The reinsurers' view

Asia Capital Re's executive vice president, strategic business, Kenrick Law, discusses the opportunities and challenges in emerging Asian markets

With a total non-life premium volume of about $165bn, the growth markets of South, Southeast and East Asia (excluding Japan and ANZ) account for close to 10% of the world's total.

From a global perspective, the region's non-life reinsurance markets are disproportionately relevant with a total volume of an estimated $35bn, translating into a global market share of about 20%. What is worth highlighting is that cession rates in Emerging Asia are among the world's highest, at more than double the global average: The region's direct insurers cede more than 20% of Gross Premiums Written to reinsurers.

Chart 1: Major non-life reinsurance markets in Emerging Asia, 2010

Accordingly, reinsurance markets have grown in tandem with the region's non-life direct insurance markets, some of which have expanded at double-digit CAGRs (e.g. China and India at around 20% and 15%, respectively) over the past ten years. Based on the region's robust economic, social, demographic and regulatory fundamentals there is no reason to believe that this growth momentum will abate anytime soon.

LOW INSURANCE PENETRATION OFFERS MAJOR CATCH-UP POTENTIAL

Asia is seeing strengthening intra-regional trade links as well as a shift from export- and investment-led growth towards a higher importance of consumption. Emerging Asia's economies are poised to remain on a steep growth trajectory, with the economic slowdown in the developed markets of Europe and North America not expected to impact the region's fortunes as adversely as it would have 10 or 15 years ago. Underpinned by continuing economic growth, non-life insurance markets in Emerging Asia are likely to keep expanding at an even faster pace than underlying GDPs: Non-life insurance penetration, i.e. premiums as a share of GDP, is still at less than half the global average of 3% and, accordingly, offers significant catch-up potential.

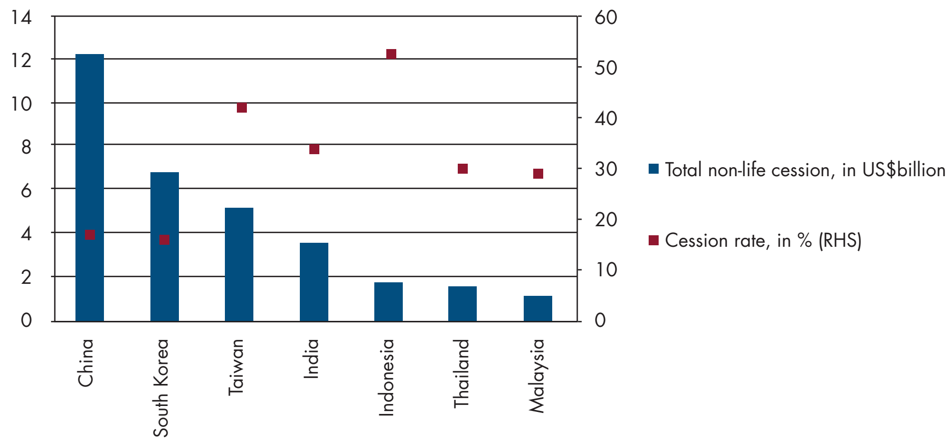
DEMOGRAPHIC AND SOCIAL TRENDS RESHAPE RISK LANDSCAPE

Emerging Asia is home to close to 60% of the world's population. By 2030, according to the Asian Development Bank, 55% of Asians are expected to live in urban areas, up from a mere 25% in 1980. The rapid rate of urbanisation, with increasing infrastructural developments in key areas of housing, power, transportation and telecommunication, is likely to aggravate risk exposure. The OECD estimates that, by 2020, Asia will account for 55% of the global middle class, as compared with its current share of just 30%. These demographic and social trends will bolster insurance demand as insurable corporate and, in particular, household assets such as motor vehicles and residential property and, accordingly, sums insured are expected to grow disproportionately. Personal lines (e.g. health, personal accident and household insurance) will experience a particular boom, increasingly catching up with commercial lines which traditionally drive insurance market growth at early stages of development. Reinsurance demand is anticipated to grow in tandem, albeit at varying pace with locally-distinct characteristics among the various markets, as direct insurers seek capital relief to sustain their rapid growth as well as risk management expertise to address the challenges of a more complex and interdependent risk landscape.

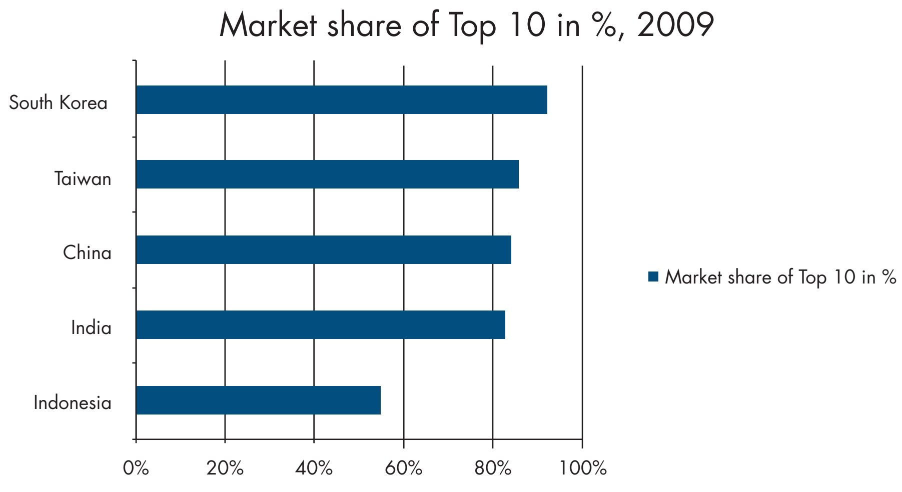
DEREGULATION AND LIBERALISATION POSE CHALLENGES

Specific regulatory trends, which are of utmost importance in influencing the region's reinsurance markets, need a particularly careful and differentiated analysis. The removal of tariff systems, if replaced by cut-throat competition, is likely to dent the growth and profitability prospects for both insurers and reinsurers. Another important trend is the ever larger footprint of multinational insurers in the region, enabled by the dismantling of barriers to market access. As the market share of these well-capitalised and globally diversified giants increases, the current buoyant aggregate cession rates may be poised to decline. Consolidation

Major non-life reinsurance markets in Emerging Asia, 2010



Sources: Asia Capital Re (cession rates), Swiss Re Economic Research (direct non-life premiums)



Source: National insurance statistics

Chart 2: Market shares of Top 10 non-life insurers (2009)

is a related trend: Driven by tightening regulation (in particular solvency capital requirements) and fiercer competition, many domestic insurance markets in Asia may face pressure to consolidate. The remaining, bigger entities, all other things being equal, will need less reinsurance.

MAJOR DIFFERENCES IN CESSION RATES

Let us take a closer look at the Emerging Asia markets. As can be seen from Chart 1, cession rates vary widely, ranging from 53% in Indonesia to 16% in South Korea. This pattern is mainly attributable to significant differences in non-life direct market structures: The number of non-life insurers operating in Indonesia amounts to close to 150. Many of them are small-sized and, therefore, heavily reliant on reinsurance. As shown in Chart 2, the Top 10 players' combined market share does not exceed 55%. Many observers expect the market to consolidate, which would depress cession rates, all other things being equal. On the other hand, the South Korean non-life insurance market offers a different picture. The market's Top 10 players account for more than 90% of non-life premiums. Based on their size and capital strength, these non-life insurers purchase relatively little reinsurance, with most of their cessions going to the only domestic reinsurer Korean Re. Another reason for South Korea's relatively low cession rate is the nature of non-life business: More than half of it consists of long-term business, a form of depositary personal lines business that requires minimum reinsurance protection. Exceptions, however, prove the rule: Taiwan displays both a high direct market concentration and an above-average cession rate, a constellation which can be attributed to a severe natural catastrophe exposure and the need to purchase reinsurance as a tool for risk mitigation. In addition, the only domestic non-life reinsurer, Central Re is partially owned by domestic insurance companies and still commands the biggest market share in Taiwan.

Given the complexity of the various forces at work, reinsurers on the ground will have to closely monitor market trends to anticipate the future direction of cession rates: While consolidation and liberalisation would suggest a reduced reliance on reinsurance, the tightening of regulatory solvency capital requirements and the increasing role of private-sector insurers (e.g. in India) point in the opposite direction.

ATTRACTIVE MARKET LOSS RATIOS

Besides promising growth potential, relatively low loss ratios offer opportunities aplenty in a number of Asian countries. This reflects both profitable (regulated) compulsory motor markets – by far the biggest line of business in most Asian markets – and the short-tail nature of insurance liabilities (casualty business is still minuscule in light of a low degree of litigiousness displayed by most markets). However, rate deregulation (such as in India) and an increasing concentration of insured values in areas prone to natural catastrophe risk may exercise upward pressure on loss ratios going forward.

Most Asian markets are proportional treaty markets, notably in China where about 95% of all reinsurance business is transacted that way. This pattern reflects the primary needs of domestic ceding companies: Capital relief to support rapid business growth as well as underwriting capacity for Property and Engineering business. However, as direct markets consolidate, non-proportional reinsurance is poised to gain in importance. South Korea may serve as an example: The market's Top 10 companies are relatively well capitalized and purchase significant amounts of XL protection from international reinsurers. As far as distribution is concerned, reinsurance intermediaries play an increasing role in Asia. What used to be a 'direct' market is gradually morphing into a broker market, not least on the back of ever more sophisticated risk advisory capabilities offered by (global) intermediaries. Reinsurers will have to increasingly look to manage relationships with brokers, and leverage their network and intelligence, to harness market access and product opportunities.

REGULATORY CHANGES FUEL DEMAND FOR REINSURANCE

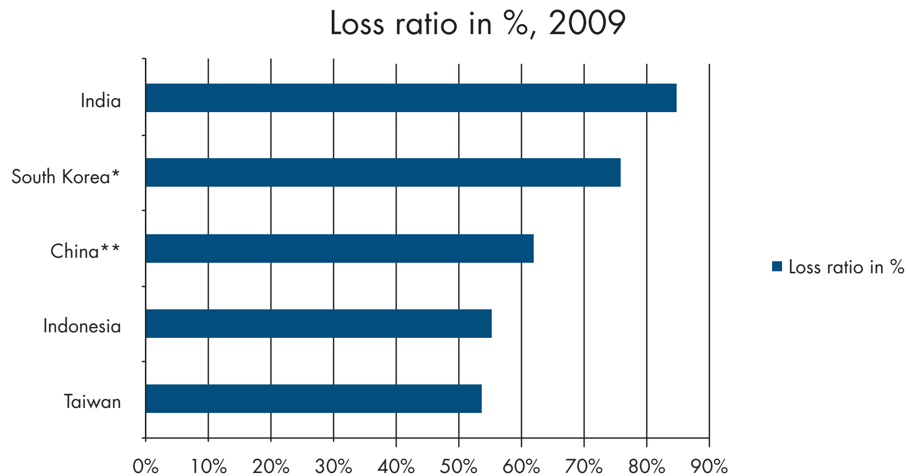
As in other parts of the world, the regulatory landscape in Asia is undergoing changes. A number of countries have adopted or are adopting risk-based solvency capital regimes (e.g. Indonesia, Malaysia, Singapore and South Korea). Even in countries (such as China) which are still running 'Solvency I'-type regulatory regimes, there is a trend towards increasing minimum capital requirements. These developments generally result in significantly heightened capital requirements and, as such, offer major business opportunities to reinsurers who offer cost-efficient alternatives to equity and to injecting additional funds.

OUTLOOK: ASIA AS BOTH A DESTINATION AND SOURCE OF CAPACITY

Going forward, the opportunities in Emerging Asia far outweigh the challenges, although a sensible approach and

commitment to long-term engagement are essential for reinsurers' success. The positive prospects may drive the region's development from one of the most attractive destinations of global reinsurance capacity to a source of its own right, as the global economic balance of power continues to shift towards the east. As corporate giants originating from Asia make inroads into 'Western' markets in an increasing number of business fields and sectors, these new dynamics of globalisation may also apply to reinsurance in the not too distant future: Domestic sovereign and non-sovereign investors in Emerging Asia do have the funds to establish new or strengthen existing reinsurance entities, and grow increasingly comfortable with the business model of insurance and reinsurance. In addition, national and regional reinsurers from Asia are fast building their technical capabilities. This is narrowing the traditional 'expertise gap' between global and regional players, and contributing to more robust risk management mechanisms within Asia.

The financial crisis has made it clear that superior corporate size and financial strength ratings alone do not lend immunity to 'Black Swan'-type market dislocations, i.e. huge unexpected shocks. Against this potentially volatile global and regional operating backdrop, local insurance companies seek to diversify their reinsurance placements more broadly to mitigate counterparty credit risk. They increasingly prefer to put their eggs in a larger number of baskets, including national and regional reinsurers with a strong capital base and proven technical expertise. On the back of robust balance sheets and significantly improved underwriting capabilities, reinsurers from Asia may not only play a more prominent role in their domestic and regional home markets but, ultimately, also on the global reinsurance scene.



Source: National insurance statistics (* 2008, ** 1H 2010); on an 'incurred' basis

Chart 3: Market loss ratios in 2009