1990-95. Faster growth is expected for unit-linked products with the fastest growth in the Latin countries: Spain, Italy and Portugal. The mature markets of Germany, Switzerland and Britain expect lower growth.

In the non-life market, a similar trend emerges, though the slowdown in growth is less severe, falling from about 11% per annum in recent years to between 5% and 9% per annum in the period 1990-95. As in life and pensions, the growth is not uniform across product lines and countries.

Respondents identified environmental pollution insurance as the area of fastest growth, predicted to grow at more than 10% per annum in 1990-95 in most countries in Europe and at more than 14% per annum in several of them. Opinion was divided in the two largest markets, Germany and Britain, presumably reflecting a dichotomy between those who based their opinion on the potential demand versus those who doubt whether such insurance will be readily available at the right price. The history of this cover in the USA is certainly not encouraging. Companies may be more willing to provide cover for sudden and accidental pollution rather than for gradual pollution; the degree of this willingness will in no small part depend on the reinsurance cover companies are able to buy. Looking at the growth trends for non-life business country by country, again the fastest growth is to be found in the Latin countries, as buyers discover insurance, together with Ireland. These countries offer the greatest potential for new demand for reinsurance protection. As in life and pensions, the mature markets expect lower growth.

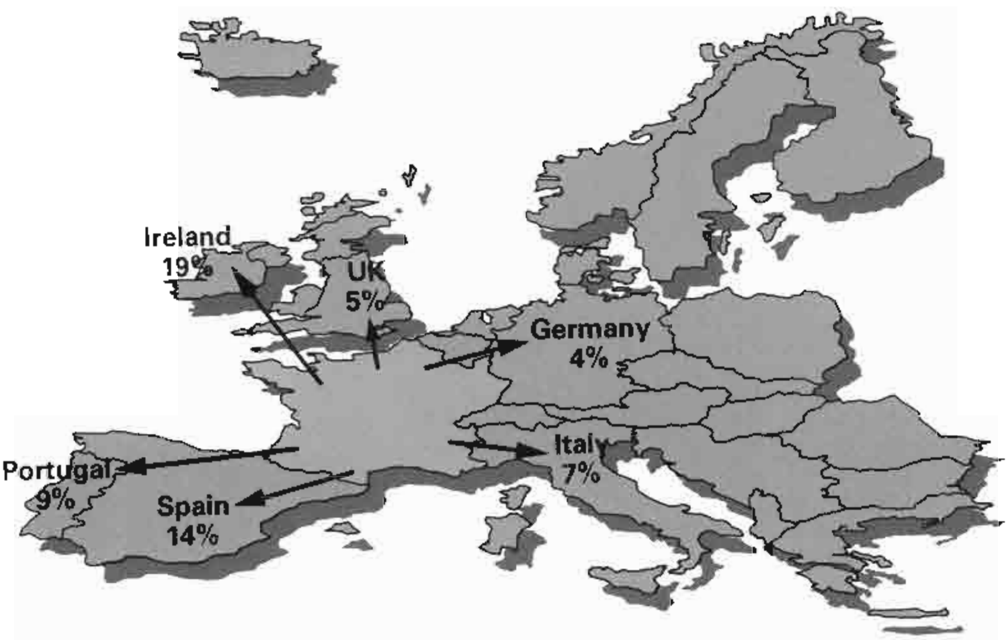
In another recent survey, (Arthur Andersen/Andersen Consulting & LOMA: *Insurance Industry Futures: Setting a Course for the 1990's*, 1988, USA) insurance executives in America considered that property and casualty insurance is increasingly being regarded by the public as a commodity; in other words, price is the only criterion for buying from one company rather than another. Six out of ten of the European executives surveyed predicted a similar trend in Europe, resulting in an increase is competition.

In the same American survey, a marked increase in self-insurance was predicted. A similar trend was found in Europe. The greatest increases in self-insurance are expected in the manufacturing and energy sectors, but some increase is expected in most sectors. This poses a major threat to the primary insurer. Not only is the overall insurance market reduced but also the best risks are removed from the market.

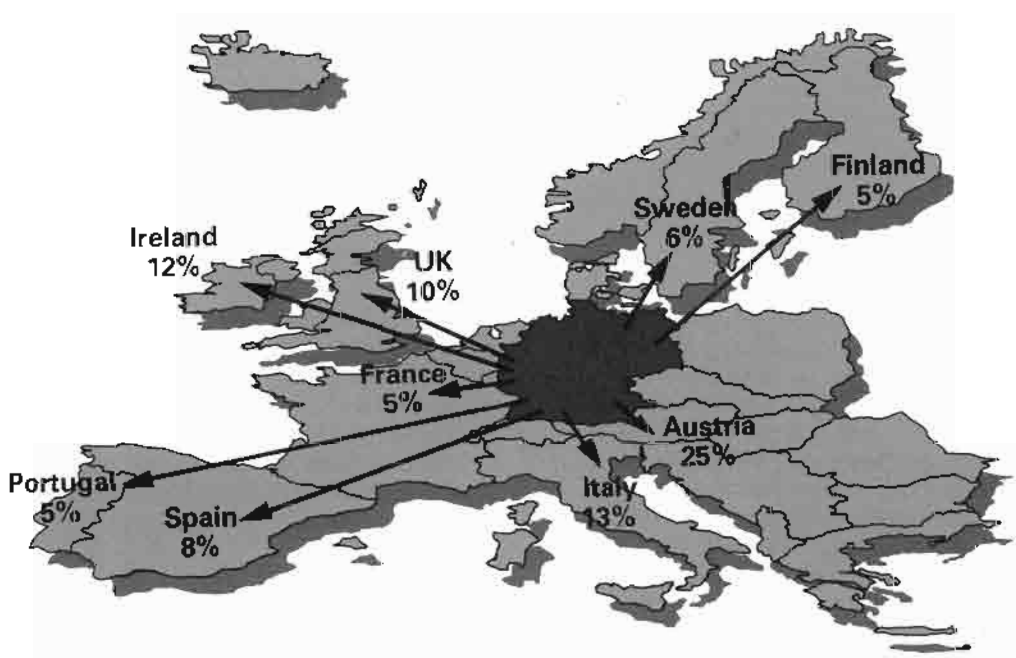
From the reinsurer's point of view, the trend is less problematic. The most important instru-

MARKET SHARE OF EUROPE BY 1995 — P&C

FRANCE



GERMANY



ment of self-insurance is a captive insurance company. From the insured's perspective, best advantage of this arrangement is achieved if the insured can provide for most of its insurance requirements, while reinsuring against catastrophic or substantial claims. In this way, the benefits of good claims experience accrues to the captive not the insurance company and yet protection against unacceptable loss is provided by reinsurance.

The backdrop to the shake-out is therefore slower growth, greater self-insurance and the treatment of non-life insurance as a commodity. These factors alone would lead to increasing competition. However the pressure is being magnified by deregulation at both a national and international level. The most important area of domestic deregulation is the removal of barriers between the insurance companies and the retail banking sector, consisting of banks, savings banks and building societies.

Currently, the banks have made substantial inroads in only three countries in Europe: Britain, France and Spain. The oldest incursion is in Britain but their penetration is relatively low. In France, banks entered the individual life market in the late eighties and in the space of three to four years captured 54% of new business as underwriters. Even more spectacularly, in the Spain of three years ago 93% of new individual life premiums were either sold through or underwritten by banks or savings banks. The study predicts that the retail banking sector will have a 10% share of the European life assurance market as underwriters by 1995 and a further 10% share as distributors of life products.

The banking industry's penetration into the non-life market has, historically, been less impressive. Recent experience of the *bancassurances* in France in trying to sell non-life products has not so far been encouraging. The majority of executives surveyed expect the retail banking sector's share of the non-life personal lines market — either as underwriters or as brokers — to be less than 10% and their share of the commercial lines market to be less than 3%. As a result, even though the banks, as retailers of insurance, are potential buyers of reinsurance services, their activities, much reported and commented on in the financial press, are not yet of great interest to the reinsurance community.

The second area of deregulation is the single European market. Respondents did not expect radical change by 1992 although by 1995 they did expect product choice to be wider and a larger number of companies to be offering insurance products. For either date, they were sceptical about the benefits of the single market to them. Swiss experts, commenting on these results, stated that from their outsiders' viewpoint, a single market in insurance will arrive sooner and have a greater impact than the EC respondents expect.

The greatest structural impact of the single market is likely to be the emergence of a number of prominent multinational insurance companies in Europe. The recent activities of some companies to internationalise their business points the way and the survey predicts that much more is to come. The proportion of respondents in non-life business earning more than 5% of premiums in foreign countries is predicted to rise from 40% to 60% in four years' time. A similar magnitude of increase is expected in the life market from about 20% of respondents to 40%.

The figures are the more significant as the respondents were drawn from the larger companies in Europe, the set of companies most likely to engage in international activity. Respondents believed that such multinational companies would operate as holding companies running a number of subsidiary businesses, each of which would be confined to a specific country. They expected to see little trade across borders except in the large commercial risks market.

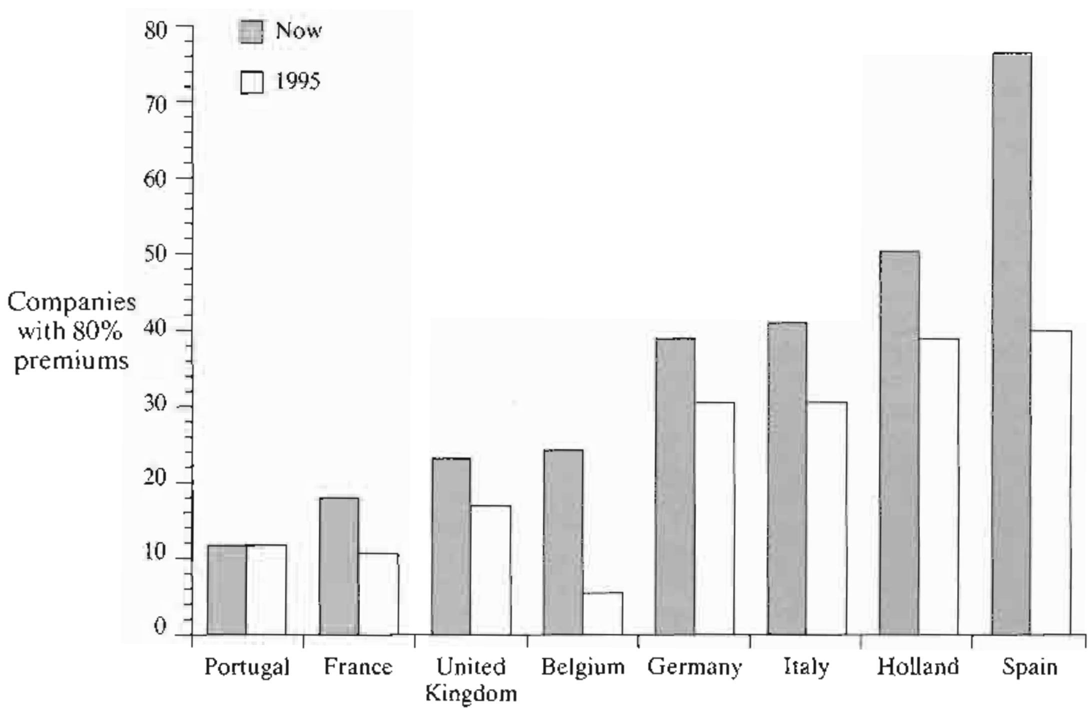
The survery predicts that four countries are most vulnerable: the under-insured markets of Portugal, Spain and Italy with high potential, and the most open mature market, the UK. British non-life respondents predict that, by 1995, half of the UK's non-life insurance market will be in foreign hands. As the largest exporter of insurance in the EC, but not to other member-states, Britain's insurance companies are expected to make small gains in most of Europe in non-life business. In life business, they are expected to be more successful, particularly in the Nordic countries and in France where they are expected to have the largest foreign presence at 11% of the market by 1995.

French insurance companies, which have most aggressively expanded across their borders in recent years are expected to penetrate all the countries around France except Switzerland. French life companies are predicted to have greater success than non-life companies. They are expected to be particularly strong in southern Europe, achieve the second highest penetration of Germany and dominate the Belgian insurance market. In Switzerland, French penetration is expected to be marginal.

The Swiss executives, the largest exporters of insurance to the EC, expect to be able to defend their market against foreign penetration better than any other country in western Europe, retaining about 90% of the market. They are also expected to have further success in expanding into the EC, particularly in southern Europe and Germany. The German respondents expect the Swiss to achieve the highest penetration of their non-life market at 5%.

The German insurance companies, themselves, are the most widely feared in Europe. They are expected to be very strong south of the Alps and Pyrenees, quite strong in northern Europe and achieve prominence in Austria. Most countries surveyed expect German insurance companies to be among the most

INDUSTRY CONCENTRATION — P&C



successful invaders of their insurance markets.

The two other large European countries, Spain and Italy, are not seen as a threat by many other countries. In non-life, the Italians are expected to make some gains in Britain, whilst in life, they are expected to gain in France. Spanish life companies will gain in Portugal. The picture which emerges is of major foreign expansion by companies from the large and mature markets of northern Europe together with local prominence of French companies in Belgium, German companies in Austria and additionally Swedish companies in the Nordic block.

For reinsurers, these European conglomerates should be viewed with concern for four reasons. First, the wider geographical spread of their portfolios potentially allows these companies to offset poor experience in one region against good results in another, which may allow them to economise on their reinsurance programmes. Secondly, there will be fewer buyers of reinsurance and they will be more powerful — able to request and achieve better rates. Thirdly, these large insurance companies may decide to enter the reinsurance market strongly. Finally, companies under pressure to achieve critical mass in another country may relax their underwriting standards in an attempt to gain market share. In such circumstances, they may attempt to mitigate their expected losses through laying off and reinsurers should be even more vigilant than usual against this risk.

The forces unleashed by deregulation are predicted to have a major impact on the structure of the market, particularly on its concentration and on the sector's financial performance. There is clearly room for greater concentration in European insurance. In 1988, in the EC, there were about 4600 companies sharing a premium income of about $270 000 million. In the USA, there were 25% more companies but 60% more premium income and in Japan a similar premium income to the EC was serviced by just 54 companies. Those figures come from Sigma, Swiss Reinsurance Company.

Using the number of companies accounting for 80% of premiums as a measure of concentration, the survey predicts a clear trend towards increased concentration. No country surveyed expected less concentration in the non-life market. The largest concentration is expected in Spain, the most fragmented market. A similar trend was also seen in the life market with greatest concentration expected in Britain. In Spain, Italy and Portugal, however, a combination of the rapid growth of the market and the extent of foreign penetration, with none of the new entrants becoming dominant, leads respondents to forecast greater market fragmentation.

Much of the concentration will result from various amalgamations. In the last two to three years, there has been an enormous increase in major international mergers and acquisitions by historical standards. The survey predicts that more is still to come. Respondents identified 1993 as the year of peak activity involving companies within the EC and 1995 as the year of greatest activity across the EC's boundary.

As with the formation of pan-European conglomerates, this increase in concentration represents a significant threat to reinsurers as the number of buyers diminishes and their buying power is enhanced. The forces causing the primary market to concentrate may thus also lead to a consolidation of the reinsurance market as competition in that market increases.

The increase in competition is expected to put a strain on the sector's financial performance. Increasing competition is at the heart of factors affecting profitability where continuing keen prices are going to require companies to control their operating costs and overheads and improve their ability to match price to risk to return a better underwriting result.

Some companies will not survive the high level of competition, so Europe can expect a relatively high number of insolvencies compared with historical experience, although low compared to the USA. Insolvency is defined as getting into financial difficulties and needing to be rescued. Thus, the number of insolvencies by 1995 in various countries may be as follows:

- Three-quarters of Spanish respondents predicted more than 10 in Spain
- Nine-tenths of Italian respondents predicted more than 5 locally
- Four-fifths of British respondents predicted more than 5 in the UK, although none predicted more than 10.

Reinsurers will need to respond to this by paying much greater attention to the solvency of their insured to minimise the risk to their own profitability resulting from bad debts. The survey thus predicts a significant increase in competition in the primary insurance market. The knock-on effect is no less severe in the reinsurance market. The imminent reduction in the number of buyers and their enhanced buying power is certain to lead to greater competition in the reinsurance market and perhaps to a consolidation of that market too.

How should management in reinsurance companies respond? They clearly must seek to protect their market by enhancing their ties with their clients. They must improve their understanding of exactly what it is that their clients are buying and why their clients buy from them — in other words, their buyers' values. They must group the market into different segments according to the differing values, and provide product and service in a way which directly delivers the appropriate values. Reinsurers must manage the relationship with their clients so that if the clients do merge with other companies, they are in a position to win reinsurance contracts from the consolidated group.

This implies a client-servicing organisation as opposed to the traditional, technical, product basis so that more individuals within the reinsurance company are close to the clients and understand their needs. However, that alone is not enough. A reorganisation would be wasted unless it was synchronised with significant retraining of staff to act in a way which meets the wishes of buyers in the segment they service and a redevelopment of systems to be organised around the client, rather than the policy. This will require a significant investment in information technology. In the survey respondents predicted that expenditure on information technology would rise from about 10% of operating expenses, including commission, to about 15% by 1995. A similar increase in expenditure should be expected by reinsurers.

It will also require a substantial investment in training. The extent of the effort involved can be seen from the fact that in some major systems being developed today, 20% to 40% of the total development effort is being devoted to improving managerial technique. The executives who responded to the survey were asked to identify the single most important issue they expected to have to face over the next five years. The most popular response was "coping with structural change". Their response is no less relevant to executives in the reinsurance market who should expect to face unprecedented turbulence in their marketplace over the next five years.

Time is short. The predicted peak of the consolidation is only two years away and the impact on the reinsurance market will follow very shortly after that. Reinsurance companies must act now if they are to position themselves not only to survive the after-shocks of the shake-out in the primary market, but to emerge as one of the winners. ■

Gideon Nissen is senior manager in the insurance industry group at Andersen Consulting which he joined in 1982. There, he has worked on projects for Eagle Star, Laurentian, Equitable and Willis Faber & Dubas as well as Forenede Forsikring among others. A graduate of Oxford, he has published Insurance in a Changing Europe 1990-95.