



**Cass Business School**  
CITY UNIVERSITY LONDON

# Global Reinsurance Masterclass Series

Strategic Thinking for the  
Reinsurance Industry

## Masterclass 1

### Re-think reinsurance

How to shape your future through a strategic  
understanding of global market forces

Professor Paula Jarzabkowski

Dr Michael Smets, Dr Adriana Allocato, Dr Rebecca Bednarek



The Global Reinsurance Masterclass Series is sponsored by ESRC, WCI and IICI



INSURANCE  
INTELLECTUAL  
CAPITAL  
INITIATIVE



# Executive Summary

---

## The reinsurance industry is experiencing intensified competition and regulation.

This Masterclass:

- Analyzes the ‘big picture’ of the reinsurance industry through Porter’s Five Forces model of competition;
- Examines the key players aligned with these Five Forces and their impact on competition and industry profitability;
- Customizes the model to cover special features of the reinsurance industry, especially the roles of brokers and modelling companies;
- Explores co-opetition, the simultaneous competition and collaboration of players, in a subscription market;
- Suggests strategic responses to competitive pressures in the reinsurance industry.

It is the first in a series of seven such Masterclasses.

*Up until 2010 reinsurers ‘had it good’. But only three years later, it already seems like a golden age is vanishing.*

*Reinsurance executives at their late-2009 rendezvous in Monte Carlo were quietly optimistic about the coming year. Granted, there had been relatively few natural disasters in 2009, and following the time-honoured pattern, the buyers of reinsurance – the primary insurance companies, and their brokers – would therefore argue for rate reductions. But those buyers had few alternatives to traditional reinsurance products. The main substitutes, securities-based products like Cat bonds or ILWs, had been given a bad name in the 2008 financial crash, and they were now a no-go area. The Monte Carlo executives were a bit anxious about investors like Crédit Suisse, and others, pumping a lot of money into reinsurance. Increased capital – perhaps even an over-supply of capacity – now that would put reinsurance rates under pressure. But no, those big investors were still finding lucrative investments elsewhere, as the financial markets had recovered quickly from the crash. No problem: 2010 was going to be just fine.*

*It all looks so different now. Reinsurers paid out on an unprecedented series of natural disasters – the Chile earthquake, Queensland floods, Japanese tsunami, Christchurch earthquakes, Thai floods... yet the*

*‘payback’ for those losses – the traditional higher premium next time round – wasn’t forthcoming. Those buyers, the insurance companies, are bigger and meaner all of a sudden – huge consolidated global firms with enough capital in reserve to cover quite a lot of their own risk. They need less reinsurance. When they do need it, they come to market with huge, bundled ‘super-risks’ that are hard to analyze, and beyond the capacity and capability of a lot of smaller reinsurers. To add insult to injury, Cat bonds are back: a popular and growing alternative to reinsurance, even a natural substitute when buyers are in ‘super-risk’ territory. Brokers have consolidated too, and invested heavily in analytical expertise, so they now know more about the various lines of business and the overall picture than some reinsurers. They are driving their own agenda more, not just connecting buyers and reinsurers. Capital has come flooding into reinsurance, an abundant commodity now that investments elsewhere don’t look so good. So reinsurers can’t charge so much for it. Even the regulators are getting in on the act, forcing reinsurers to make costly changes to the way they operate and making it ever-harder for anyone to stand out on anything but their rates.*

*No wonder reinsurers are fighting each other tooth and nail to get into emerging markets like Brazil and China. What other future is there?*

## Executive Summary (cont.)

---

The risk business is getting riskier. From 2010 to 2012, almost every trend in the markets has conspired to systematically squeeze reinsurance profits and pressurize traditional practices. And those markets are increasingly volatile.

Rather than working from risk to risk, from deal to deal, while market forces close in, these 'Masterclasses' show how reinsurers – senior and junior – can take charge of their future. We offer reinsurers a strategic understanding of the 'bigger picture' beyond their individual specializations.

Armed with this understanding, reinsurers can:

- make strategic choices about the kinds of business to pursue;
- manage appropriately the relationships on which they depend;
- build the competences which are needed now and for the future, and use them more effectively.

The present Masterclass I sets the framework for the subsequent Masterclasses II–VII.

# 1. Competitive forces in reinsurance

## 1.1 Industry structure

Michael Porter's "Five Forces" model<sup>1</sup> is a widely-used managerial tool for analyzing potential industry margins and for classifying features which affect the competitive environment.

According to Porter:

- Industry structures are determined by the interplay of five forces: bargaining power of buyers, bargaining power of suppliers, threat of new entrants, threat of substitute products, and intensity of industry rivalry. The strength of each force is specific to each different industry.
- The interaction of these competitive forces determines the intensity of competition and associated profit margins of an industry.
- All competitive forces and their interactions are governed by a regulatory framework that sets the 'rules of the game' for all participants.

Figure 1.1 shows these five forces in their regulatory context, and the industry-specific players that apply them in the reinsurance market. The following subsections 1.1.1–1.1.5 discuss these types of players, along with the ways in which they affect reinsurance profitability. Section 1.1.6 then looks at how regulatory change may threaten reinsurance profitability, or provide new opportunities.

This model is a useful starting point to explain why reinsurance profitability has been systematically squeezed so hard since 2010. We can also use it to suggest ways in which reinsurers can fight back against this squeeze.

However, later in this Masterclass (see section 2) we will customize the model to include some special features of the reinsurance market – and explore the possibility that it may benefit competing forces to collaborate, as allies, to counteract some of the competitive pressure.

← Competitive Forces impinging on the industry

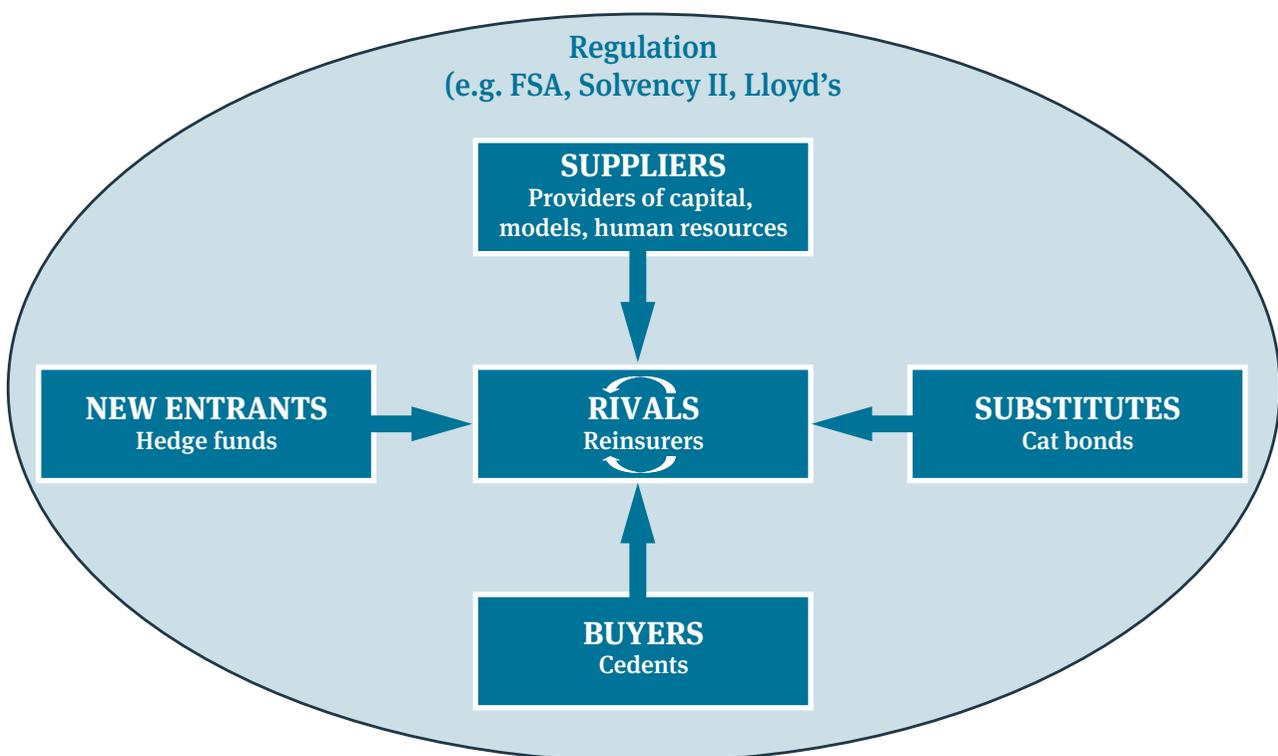


Fig 1.1 Re-insurance industry structure following Porter's 'Five Forces' model. Note that this model is a starting point only: it will be modified in section 2 to accommodate special features of the reinsurance industry

<sup>1</sup>Porter, M. E. 1980. Competitive strategy. New York: Free Press; Porter, M. E. 2008. The five competitive forces that shape strategy. Harvard Business Review 86(1): 78-93.

# 1. Competitive forces in reinsurance (cont.)

## 1.1.1 Buyer power – how changing cedent behaviour is squeezing reinsurance profits

In reinsurance terms, insurers pay to ‘cede’ or transfer risk to reinsurers, and these insurance-industry buyers are therefore known as ‘cedents’.

The general trend for insurers is strongly towards consolidation (see Masterclass II), and a relatively small fraction of reinsurance spend remains with small insurers. As cedents consolidate, becoming larger ‘super-cedents’:

- they can bundle risk more effectively and thus decrease their reinsurance spend;
- they are more able to walk away from the market and retain risk internally, covered by their own large capital reserves, when they consider the market price unattractive;
- there are fewer overall buyers of reinsurance, increasing their comparative power as reinsurers have fewer places to go for reinsurance volume.

Of course, buyer power is not uniform across all cedents. It remains true that smaller insurers, and insurers in emerging markets, remain highly reliant on reinsurance as a proxy for capital, freeing up internal capital reserves to fund growth. But considered as a group, cedents have been bulked up by consolidation into ‘heavier hitters’ in their negotiations with reinsurers. They are reducing the amount of cover they buy, and using their buyer power to lower the rates they pay for it – both of which reduce reinsurance profits.

The good news for reinsurers is that to some extent, there is a balancing force built into the rise of the ‘super-cedent’. The more complex their risk programmes, and therefore the more technology-intensive their risk analysis, the fewer reinsurers are left for those super-cedents to consider. The pool of possible reinsurers is artificially limited to a few select heavyweights with sufficient analytic capability. These reinsurers can then take a firmer stance on their rates. In this way super-cedents are limiting their own buyer power when it comes to certain products.

**In general:** consolidation of cedents is a dominant, and ongoing, trend in most markets, which is squeezing reinsurance profits. This struggle over profit is, of course, central to the relationship between cedents and reinsurers, yet forces for co-operation also exist. Used strategically, these may offer reinsurers a way of mitigating the squeeze on their profits. Such **co-operation** is examined in section 3.2.

## 1.1.2 Threat of substitute products – taking premium out of the reinsurance industry

Substitutes are dangerous if they offer a better price-performance ratio than the core products in an industry. Getting the same value cheaper, or better value at the same price, is always attractive! In many segments of the global market, cedents have had over a decade of experience in using **Cat bonds** as a cheaper substitute for traditional reinsurance products. Cat bonds are securities whose returns depend on the occurrence of a specific insurance event. They are not normally considered part of the core reinsurance market, as they are not generally offered by reinsurers. Yet Cat bonds need to be on every reinsurers’ radar screen, as they can absorb ceded premium that would otherwise have gone to traditional reinsurers. In fact, since 1996, the Cat bond market has seen US\$ 44bn of cumulative reinsurance issuance.

While Cat bonds, together with hedge funds and pension funds that write them, took a hit in the financial crisis, they have since bounced back and, by 2012, reached their highest level for new issuances and outstanding volumes in four years.<sup>2</sup> All of this is money which is *not* going to reinsurers. So to understand the levels of competition and potential profits in the reinsurance industry, reinsurers should look further afield than their traditional rivals.

So far, substitutes like Cat bonds have mainly hit reinsurance rates by competing on price, but little attention has been paid to value beyond sheer risk coverage. A better understanding of the value provided to cedents enables a much more strategic positioning of traditional reinsurance products relative to potential substitutes. It may even justify a price premium for a traditional reinsurance product, if it can be seen to offer something not found in the substitute, such as a long-term relationship and reliability, which cedents value sufficiently (see Masterclass V).

Another important form of substitution is **internal retention** on the part of cedents – simply doing without the reinsurance product. In all, increased consolidation (as described in 1.1.1) enables cedents to retain and cover more of their own risk as a substitute to ceding it on the reinsurance market. In particular, casualty and property-per-risk retention are increasing after a decade of declining frequency. Cedents increasingly consider this a risk they can carry more of.<sup>3</sup>

<sup>2</sup>Source: [http://thoughtleadership.aonbenfield.com/Documents/201209\\_ab\\_securities\\_ils\\_annual\\_report\\_2012.pdf](http://thoughtleadership.aonbenfield.com/Documents/201209_ab_securities_ils_annual_report_2012.pdf)

<sup>3</sup>Source: [http://thoughtleadership.aonbenfield.com/Documents/20120909\\_ab\\_analytics\\_reinsurance\\_market\\_outlook\\_external.pdf](http://thoughtleadership.aonbenfield.com/Documents/20120909_ab_analytics_reinsurance_market_outlook_external.pdf)

# 1. Competitive forces in reinsurance (cont.)

“They went from buying proportional to non-proportional and stopped ceding treaties from local operating entities. A lot of meat from the bone was gone for us, we lost 50% of our premium just due to this.” (Reinsurer)

**In general:** Use of substitute products, and internal retention, both of which deprive reinsurers of premium, are increasing as a result of consolidation in the insurance industry (see Masterclass II). One way for reinsurers to push back may be to educate their clients about the superior value of their products, or to liaise with brokers to do so on their behalf (see Masterclass VI).

## 1.1.3 Supplier power – how supply of capital, and cost of resources, are squeezing reinsurance profits

“What you would expect now is a hardening in the market, after this gruelling year [2011] ...however at the moment the investment community sees reinsurance as a nice alternative: there’s not enough investment opportunity in other[financial] sectors. So at the moment too much investment capital flows back into reinsurance.” (Reinsurer)

Reinsurers are reliant on suppliers of capital, suppliers of analytical and other services, and on the general supply of human resources – well-trained, highly-skilled staff. If the cost of services or human resource goes up, it eats into reinsurance profitability.

Following the law of supply and demand, an abundant supply of capital means that reinsurers cannot charge as much for it, because it is no longer as scarce. Broadly speaking, an increasing availability of capital reduces reinsurance rates and, unless somehow counteracted, reinsurance profits. Thus, when thinking about **suppliers of capital**, as with potential substitutes, it is important to keep an eye on adjacent markets and what their development may do to capital supplies in reinsurance.

The year 2011 provides a good illustration: pay-outs on the second-worst year on record in terms of reinsured disasters drained capital from the industry and should have provided the basis for rate increases the next year. Typically, large losses in one year and the prospect of rate increases the next attract new capital to the industry, which then

moderates the extent of rate increases. In 2012, though, an extraordinary US\$ 6bn of capital entering the market overcompensated for the 2011 pay-outs, taking reinsurance capital to an all-time high during the first half of 2012.<sup>4</sup> This was because such peaks in supply of capital are not only connected to reinsurance events, but also to the return on capital which is available in other financial markets. Low interest rates there (such as one might expect during a banking crisis) create a surge of interest in the high risk/high return property catastrophe market.<sup>5</sup>

The **modelling companies** which reinsurers rely on for vendor models form another important group of suppliers to the reinsurance sector. Even if reinsurers have their own internal models, they are reliant on three big modelling companies due to the widespread usage in the industry of just a few select models. Modelling companies are suppliers for the industry as a whole, providing a framework which brokers and cedents – as well as reinsurers competitors – also use, which sets technical boundaries for the market’s collective pricing of risk. The power of these modelling companies has increased as the industry, with the help of these suppliers, has become increasingly technical in the last decade. Partly this is a response to the demands of regulation; partly also to cedents’ bundling of analytically-challenging ‘super-risks’ (see 1.1.1 on p4).

The supply and training of **human capital** into reinsurance has also become more important as reinsurance has become more technical. For example, in the past, underwriters were largely trained internally on the job, whereas now, reinsurance is largely reliant on individuals with prior actuarial training.

Reinsurance firms must therefore develop new recruitment strategies that meet the expectations, in terms of career benefits and opportunities, of the employees they will need in the future. This may not appear to be an imminent requirement in 2013, because recruitment in other financial sectors is still lower in the wake of the banking crisis, but it is bound to become a more urgent problem once competition for talent picks up again.

**In general:** low returns in many financial markets have increased supply of capital, which squeezes reinsurance prices and profits. Increasing technical sophistication is giving more power to suppliers of analytical models, and to potential reinsurance employees with rare technical skills; both drive up the cost base for reinsurance operations.

<sup>4</sup>Source: [http://thoughtleadership.aonbenfield.com/Documents/20120909\\_ab\\_analytics\\_reinsurance\\_market\\_outlook\\_external.pdf](http://thoughtleadership.aonbenfield.com/Documents/20120909_ab_analytics_reinsurance_market_outlook_external.pdf); <http://www.commercialriskeurope.com/cre/1614/88/Reinsurance-market-has-more-capacity-than-at-start-of-2011-with-6bn-of-new-funds-Moody-s/>

<sup>5</sup>Source: <http://www.insurancenews.com.au/analysis/dancing-the-reinsurance-dance>

# 1. Competitive forces in reinsurance (cont.)

Unfortunately, these trends are largely out of reinsurers' control. Reinsurers, therefore, must ensure that the value created from inputs like models, human resource, and financial capital outweighs their cost. They can achieve this by tailoring reinsurance products to the current market life cycle (see Masterclass II), sharpening their strategic profile (see Masterclass III), or effectively using highly-skilled staff (see Masterclass IV).

## 1.1.4 Threat of new entrants

Like substitute products, new entrants compete on the basis of price-performance ratios, but as industry outsiders (at least initially) they have to overcome barriers to entry. The threat of new entrants depends on the nature and 'height' of those barriers.

In reinsurance, close, longstanding relationships between reinsurers and cedents (see Masterclass V) have traditionally posed a barrier to entry, but recently their perceived value to cedents seems to have waned a little. The regulatory environment represents another such barrier to entry due to its (increasingly) stringent nature. For instance, new entrants must be able to build and maintain a sufficient capital base: this capital intensity of reinsurance is increasingly heavily regulated. Entrants must also invest heavily in building a high level of prior knowledge and human resources expertise, especially concerning risk modelling, ahead of participation.

While these barriers offer some protection for incumbent reinsurers, they are far from insurmountable. New entrants do find their way into reinsurance, particularly from among hedge funds and insurers. These are companies that can more easily scale these barriers, using their prior knowledge and resources.

**Hedge funds** have been providing Cat bonds (as described above) in the reinsurance market and have also quickly expanded into providing traditional reinsurance products. With their established pools of investment capital, they jump the barriers to entry represented by the capital intensity of reinsurance. In particular there was strong growth in such new entrants to take advantage of rate increases following the 2005 hurricane season (which included Katrina) when rates were at a historical high, a phenomenon referred to as the 'new Bermudian market'.

"Hedge funds – we see them as a threat because they take the steam out of our market. Smart money knows when there is money to be made. So when profitability is high, "Money" goes and starts a new Bermuda entity, and that takes a little bit of the steam out of our market." (Reinsurer)

In 2011/12 several well-known hedge funds continued to announce the formation of reinsurance companies in response to fickle investment opportunities elsewhere, and because they wanted to use reinsurance premium as a captive pool of capital to reinvest in the hedge fund itself. Examples include two \$500 million dollar Bermudian reinsurance companies, TP Re and SAC Re, set up by hedge funds in 2012.<sup>6</sup>

**Insurance companies** already operate within the same regulatory framework as reinsurers and are thus able to jump most of the above barriers to entry. Examples include Allianz Re which diversified from insurance to become one of the largest reinsurers in the world, and Atradius, which used its specialist credit and surety knowledge to become a key reinsurer in that space through Atradius Re.

**Brokers** (see section 3.1) might help new entrants gain a foothold in the market, but they can also help incumbents defend their turf by more intelligent matchmaking with suitable clients (see Masterclass VI). This is a complementary role for brokers which potentially adds value to reinsurance services.

**In general:** there was a surge of new entries from hedge funds in 2012, due to forecast rate rises after the many disasters of 2011, and also connected to poor returns in financial markets.

## 1.1.5 Rivalry with other reinsurers

The forces of industry discussed in the above analysis, such as new entrants, growth of Cat bonds and the supply of reinsurance capital have led to intense rivalry between reinsurers, because their core business is under attack from all sides. In particular, the growth of reinsurance capital – from 342 billion in 2008 to 480 billion in 2012 – has meant increased competition for a comparatively static amount of reinsurance premium in traditional markets. In non-Cat lines of business the demand for reinsurance is actively declining.<sup>7</sup>

<sup>6</sup>Source: <http://dealbook.nytimes.com/2012/09/04/with-lax-regulation-a-risky-industry-flourishes-offshore/>

<sup>7</sup>Source: [http://thoughtleadership.aonbenfield.com/Documents/20120909\\_ab\\_analytics\\_reinsurance\\_market\\_outlook\\_external.pdf](http://thoughtleadership.aonbenfield.com/Documents/20120909_ab_analytics_reinsurance_market_outlook_external.pdf)

# 1. Competitive forces in reinsurance (cont.)

While emerging markets are still growing, the premium on offer there in 2012 remains comparatively tiny compared to the likes of North America. Some territories do have the potential to counteract the general trend of declining total premium. Foremost among them is China, where unlocking the local market could disrupt the traditional frontiers of the reinsurance business.<sup>8</sup> Brazil is another attractive emerging market. Most lines of business in Brazil experience an annual increase in insurance penetration of around 10% and, consequently, cedents are purchasing more and more reinsurance capacity in response to their growing exposures.<sup>9</sup> In response, major brokers and reinsurers are developing local offices in such emerging territories, and new business models to enable them to compete on a global base. Competition between reinsurers for reinsurance profit and premium is therefore no less fierce in emerging markets than in the traditional ones.

However, reinsurers can to some extent choose their competition, by carefully defining their strategy. Despite the increasing connectivity of the global reinsurance market, 'the market' is not monolithic. Most players have strong preferences for the business they seek – or don't seek (see Masterclass III). In consequence, not everyone is everyone's rival, and rivalry in some segments is more intense than in others.

A reinsurer's strategy must depend on how they perceive the competition in their segment of the market. So reinsurers must be clear about the different segments they perceive and the criteria by which they defined them (see Masterclass III). Any market can be made to look attractive, if it is defined narrowly enough, but reinsurers must beware that the boundaries they perceive may not actually be barriers. As markets converge, competitors from other market segments, or even other capital markets, may become new entrants in another and take market share from the incumbents. Take for example the rise of 'Zurich start-ups': eleven new reinsurers have entered Europe since 2011, increasing competition and driving down margins. Yet many of these entrants were Bermudian firms, which might not previously have been thought to be competitors in Europe, because of their historic focus on the US catastrophe market segment.

**In general:** rivalry has strongly increased over the last four years, both as a consequence of the increasing power of buyers and suppliers, the availability of substitutes and new entrants, and as

a consequence of incumbent reinsurers' own growth ambitions. Simply put, if the market is no longer growing, any growth by one incumbent has to be achieved at the expense of another's market share.

## 1.1.6 Regulation – the rules of the game

The EU's forthcoming Solvency II directive and Standard and Poor's recent economic capital model (ECM) reviews are changing the reinsurance landscape. These are (or will be) relatively stringent requirements, aimed at safeguarding reinsurers' liquidity even in the case of large payouts for catastrophic events. They are increasingly focusing the industry on internal capital modelling, sophisticated quantification of risk, and strict boundaries around risk appetite and tolerance.

In themselves, these increasing demands cut into industry profits, as compliance with new standards is always costly. More profoundly, though, regulatory changes are also sharpening some of other forces in our model. For instance, Solvency II is likely to create an even more technologically-focused environment than previously, because those who can demonstrate effective internal capital modelling will be advantaged in this new, more stringent regulatory environment.<sup>10</sup>

A regulation-driven technology focus further increases the bargaining power of the suppliers of those vendor models that are used for the more stringent risk quantification. There is a further side-effect of the standardization that is inherent in the stipulated use of models: it becomes increasingly difficult for reinsurers to differentiate themselves based on the quality of their analysis. Direct rivals, new entrants and brokers can offer very similar services, which allows cedents greater freedom in shopping around for those services and increases their buyer power.

Finally, regulatory rating agencies provide cedents with information about reinsurers' risk profiles and financial positions. As a result, while market transparency increases with increased scrutiny, the room for reinsurers to differentiate themselves is further constrained, because the agencies 'even up' information asymmetries that reinsurers could previously exploit. Thus, in the absence of strong differentiation, competition increasingly hinges on price, which heralds further rate reductions.

Still, some local variation remains, as every regional market has to meet its own local regulatory system setting out the rules of the game. These local

<sup>10</sup>Source: [http://thoughtleadership.aonbenfield.com/Documents/20120910\\_ab\\_analytics\\_evolution\\_criteria.pdf](http://thoughtleadership.aonbenfield.com/Documents/20120910_ab_analytics_evolution_criteria.pdf)

# 1. Competitive forces in reinsurance (cont.)

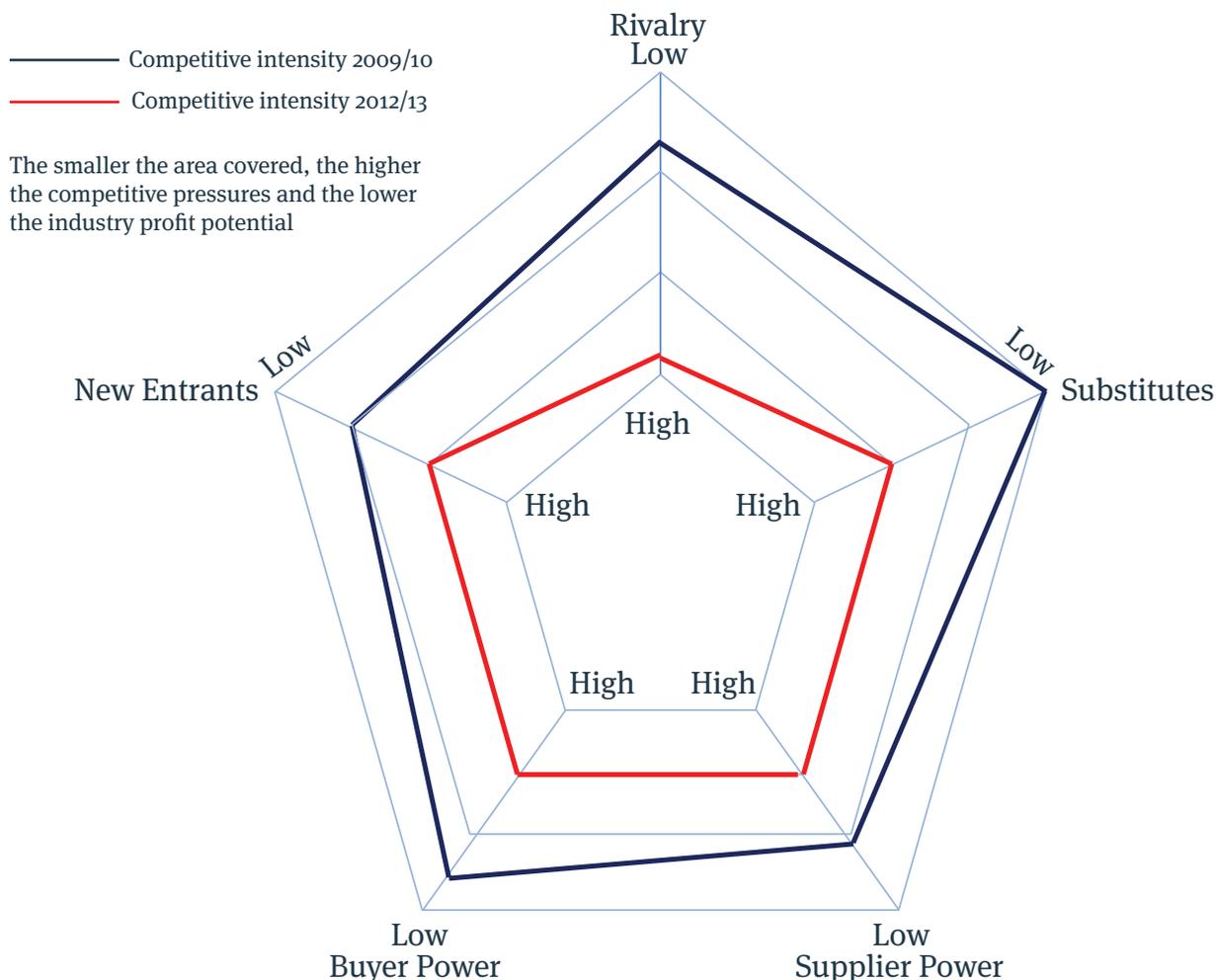
regulations may be very different from each other: for instance Bermuda is recognized as having less stringent capital requirements<sup>11</sup> than Lloyd's syndicates operating under the UK regulation administered by the Financial Services Authority (FSA), which is stricter than in most other markets. Reinsurers' planning for the future needs to differentiate which markets are likely to benefit or suffer from specific regulatory changes.

In general: forthcoming regulatory change will cost reinsurers via changes in working practices and greater technological focus. However, stricter regulation could also provide opportunities for reinsurance companies as some cedents may demand more capital (via reinsurance) to comply with the new standards.

“Solvency 2 could throw up opportunities where people just need more capital in certain areas. And then we'd hope we'd be in position to give maybe quota share type solutions, so that they've got somewhere safe to park some of their premium and it takes the capital strain off their own balance sheet.” (Reinsurer)

## 1.2 The cumulative impact of Porter's Five Forces on reinsurance profitability over recent years

From our analysis of the 'Five Forces' in section 1.1, we can see from our 'In general' summaries that every one of the five forces has increased its pressure on reinsurance profits over the past couple of years, as shown in figure 1.2.



**Suppliers** have hugely increased the pool of capital invested in reinsurance, driving rates down. Increased use of **substitutes** such as Cat bonds have diverted premium away from traditional reinsurance products. **New entrants**, diversifying from Hedge Fund or Insurance company activity, have divided the reinsurance pie ever more thinly. **Buyers** have consolidated and gained power to drive down rates by bundling risk, or by retaining it. **Rivalry** between reinsurers has intensified as more incumbents are competing over a smaller pie of ceded premium. **Regulation** has driven standardization, transparency and technicalization and, in doing so, has reduced the ability for reinsurers to differentiate themselves on criteria other than price.

Figure 1.2 Changes in market forces (Porter's Five Forces) and their cumulative effect on reinsurance margins, 2009-12

<sup>11</sup>Source: <http://dealbook.nytimes.com/2012/09/04/with-lax-regulation-a-risky-industry-flourishes-offshore/>

## 1. Competitive forces in reinsurance (cont.)

---

These five forces, embedded in a regulatory context, collectively define an industry's average profit potential. Over time, the strength of any individual force may wax or wane and some fluctuations may even cancel each other out. It is unusual when all five forces change in lockstep, however, and industry profits come under pressure from all sides.

In these circumstances, a strategic understanding of those trends is critical. Because even though industry profitability is under pressure, any individual company can beat the trend and maintain

organizational profitability by managing the situation more astutely. Some special features of the reinsurance industry, if employed strategically, can actually help achieve this goal.

In the following sections we will first look at those special features of the reinsurance market which are not covered by the Porter's Five Forces model. We will then customize the model to include players who may compete, but also might also collaborate with reinsurers – to return value and profit to the reinsurance product.

### Study Question 1

- (a) Relate Figure 1.1 to the market(s) you operate in. List at least three firms or players in your market(s) who fit into each of the categories in the diagram.
- (b) In your market(s), can you identify any particular player among suppliers, recent entrants, or substitute products, which has a particularly powerful effect on profitability in your market? Are you especially affected by this player, or are the effects felt more by other players in your market?
- (c) In the same market(s), describe any recent change in local or global regulation and identify consequences you have seen across several different deals.

## 2. ‘Porter Plus’ – a new customised approach to competitive forces in reinsurance

Porter’s theory is a good starting point for our ‘big picture’ of the reinsurance industry. However, it needs modifying because of certain special features of the industry.

### 2.1 Complementors

Porter’s model does not consider ‘complementors’, industry players who provide complementary products or services which add value to existing reinsurance products.

Brokers are a hugely important type of complementor in the reinsurance industry. They offer analytic services that help cedents structure their programmes, and they channel programmes towards reinsurers with a commensurate risk appetite (which can save reinsurers a lot of work in finding business). Masterclass VI addresses this matchmaking role of brokers in greater detail.

At the same time, though, the risk-modelling services that brokers provide were previously the domain of large reinsurers. These complementary services do more than facilitate the placement of reinsurance programmes. They also, in a way, encroach upon reinsurers’ service territory, as substitute services. Where brokers provide strong modelling services to their clients, highly-technical reinsurers have less room to distinguish themselves, which increases competitive pressures.

In short, brokers act as complementors, but also as providers of substitute services, so we can see that brokers play an especially complex role in the market. We cannot place them within any single group in the original Porter scheme, so we will put them in a category of their own. The role of the broker will be examined in detail in section 3.1.

### 2.2 Co-opetition

First, Porter’s model frames business relationships as solely competitive. As we have just seen in 2.1, this is not true for brokers, and possibly not for some other industry players, either. In fact, different players may combine competitive and co-operative strategies. Such **co-opetition**<sup>12</sup> allows the players involved to increase the size of the ‘pie’ through collaboration before competing over their share of it. Especially when the size of the market ‘pie’ is under pressure from many angles, co-opetitive strategies may work to everyone’s advantage.

Thus, when applying Porter’s “Five Forces” framework to reinsurance, it is also important to extend it through the concept of co-opetition. For instance:

- relationships between reinsurer and **cedents** cannot be understood in solely competitive terms, as they involve collaborative elements of mutual learning and trust. Sometimes, greater collaborative transparency on the part of the cedent can help settle on favourable terms, as reinsurers are more comfortable that they fully understood the risk;
- in their role as complementors, **brokers** collaborate with reinsurers by feeding them business that fits their declared risk appetite, even while they try to drive reinsurance prices down for their clients;
- despite their rivalry, **reinsurers** rely on each other to evaluate risk and set appropriate terms for subscription.

<sup>12</sup>Dowling, M. J., Roering, W. D., Carlin, B. A., & Wisniewski, J. 1996. Multifaceted relationships under co-opetition: Description and theory. *Journal of Management Inquiry*, 5(2): 155-167; Nalebuff, B.F., & A.M. Brandenburger. 1996. *Co-opetition*. London: Harper Collins.

## 2. 'Porter Plus' – a new customised approach to competitive forces in reinsurance

### 2.3 Porter-Plus

If we add these two extensions to Porter's framework, we arrive at the following expanded model (Figure 2.3), which we will refer to as 'Porter-Plus'.

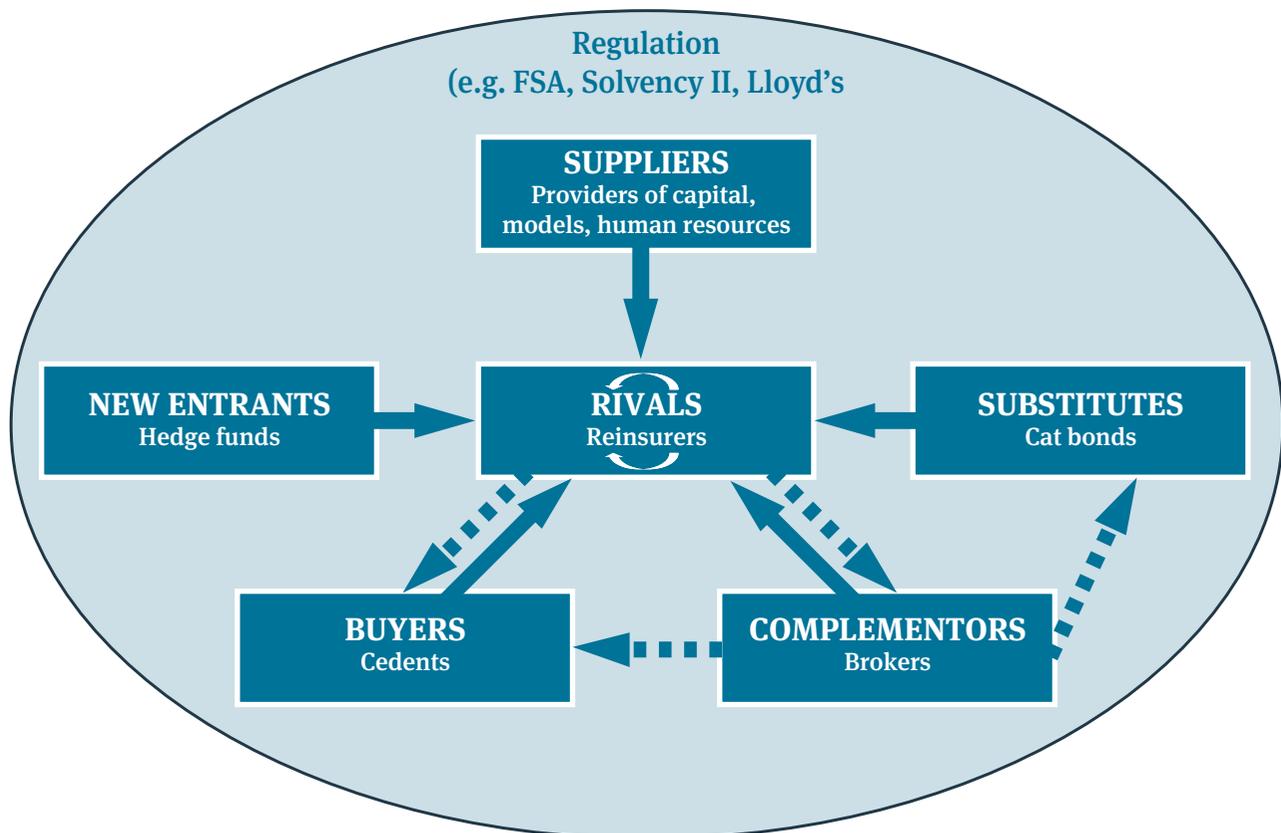
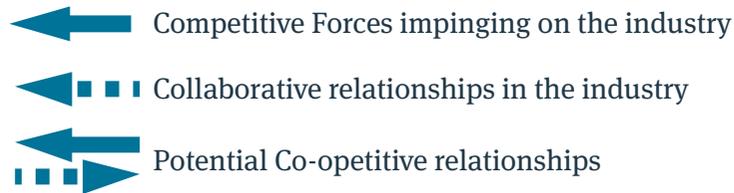


Figure 2.3 An expanded 'Porter-Plus' model of competitive and collaborative relationships in the reinsurance industry. This builds on the five forces of Porter's theory (shown in Fig 1.1)

In the following sections we describe how actions by each industry player affect the profitability of reinsurers, and what relative power they currently wield to do so.

#### Study Question 2

- Are you aware of instances where brokers have encouraged cedents to take their programmes outside of the reinsurance industry, by buying substitute products? Or of the opposite, where the cedent has been persuaded to place their premium with a reinsurer rather than a substitute?
- Can you describe an instance in which greater transparency between a cedent and a reinsurer resulted in a better deal than would otherwise have been the case, for either or both parties?

### 3. Collaboration and co-opetition strategies in the reinsurance industry

As we explained in section 2, reinsurers naturally find themselves in competitive relationships with other reinsurers, cedents, and – to some extent – brokers, all of whom may exert or moderate one of Porter’s Five Forces on reinsurance profits. But there is also potential for collaboration with each of these players which can add value to the reinsurance business. In the following sections we examine these opportunities.

#### 3.1 The complex role of the broker

Brokers have always played a central role in the reinsurance industry – naturally, as they are intermediaries who connect buyers and sellers. Yet the nature of this role has evolved over time, into multiple roles. Figure 3.1 outlines the evolution of brokers’ roles from competitor to substitute to complementor (examined below in 3.1.1–3.1.2).

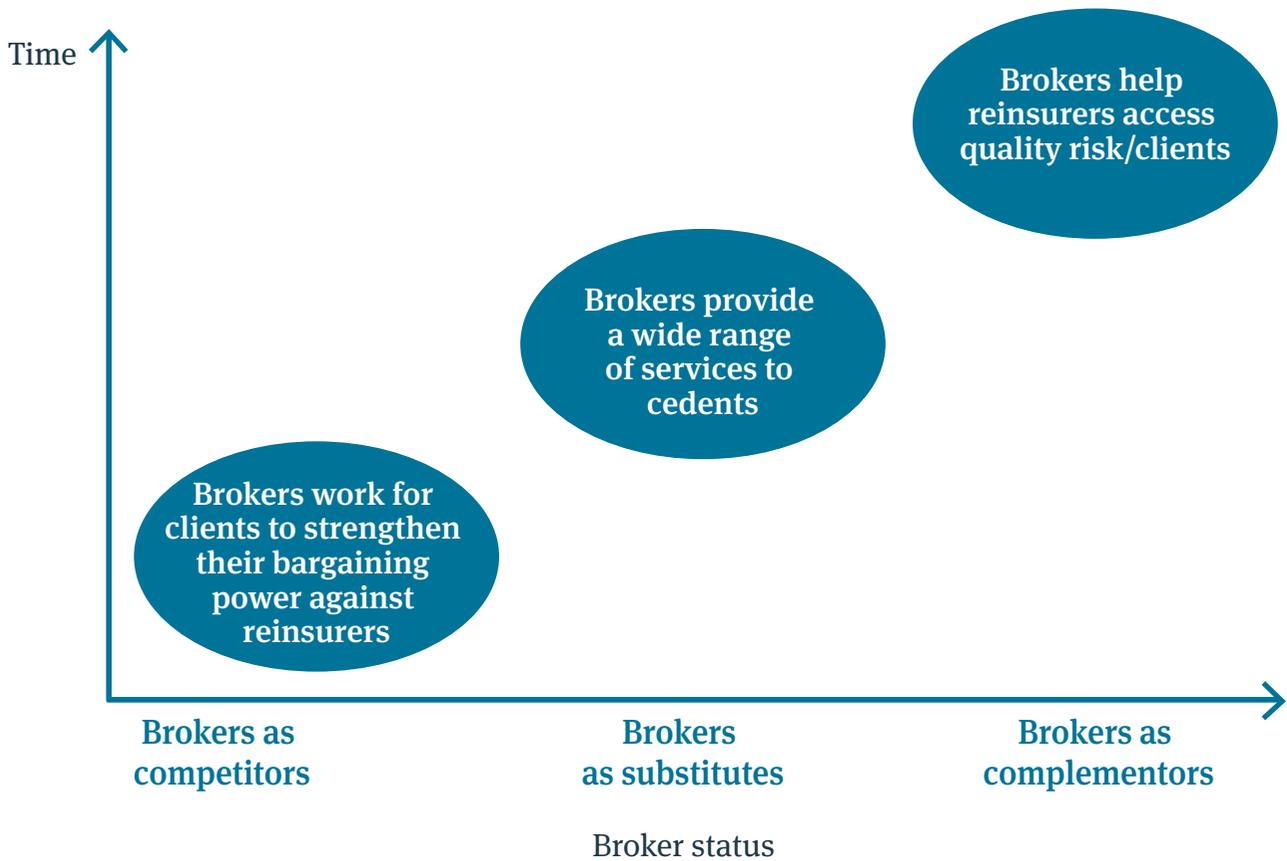


Figure 3.1 Historical evolution of the roles played by brokers in the reinsurance market

It should be noted, though, that these roles are played to different extents in different reinsurance markets. European reinsurers have a history of by-passing the role of the broker and have traditionally

been more likely to see brokers as competitors. The role of brokers as complementors is more established among reinsurers in Lloyd’s.

## 3. Collaboration and co-opetition strategies in the reinsurance industry

### 3.1.1 The broker in competition with the reinsurer

Brokers work as **competitors** to reinsurers as they try to gain the best price possible for the reinsurance buyers: they work for their clients not reinsurers. On cedents' behalf, they drive down prices by restructuring programmes so as to obscure year-on-year comparability, negotiating favourable deductibles and retention levels, plus terms and conditions, and generally through the breadth of their distribution channels. In Porter's terms, they strengthen buyer power and shift margin from reinsurance sellers to buyers.

As brokers have evolved into more sophisticated service providers in their own right, offering analytic services and structuring advice, their relationship with reinsurers has changed to that of a provider of **substitute** services. These services used to be provided by reinsurers. It used to be the case that a cedent who was actually unsure of the level of risk they were handling could go to a very expert reinsurer to get the risk analyzed – at the cost of a higher premium. Nowadays, a broker might do this for them, enabling the cedent to go with a lower reinsurance premium.

This shift reduces margins, but also deprives reinsurers of an opportunity to distinguish themselves in the eyes of the cedents. The provision of analytical capabilities and training, high-powered computing capacities which individual insurers don't possess, or wording/legal advice used to help differentiate high-quality from low-cost reinsurers. Without this opportunity for differentiation, price competition is yet further emphasized, intensifying rivalry within the industry.

### 3.1.2 The broker as complementor to the reinsurer

Despite the various ways in which brokers have reduced profitability in the reinsurance industry, reinsurers must not overlook their role as **complementors**. Unlocking the value of this role depends more strongly on reinsurers' collaborative attitude, though.. For example, new reinsurance entrants into particular markets again and again highlight their reliance on brokers to both 1) sell their particular brand to cedents; and 2) show them the available risk in those markets. In this sense, brokers can act as a distribution channel for both insurance risks *and* reinsurance capacity.

In their function as a distribution channel, brokers not only help cedents access risk capital, they also help reinsurers access quality risk/clients. In this sense, reinsurers work with brokers to access the

type of risk they are targeting, to fill in gaps in their own knowledge (for example, when assessing clients in new markets, where the reinsurer lacks the background knowledge and experience) and to supplement their own resources (such as via brokers' local offices). These types of benefits, however, are often overlooked by reinsurers while they deplore the rise of brokers and cedent power.

**In general:** brokers now perform much more varied services than in the past. Understanding the value they can create for reinsurers, via intelligent matchmaking with cedents, can relieve some of the competitive pressure reinsurers face through strengthening buyer power (see Masterclass VI).

## 3.2 Co-operation between buyer and seller of reinsurance

Standard operating procedure is still for cedents (and their brokers) to obscure year-on-year changes, complicate comparison and make their risks less intelligible. This is the very opposite of a co-operative approach. Cedents aim to make their deals look more attractive – but instead, reinsurers are instinctively likely to charge a higher premium for a risk they feel they do not fully understand.

Instead, we would argue that both buyer and seller, cedent and reinsurer, can benefit from a long-term relationship built on transparency and trust. The reinsurers can add greater value for their cedents when they are able to understand the cedent, their strategy and risks, while gaining access to the information they need to be confident in their risk assessment. In a more collaborative approach, a cedent gains a partner who truly understands their risk profile, who can be trusted to pay their claims promptly, and who is able to assist them through free consultancy services.

Many relationships between buyer and seller in reinsurance have traditionally been based on the idea of 'payback': if a reinsurer wears a loss with a cedent, there is enough continuity in that relationship for the reinsurer to reap the benefits of the consequent rate rises. The tradition of payback is *de facto* a collaborative strategy; pure competition might suggest that the cedent avoids payback and simply shifts to another reinsurer to access cheaper rates. The 'payback' tradition has been a tacit recognition of the two-way benefits of longstanding relationships, mentioned above. Maybe it is time for reinsurers to emphasise more explicitly these benefits, gained via learning and information quality, to counter a drift away from long-term relationships (see Masterclass V).

### 3. Collaboration and co-opetition strategies in the reinsurance industry

---

#### 3.3 Reinsurers: collaboration

As reinsurance is a subscription market (whereby all reinsurers take a share of a particular risk at the same market price) there is widespread realization among reinsurers that they rely on having *good* competitors. That is, competitors who will not undercut on price and share certain standards of risk assessment. This is taken to the extreme in Lloyd's where **collaborative** efforts have seen the establishment of a single market voice, sharing of resources and setting standards of appropriate practice between reinsurers.

“...There is a community nature to the market where different syndicates don't purely see each other as competitors, but also refer business between them to keep it within the Lloyd's market.” (Reinsurer)

Reinsurers must not lose sight of this distinctive nature of their market, in which it is vital to balance competition and collaboration. An appreciation of strategic groups in reinsurance (see Masterclass III) will show which players are more natural competitors or collaborators.

#### Study Question 3

- (a) List the roles played by brokers for both insurers and reinsurers. In what ways can you make better use of these?
- (b) Identify a specific recent example in your market of co-operation (i) between reinsurers (either bilaterally or as an association) (ii) between reinsurer and cedent, which benefitted both or all parties. Was the benefit to you one of profitability, or something else?

## 4. Conclusion: the squeeze on reinsurance margins – and ways forward suggested by our strategic analysis

As we showed in section 1, between 2009 and 2012 every one of the market forces we have identified – exerted by the groups of players as a whole, rather than individual buyers or brokers or investors – has intensified its pressure on reinsurance margins.

For reinsurers to fight back and grow against these concerted forces, there are three main options. All of them require the strategic understanding of the industry which we have developed in this Masterclass – an understanding framed in terms of co-opetition, a mix of competition and collaboration.

1. **Refine competitive strategy in both traditional and emerging markets.** This is the focus of Masterclass II, which seeks to understand and predict types of cedent behaviour, and of Masterclass III, which goes on to develop the idea of ‘strategic groups’ of reinsurers each based on a different business proposition, suited to different types of cedent.
2. **Improve the internal effectiveness of reinsurance operations.** This is especially the subject of Masterclass IV, which examines the strengths of old and new approaches to the risk appraisal process, the way they can be blended, and the new capabilities they require.

3. **Develop collaborative strategies** to benefit both reinsurer *and* any of: buyers, brokers and/or the reinsurance community in general. Masterclass V investigates the links between relationships, information, and three different kinds of trust in business relationships, all vital to reinsurance deals. Masterclass VI focuses on the roles of brokers, and the skills they can contribute to create competitive advantage for both reinsurer and cedent.

The reinsurance industry finds itself in a situation of extreme flux. The current industry structure might be radically shaken up, soon. New regulations could erect greater barriers to entry in fiscally strict countries, leading to greater competition in so-called tax-havens. More accurate technical models for a particular territory could boost the bargaining power of the modellers. A lack of significant ‘payback’ from events in 2011 might easily challenge some traditional assumptions of collaboration. There are so many “what if...?” scenarios which could unfold...

In Masterclass VII, the last in our series, we demonstrate how strategic understanding of the reinsurance industry could help you plan for scenarios you may soon have to face – enabling you to shape your future, not just react to it.

### Study Question 4

The balance of competitive forces and collaborative will is always evolving. In your market, what changes to these elements are you seeing that are not already part of our analysis above? How do they fit into the categories we have described? Or – are they a new force to be added to ‘Porter Plus’?

## List of Global Reinsurance Masterclasses

- **Re-Think reinsurance:** How to shape your future through a strategic understanding of global market forces
- Fit for purpose? How to tailor reinsurance products to insurance industry lifecycles
- Winning the game: How to identify reinsurance rivals and spot growth opportunities
- Be a better reinsurer: How to align structure, knowledge and roles for operational excellence
- Strategic reinsurance relationships: How to evaluate information and build trust
- Intelligent matchmaking: How to maximise value from broking
- Imagining the future: How to stay ahead in the reinsurance game through scenario planning

The aim of the Global Reinsurance Masterclass Series is to support (re)insurance and broking companies in analysing their position and improving their competitiveness during a period of global change. They are based on in depth analysis of a global reinsurance data set, supplemented with analysis of secondary data and findings from complementary industries.

Each masterclass functions as a standalone module that can be used on its own or in conjunction with other masterclasses.

**Cass Business School**  
106 Bunhill Row  
London EC1Y 8TZ  
T: +44 (0)20 7040 8600  
[www.cass.city.ac.uk](http://www.cass.city.ac.uk)



#### **Cass Business School**

In 2002, City University's Business School was renamed Sir John Cass Business School following a generous donation towards the development of its new building in Bunhill Row. The School's name is usually abbreviated to Cass Business School.

#### **Sir John Cass's Foundation**

Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.