



The strategic role of reinsurance in the United Kingdom's (UK) non-life insurance market



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ARTICLE INFO

Article history:

Received 16 June 2014

Accepted 14 September 2015

Available online 25 September 2015

JEL classification:

G22

G32

Keywords:

Reinsurance

Insurance

Strategy

United Kingdom

ABSTRACT

Using panel data for five main lines of insurance in the United Kingdom's (UK) non-life insurance market we demonstrate that by increasing the level of reinsurance, primary insurers increase their product-market share at the expense of less reinsured rivals. We also observe that the influence of reinsurance and other financial variables on insurers' growth in product-market share differs across lines of insurance business. We conclude that reinsurance performs an important strategic function in insurance markets through its impact on product-market outcomes in competitive insurance markets. Additionally, we find that leverage is the most important factor affecting product-market share at the aggregate business level of the insurance firm.

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1. Introduction

Recent studies reported in the finance literature demonstrate that corporate hedging decisions affect the strategic performance of firms and as a result, product-market considerations are an integral part of the corporate risk management process (e.g. Harris and Raviv, 1991; Froot et al., 1993; Adam et al., 2007). In the spirit of this stream of research, the present study examines the strategic role of reinsurance in influencing annual changes in product-market share in five main segments of the United Kingdom's (UK) non-life (property–liability) insurance market – motor vehicle, property, legal liability, personal accident, and miscellaneous and pecuniary loss.

Reinsurance is a conditional financial claims contract written by a third party (the reinsurer) that indemnifies the counterparty (the primary insurer) for random loss events in return for a share of annual premiums written (Doherty and

Tinic, 1981).¹ Doherty and Tinic (1981) report that reinsurance enables primary insurers to more effectively manage cash flow volatility, maintain future underwriting capacity, and reduce the probability of ruin. The strategic finance function of reinsurance is important not only because solvency risk matters to policyholders and insurance industry regulators, but also because of market imperfections (e.g., frictional costs and taxes) retaining capital can be costly for funding providers (Harrington and Niehaus, 2003). Froot and O'Connell (2008) also contend that managers of insurance firms are particularly likely to reinsure non-standardized and difficult-to-assess risk exposures (that often typify lines of non-life insurance such as legal liability). This risk-transfer/risk-sharing capability enables primary insurers to economize on the costs of financing positive NPV investments, protect

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¹ Winton (1995) points out that there are two main risk-sharing treaties between a reinsurer and insurer: proportional (e.g., quota share) treaties where losses are shared between the parties on an agreed percentage basis; and non-proportional (e.g., excess-of-loss) treaties where the reinsurance company absorbs all losses over an amount that is retained by the insurer subject to an upper limit. Adiel (1996) also notes that in insurance markets, reinsurance can also include financial (or finite) reinsurance that commonly provide an up-front capital injection or relief to reserves (surplus) linked to the net present value (NPV) of liabilities with the level of ceded premiums linked to the value of future claims and profit emergence. However, data on different risk-sharing reinsurance treaties and financial reinsurance arrangements were not publicly available for the full period of our analysis (1987–2010).

cash holdings, reduce premiums (prices), and increase their market power. Jean-Baptiste and Santomero (2000) further observe that reinsurers possess proprietary advantages (e.g., superior information on emergent risks) that primary insurers can share (at cost) in order to more accurately price assumed risks and thereby secure competitive advantages over rivals.

Fresard (2010) argues that when external finance is costly, capital and liquidity management decisions can play important roles in influencing competitive outcomes for firms. Zou and Adams (2008) add that risk management decisions (such as (re)insurance) can be influenced by size-related factors such as the ability of firms to efficiently diversify and retain risks. The present study thus examines the extent to which reinsurance (as a common indemnity risk management contract in insurance markets) influences the product-market position of insurance firms while simultaneously controlling for other potentially important intervening firm-specific factors such as leverage, liquidity, and size. Our research is motivated in four key regards. First, insurance product-markets are becoming more price competitive in developed economies such as the United States (US) and UK, particularly in the wake of the recent global economic crisis (Doherty and Lamm-Tennant, 2009; Best, 2012). This has heightened the importance for empirical research on how reinsurance can be used to secure strategic competitive advantages – for example, by allowing insurers to reduce prices but at the same time maintain solvency and sufficient holdings of cash (liquidity) for investing in positive NPV projects. Second, indemnity contracts, such as reinsurance, are pure hedge instruments that cannot be used for speculation (Doherty, 2000; Aunon-Nerin and Ehling, 2008). This means that by acting as a pure hedge against claims volatility, reinsurance enables primary insurers to more effectively plan and price new products and to ensure sufficient risk capacity for such new lines of business. Therefore, risk financing impacts on primary insurers' marketing strategies and the micro-structure of insurance markets, which in turn directly influences the product-market share of insurance firms. Such perspectives are likely to be of commercial, regulatory and policy interest. Third, our single country/single industry focus 'naturally' controls for biases (e.g., due to differences in risk management practices and product-market structure) that can arise in cross-industry and/or transnational research. At the same time, the results of the present study could be generalized to other industrial sectors (e.g., banking) that also use hedging tools to grow their business and maximize the value of the firm. Fourth, our study provides insights on the product-market linkages between reinsurance, and capital and liquidity management decisions in insurance firms. For example, Zanjani (2002) argues that the ability of insurers to differentiate product prices, and so influence their competitive position in markets, can be related to their marginal costs of capital, liquidity position, and ability to transfer assumed (extreme) risks through the purchase of reinsurance. However, this strategic dimension of reinsurance has neither been given sufficient emphasis nor fully investigated in previous empirical studies of insurance markets. In this respect, our research adds to the extant literature on the impact of capital, liquidity and risk management on the product-market position of firms and the shaping of market structure.

In summary, our results indicate that increasing the level of reinsurance allows primary insurers to grow their product-market share at the expense of less reinsured rivals. We also observe that the influence of reinsurance and other financial variables on insurers' growth in product-market share varies between lines of insurance business. Additionally, financial leverage is an important factor affecting product-market share at the aggregate business level of the insurance firm.

The remainder of our paper is structured as follows. Section 2 provides institutional background information on the UK's non-

life insurance market. In Section 3 we review the relevant strategic finance literature and develop our primary research hypothesis. Section 4 describes our research design, including an outline of the modeling procedure employed, definition of the variables used, and a description of the data. Section 5 analyses and discusses the empirical results. Finally, Section 6 concludes the paper.

2. Institutional background

The UK's non-life insurance market comprises about 360 or so locally licensed and active domestically-owned and foreign-owned companies, subsidiaries and branches of varying size, ownership structure, and product-mix.² The market currently generates approximately £47 billion (US\$76 billion) in net (of reinsurance) annual premiums (Association of British Insurers, 2011).³ In addition, 87 Lloyd's syndicates currently underwrite non-life premiums of roughly £24 billion (US\$39 billion) mainly in marine, aviation and transport (MAT) lines of insurance (Best, 2012). By this standard, the UK is the largest insurance market in Europe and the third largest in the world after the US and Japan (Shiu, 2011). The annual value of non-life reinsurance premiums in the UK (including Lloyd's) is about £23 billion (US\$37 billion) with approximately 70% of annual market reinsurance premiums transacted with global reinsurance corporations such as Munich Re and Swiss Re (Datamonitor, 2011). The UK's non-life insurance and reinsurance markets are relatively unregulated with regard to the quantum of losses that can be covered, indemnity terms, type of contract permitted, and so on (Shiu, 2011). In many ways, reinsurers operating in the UK are regulated on much the same basis as primary insurers (Kader et al., 2010). For example, insurance and reinsurance companies operating in the UK have to be approved and licensed by the insurance industry regulator.⁴ The regulator is, among other things, responsible for monitoring and reviewing the capital adequacy (including reinsurance arrangements) of insurance and reinsurance companies doing business in the UK. Since 2007, UK-based reinsurers are also subject to the European Union's (EU's) Reinsurance Directive which aims, among other things, to ensure consistency in reinsurers' reserving practices, standards of capital maintenance, and solvency reporting (Kader et al., 2010).

The UK's non-life reinsurance market is a potentially interesting environment within which to conduct this research project for three main reasons. First, as in other developed insurance markets such as the US, reinsurance is becoming an increasingly important capital and risk management device in the UK as a greater range of potentially high value and difficult to predict risk exposures emerge (Froot, 2001). Reinsurance is also likely to become a particularly salient strategic issue for UK insurers following the implementation of

² Additionally, 548 non-life insurers licensed by European Economic Area (EEA) member states are permitted to conduct business in the UK under the 1992 Third European Insurance Directive (Financial Services Authority, 2013). However, these non-life insurance firms are not regulated by the UK insurance industry regulator and so they are outside the scope of this study.

³ Approximately 150 or so inactive (and mainly small) non-life insurance funds were also authorized to operate in the UK as at the end of 2010. Furthermore, about 600 EU-based insurance carriers are currently permitted to transact insurance business in the UK under various promulgations of the EU's Third Non-Life Insurance Directive. In addition, the relative proportion of total annual premiums currently written (plus the approximate number of firms) in the five main lines of business examined in the present study are: motor vehicle – 37% ($n \sim 50$); property – 30% ($n \sim 70$); legal liability – 11%; ($n \sim 60$); personal accident – 14% ($n \sim 45$); and miscellaneous and pecuniary loss – 8% ($n \sim 60$) (Association of British Insurers, 2011).

⁴ During the period of our analysis (1987–2010) UK insurance companies were regulated first by the Department of Trade and Industry (DTI) and from 2001 by the Financial Services Authority (FSA). From 1 April 2013, the statutory supervision and regulation of UK insurance companies has been conducted by the Prudential Regulation Authority (PRA) while insurance market practices and consumer issues have been regulated by the Financial Conduct Authority (FCA). Both regulatory bodies are subsidiaries of the Bank of England.

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