Alternative capital goes mainstream in insurance: envisioning the future impacts
Digital technologies, evolving customer expectations and shifting demographics are among the top megatrends driving change in the next wave of the insurance industry. However, in terms of long-term impact, the mainstreaming of alternative capital bringing greater capital options across insurance and reinsurance, when combined with the megatrends, may be more powerful in shaping the industry’s future.

Certainly insurance-linked securities (ILS), which include catastrophe bonds, industry loss warranties (ILW) and collateralized reinsurance, have already profoundly changed how insurers and reinsurers approach the commercial market. First introduced in the 1990s, such forms of capital are so common now that calling them “alternative” is something of a misnomer. Indeed, alternative capital is just capital seeking the most efficient path to market. That path, when combined with the next wave of technology and data capabilities, has the potential to also transform (re)insurance marketplaces in ways limited only by the imagination.

The rise of alternative capital

Alternative capital has expanded dramatically because it offers acceptable returns and risk diversification for capital markets and a lower cost of capital than traditional channels for insurers. Though more capital is available to insurers than ever before, alternatives are expanding faster than traditional capital. Currently, they make up 16% of available reinsurance capacity. As shown in Figure 1, the continuing growth is especially telling after consecutive years of catastrophic losses, which have tested the fortitude and staying power of these non-insurance financial channels.

Figure 1: Change in global reinsurance capital

Source: Company financial statements, Aon Business Intelligence, and Aon Securities Inc.
Recent mergers, joint ventures and alliances have further legitimized the view that alternatives are complementary to traditional insurance and reinsurance. These deals provided acquiring companies with important capabilities and competencies they did not have previously. For incumbent insurers and reinsurers, alternative capital offers flexibility and fluidity in capital deployment across cycles. Developing or acquiring alternative capital capabilities allows (re)insurers to be agnostic to specific instruments, even as they must navigate a complex mix of opportunities and risk. The threat of cannibalization is real, but so too are the related opportunities to transform current operations, adopt entirely new business models and strengthen competitive positioning against nontraditional players, including tech giants.

For asset managers, alternative capital represents a shift in how risk is viewed in the pursuit of returns. Asset managers are recognizing it is no longer sufficient to view these insurance-linked securities as solely financial modeling exercises, but instead they must embrace the details and economics of risk by merging classic financial bet-placing with key elements of expert, risk-based underwriting. This is especially important as alternative capital makes its way into insurance products with long-tail exposures, such as cyber liability, which financial markets have not dealt with before.

For both carriers and asset managers, a shift in perspective must occur. Asset managers must think and act more like traditional carriers, while carriers must adopt the mindset of asset managers. This fundamental sector convergence becomes especially interesting when viewed as new platforms for innovation in the industry. Imagine the possibilities of new business models, new forms of competition, lower-cost risk transfer and more insight-driven risk servicing as capital finds its most efficient path to customers and profitable returns – powered by the next wave of technology.

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Looking ahead: four potentially powerful scenarios

The mainstreaming of alternative sources of capital in insurance and reinsurance presents potentially revolutionary opportunities and risks, especially where it intersects with technology-driven disruption and innovation. The potential impacts align to the issues and threats most on the minds of senior leaders – from the entry of tech giants into insurance to new competition from disruptive business models and platforms to the cannibalization of existing businesses.

1. Digital insurance capital markets

Imagine a future where a cohesive and trusted digital processing platform is paired with encrypted, transparent risk data collected in real time from a range of verified sources, thus creating a virtual marketplace where participants (insurers, reinsurers and capital providers) can bid on specific risks using the most efficient form of capital. Emerging technologies such as blockchain, IoT sensor data, geographic information systems, trusted identity verification, natural language processing, artificial intelligence and advanced microservices architectures can make this a reality.

The digital marketplace created by these combined capabilities completely changes the supply chain and opens the possibilities for risk transfer in a completely new and cost-efficient way. Self-sovereign identity systems using blockchains provide a missing link that allows buyers and sellers to trust this new form of commerce; verified and encrypted risk data instantly accessible to all parties facilitates better cost efficiency in risk placement. As cryptocurrency becomes inevitably legitimized in the global financial markets, this form of “capital exchange” may take on even further forms of commercial disruption.

2. Conscious cannibalization

As with all transformation strategies, fully operationalizing alternative capital as a mainstream capability requires (re)insurers to navigate organizational challenges. The biggest consideration for incumbents is the cannibalization of existing business models. They must be prepared to “consciously cannibalize” their own businesses by embracing alternative capital more fully, even if it puts traditional insurance and reinsurance revenue streams at risk.

The basic challenge industry executives face is how to balance the downside of cannibalization today vs. the upside of enhanced capabilities in the future. Insurers must address organizational hurdles ranging from strategic decision-making (e.g., how and where to deploy capital fluidly) and organizational models (e.g., reporting lines for insurance vs. reinsurance vs. ILS) to the integration of key systems and digitization of core processes (e.g., handling account processing that may cross over platforms currently housed in siloed operations).

For the boldest carriers, conscious cannibalization may be a launching pad for transformation, fueling creative self-disruption and pushing them out of declining or low-growth businesses toward more promising and sustainable ones.
The most successful sharing and peer-to-peer platforms have redefined the customer experience and raised the baseline of customer expectations. Insuring experiences in nontraditional ways and innovating with self-insurance are prime examples.

Consider a multinational home-sharing company that offers not only property and liability protection for both buyers and sellers of vacation property rentals but also risk protection and compensation for exposures rising from related, often episodic, experiences such as skydiving or whitewater rafting. Insurance becomes not just a matter of risk transfer but also a means to maintain a positive (and safe) overall experience for customers on both sides. Now imagine alternative capital funding this risk transfer seamlessly and potentially transforming today’s transactional insurance buying behavior into insurance for the total customer experience.

With the emergence of dual-purpose assets (e.g., personal vehicles used for ride-sharing) and greater personal and business exposure crossover, the insurance industry should develop hybrid products to match. That means combining the concept of 24/7 insurance protection with personal/commercial and first-party/third-party considerations.

Because risks in the sharing economy will be insured differently, exposures are difficult to quantify, and the loss outcomes are often uncertain. This presents challenges with strategic deployment of capital and may open the door for nontraditional capital to facilitate the development of innovative products.

While historically, alternative capital has played at very high excess levels, the advent of greater risk insight fueled by new forms of technology and digital data may change asset manager appetite for risk transfer placement. Imagine the power of IoT-connected sensors on vehicles, appliances and other insurable assets as a continuous stream of valuable risk data, allowing non-carriers to take on more risk with more confidence. Take that a step further and imagine the power of those risk insights enabling greater appetite for new forms of self-insurance: the home-sharing business and the ride-sharing business taking on more risk and leveraging alternative capital for stop-loss protection. And then imagine the day when risk protection is seamlessly embedded in the consumer purchase, the business lease, the pay-by-the-moment experience – potentially insured by today’s insurers and reinsurers or potentially insured with alternative capital.
The bottom line: intra-industry convergence drives the industry’s next wave

The insurance industry sector convergence is clearly here to stay and promises to bring both challenges and opportunities to both traditional (re)insurers and alternative capital markets. But the true potential powered by the connection of capital to new platforms, new business models and new innovations lies ahead and may present forms of industry disruption we can only imagine.

Authors

Gail McGiffin
Principal
Ernst & Young LLP
gail.mcgiffin@ey.com

Jeremy Weiss
Senior Manager
Ernst & Young LLP
jeremy.weiss@ey.com

Contributors

Americas
David Connolly
John Ferrara
Bernhard Klein-Wassink
Samer Ojjeh
Sophia Yen

Bermuda
Craig Redcliffe
Ben Wright

Asia-Pacific
Bonny Fu
Steven Girvan
Lai Yu

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