“Finding the optimal path to growth, profitability and solvency”

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DENIS KESSLER

In an exclusive interview with l'Argus de l'assurance, SCOR's CEO speaks about the main lines of his new strategic plan, Optimal Dynamics. Providing his commentary on the current economic, political and financial climate, and predicting a rise in interest rates, he describes each of his ambitions for a market on which he intends to take the fifth leading position. All that remains is for SCOR, which Denis Kessler calls a global group, to reach its optimum size in order to enjoy broader market position possibilities while maintaining its solvency.

SCOR’s THREE-YEAR PLAN

“Finding the optimal path to growth, profitability and solvency”

You have just announced your new strategic plan, Optimal Dynamics, at a time when political and economic visibility has never been so low. Is there much point in having a three-year plan nowadays?

Before the crisis, when we drew up costed three-year plans, we estimated our return on assets and focused on liabilities, our core business. Today, our main problem is no longer liabilities but rather assets. How can we balance accounts under a financial regime with risk-free interest rates at 1%? Solvency II standards and the capital charges required by rating agencies urge us to invest in risk-free assets with very low returns. Our main concerns are now after-tax returns, counterparty risk and sovereign risk. Financial transactions are now taxed. This changes the financial balancing of all reinsurers who have assets totalling a multiple of premium income. In addition, the low risk-free rates – in terms of economic value – limit the impact of discounting liabilities. Now, combined ratios that were “satisfactory” at 98% when the rates were at 5% are no longer acceptable when rates are bordering on 0%! This is why we absolutely have to improve technical profitability...

Have the sector’s fundamentals changed?

Reinsurance retains a major advantage, and investors are fully aware of this: our business is not very dependent on the general economic climate. Even when there is a decline in activity, existing assets are still insured. Furthermore, demand for natural catastrophe coverage is not correlated to the economic and financial
situation. This is corroborated by the success of cat bonds, which attract investors looking for a good return. One thing has changed though: before the crisis, insurers and reinsurers did not heed central banks as we must do today. One of our current major concerns is the future development of monetary policy. This variable, which dictates most of the sector’s profitability, is out of our control, which is why we need several rate scenarios.

You are an economist, did you underestimate this influence?

We thought that central banks could not pursue this lax monetary policy (quantitative easing) for this long. Central banks have been dilating their balance sheets since 2008, multiplying them by three on average! They have rolled out a very active and unconventional policy to stop the liquidity crisis and help to refinance the banking system and States by purchasing government debt securities... This is a serious departure from the traditional principles of monetary policy! We thought that these practices would have been called to order earlier and that rates would have gone back up. It seems that this is now the case. The time has come for a shift in monetary policies.

What do you predict will happen?

Interest rates will be put up. We were already convinced of this a year ago when we drew up our strategic plan, and we have been certain since June this year. In the space of two months, the interest rates on US 10-year Treasuries have increased by almost 100 basis points. We do not yet know whether this rise will be brutal or gradual, or if interest rates will stabilise at 3% or 5%. We based our plan on three scenarios: a sharp hike in rates, a gradual rise, which is our main scenario, and the rates remaining at a very low level if the economy suffers a third dip.

How do you intend to overcome these uncertainties?

We have positioned the group to be able to manage the next three years as optimally as possible, i.e. by cutting the costs of this monetary transition while maximizing return on investment. We have reduced our portfolio’s sensitivity as much as possible, by shortening our assets’ duration and by keeping it above the duration of our liabilities (known as a roll-over strategy) to generate significant financial cash flows. What this really means is that we have €5.8 billion in cash to be reinvested within the next two years in assets with a higher interest rate. We are one of the companies for which the negative impact of a hike in interest rates will be mitigated, as we minimize unrealized losses and immediately reinvest them at a higher rate of return.

What do you think about the inflation risk?

Inflation and economic recovery go hand in hand. Evidence of this can already be seen in the USA. As soon as there are signs of recovery, inflation immediately reappears. This is why central banks have to increase interest rates if the situation
improves, because they will have to absorb the excess liquidity created since the crisis. We are less sensitive to this eventuality, feared by insurers in the long-tail casualty and liability businesses as inflation increases the value of their commitments and leads them to increase their reserves. In Non-Life reinsurance, SCOR is not very present in long-tail businesses. In Life reinsurance, we have prepared for the inflation risk by positioning the group on biometric risks, with annuities that are not indexed to inflation. The plan provides for an increase in our casualty exposure in the next three years to benefit from the inevitable rise in pricing.

**You are one of the market’s five multi-liners, but in terms of size and stock market valuation, SCOR falls below its competitors. Will your plan enable you to catch up?**
Regardless of the events we have had to deal with (financial crisis, collapse of Lehman Brothers, debt crisis, tsunami, etc.), our net assets have continued to grow. Our market valuation has risen from €300 million to €4.7 billion in eight years, and now corresponds to our net asset value. That said, market capitalization is not the right indicator to use. What interests our clients is solvency, and I should know that this is our main asset. SCOR’s rating has risen from BBB- to A+ (up 5 notches) and we are the only company to have been upgraded twice during the financial crisis, without any capital increases. SCOR is only one notch behind the four other multi-liners, as against nine notches eight years ago. We are a leading reinsurer today, one accepted by all companies.

**You have really turned the group around. What is the next step?**
The new strategic plan follows on from the previous one. If it isn’t broken, don’t fix it! The group is driven by two businesses of similar size, Life reinsurance and Property & Casualty reinsurance, through which we can mitigate the volatility of our quarterly results, the lowest volatility on the market since 2005, and we maximize the benefits of diversification. We have established that with a 50/50 ratio between Life and non-Life, we save 27% in capital, which is a lot! This reflects a strategy rolled out in 2003, when I refused to sell off the Life business, specifically because I predicted that the regulator and rating agencies would in time acknowledge the benefit of diversification. We have developed our Life reinsurance business since then, and it is a market on which it is extremely difficult to gain a foothold as the first five leading players account for 85% of premiums. The barriers to entry are very high. With the acquisition of Generali US, SCOR has become the number one Life reinsurer in the USA, who would have predicted that ten years ago?

**How do you see your group in three years’ time?**
Ultimately, our revenue distribution will follow that of the global reinsurance market. We are present on both mature and emerging markets. With the acquisition of Generali US, this year we will reach €10.9 billion in premiums (pro forma data). Overall, our new plan targets average annual premium growth of 7%. This should be higher in P&C (+8.5%) than for Life reinsurance, based on generally stable pricing mechanisms.

**Do you think that the recent global catastrophes will affect pricing?**
American Cats are often the focus of the Rendez-vous de Monte Carlo, while they only account for a small portion of global reinsurance. All discussions on changes to US Cat pricing and the effects of the surge in ILS\(^1\) do not outline developments in reinsurance on a global level. Reinsurance markets are fragmented and balance themselves independently from one another: what happens in Japan or in Europe is not dependent on Cats in Florida!

**What are your main goals in the medium term?**

Optimal Dynamics has the same targets as the Strong Momentum plan that is coming to an end. Despite uncertainties with regard to a rise in interest rates, we continue to aim for a return on equity (ROE) of 1000 basis points above the risk-free rate. We are also keeping our goal of providing a high level of solvency, with a solvency ratio created by our internal model ranging between 185% and 220% of SCR\(^2\). In terms of operations, we are aiming for a combined ratio of 93%-94% in P&C, i.e. 100 basis points more than today, and a 7% margin in Life, consistent with its increased weighting in our portfolio of financial solutions and longevity, for which we also plan to double the portfolio. I must state that our growth will be entirely self-financed for the duration of the plan.

**Finally, what is the philosophy behind these figures?**

SCOR’s strategic plan aims to identify the optimum path that dynamically combines growth, profitability and solvency. How can we successfully maximize profitability over the next three years while complying with the selected level of solvency? The plan also provides for a series of corrective measures aimed at returning to this path should we stray from it. This innovative approach has been made possible thanks to our internal model, an extraordinary tool for making strategic decisions. This model has already been submitted to ACP (the French prudential supervisory authority). We set great store by the concept of optimum size. In our sector, economies of scale are constantly on the rise, mainly because fixed costs are growing considerably. Take, for example, “compliance” costs: out of every ten employees hired, six work in the areas of supervision, reporting, compliance and risk analysis. We must draw up highly expensive pricing, underwriting and modelling tools and only high business volumes can offset this cost. Even if our fixed costs increase, we are improving productivity by setting ourselves the target of a 4.8% cost ratio. At the same time, diversification is increasing with our size, and the size of risks is also increasing considerably. All this means that our optimum size is not that of our competitors, but the size that will enable us to maximize economies of scale and diversification.

**Does this leave the door open for possible acquisitions?**

The Optimal Dynamics plan is based solely on organic growth. When we must make acquisitions, we must comply with stringent criteria to ensure that they fully meet the plan’s objectives in terms of risk appetite, profitability and solvency.

**In a more general sense, do you predict consolidation in the sector?**

\(^1\) Insurance Linked Securities

\(^2\) Solvency Capital Requirements
If there were to be mergers or acquisitions in the reinsurance market, I think that they would above all concern small- and medium-sized companies. I do not believe that this will concern the largest reinsurers due to risk diversification. The equation is simple: cedants tend to allocate most of their risks among the five operators for diversification purposes, and entrust the rest to second-rate players. As SCOR is one of the first-rate players, we play a direct part in establishing policy terms and conditions. We believe that SCOR, in this sense, is more than capable of generating growth more quickly than other market players due to our relative size. Other things being equal, cedants have relatively fewer policies with SCOR, and our counterparty risk is therefore lower than our competitors’. This legacy is one of our main advantages today.

**Do you still refute that reinsurance is systemic?**

There is no systemic risk in reinsurance. It is a complete fabrication on the part of central bankers and politicians. These persons have just decided that they will need another year to publish their list of systemic reinsurers, which just goes to show how urgent it is!

**INTERVIEW BY MARIE LUGINSLAND,**
**WITH GÉRALDINE VIAL AND ANNE LAVAUD**

**ACTING AS A GLOBAL GROUP**

SCOR made a commitment to globalization very early on. It was the first French company to adopt the legal status of Societas Europaea for all its companies, and went a step further by opening offices around the world and hiring local personnel. “Whether in India, the USA, Singapore or Korea, we do not have expatriates. Similarly, we prefer branches to foreign subsidiaries”, says Denis Kessler, stating that SCOR’s management is split between New York, Charlotte, London, Cologne, Zurich, Paris and Singapore.

As a result, the balance of power between Europe, which accounted for 60% of revenues only three years ago, and the USA and the rest of the world has been turned on its head. Today, 94% of business is conducted abroad.

**ACTING AGAINST CCR’s MONOPOLY OF THE FRENCH STATE GUARANTEE**

At Denis Kessler’s instigation, a case was submitted to the French Constitutional Council with regard to CCR’s guarantee from the French State. Not wishing to comment on ongoing proceedings, SCOR’s CEO limited himself to stressing that his approach did not target the Nat Cat regime as such, but the reinsurance terms surrounding it. He has long since wondered why the law grants a single reinsurer the advantage of the State Guarantee while lawmakers have simultaneously thrown out the solution of a monopoly.

This is a specifically French exception that he believes enables the Caisse Centrale de Réassurance to poach on other reinsurers’ patches, in New Zealand or in Japan, armed with the French Republic’s AA rating!

**STRATEGIC AXES**
- Maintain the 50/50 balance between Life and P&C in order to minimize result volatility and maximize diversification benefits (following on from the previous plan).
- Minimize the costs of the economic and political transition in a sudden hike in interest rates by maximizing yields over the plan.
- Increase Casualty exposure over the three years to benefit from pricing increases.
- Double the longevity portfolio.
- Pursue the financial solutions offering enabling companies to reduce their capital requirements, supported by two dedicated teams.
- Base revenue distribution on that of the global reinsurance market, targeting a leading position in each of its markets.

MEDEF: ACTING AS A KEY INTERFACE
Denis Kessler’s involvement within Medef (the French employers’ association) is long-standing. The SCOR boss has long spoken out within the association so that insurers and reinsurers could be heard in their areas of expertise: from pension reforms to shale gas and Syria. He has been successful in that many peers have positions in the association’s various commissions. Denis Kessler supported the election of Pierre Gattaz, who returned the favour to the insurance sector as Claude Tendil, CEO of Generali France, was appointed Chairman of the social welfare commission (protection sociale) and Stanislas Chapron, Chairman of the Board at Marsh France, was appointed Chairman of the Commission for closer relations (Rapprochement des mondes).
In July, Bernard Spitz, Chairman of the Fédération française des sociétés d’assurance (FFSA), was appointed Chairman of the International/Europe unit and was announced as a member of Medef’s executive board and committee. Denis Kessler did not wish to canvas for these positions...

THE STRATEGIC PLAN’S MAIN INDICATORS
- Average annual growth of 7%. This should be higher in P&C (+8.5%) than for Life reinsurance, based on generally stable pricing mechanisms.
- Return on equity (ROE) 1000 basis points above the risk-free rate.
- A level of financial security equivalent to that of an AA rating.
- Return on invested assets of 3% by 2016.
- Combined ratio of 93%- 94% in P&C, i.e. 100 basis points more than today.
- Life technical margin of 7%, as against 7.5% in 2013).
- €10.9 billion in premiums in 2013 and €13.3 billion in 2016.
  (Estimations - pro forma, including Generali US)