

# The convergence of capital and reinsurance markets

Insurance risk is filtering through to the investment community



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For more than a decade, there has been much discussion on the topic of closer links between capital markets and reinsurance markets. The early catalyst of this discourse was Hurricane *Andrew* in 1992, which produced a devastating loss of \$16bn for (re)insurers, more than four times the size of any prior catastrophe loss. One study on hurricanes and earthquakes, conducted by a California State University professor, showed that the insurance industry could suffer even worse losses, possibly as much as \$100bn. Fears of such losses led to a severe tightening of the catastrophe property reinsurance market and prompted initiatives to search for other mechanisms to transfer the catastrophic risk arising from natural perils.

Key to these explorations was the recognition that the assets in overall global capital markets were counted in the trillions (\$28trn for the United States alone). If a more direct link could be made between insurance risks and the overall capital markets, then the pressure on (re)insurer capital could be reduced. The first such link was made in 1994, with the first use of a catastrophe bond. However, other initiatives, such as the trading of catastrophe options on the Chicago Board of Trade, never took off. Furthermore, while catastrophe bonds have experienced growth over the years, they still constitute only a small part, estimated at less than 5%, of the overall market for risk transfer of natural peril risk.

This slow progress in linking reinsurance and capital markets has led some observers to question whether convergence was illusionary and whether cat bonds were an interesting but insignificant development in the joining of these two major sectors of the financial services industry. Major developments in recent years, however, suggest that we are getting closer to convergence.

First, we have seen the emergence of a number of hedge funds, mostly in Bermuda, that are dedicated to assuming (re)insurance risk. Generally, these funds prefer large lines, as they try to maximise the efficiency of their relatively small staffs. Hedge funds thus provide a direct link between investors and insurers and/or reinsurers. Second, the structure of catastrophe bonds displays more variety, thereby increasing their attractiveness to both cedants and investors. In the early days of the catastrophe bond market, issues tended to be single-peril and single-tranche. Now, it is common

to see multiple tranches, different perils and varying maturities.

We have also seen interesting developments in the traditional indirect link of capital markets to (re)insurers. Similar to other industries, investors participate in insurance risks by becoming shareholders in insurance companies, and this remains as probably the most effective link between the sectors. What is new in recent years is the speed with which this indirect linkage is utilised. After Hurricane *Andrew*, it took more than six months before the first mono-peril reinsurer was launched in Bermuda. Within two months of the events of September 11, 2001, no fewer than six new insurers were set up in Bermuda to take advantage of the hard market.

What we appear to be witnessing is a growing nexus of professionals who are conversant with the tools and customs of both capital and insurance markets. Many of the people working on insurance issues at investment banks and hedge funds have been trained in the insurance sector.

Guy Carpenter alone has at least five such former professionals working in the field.

Cedants are benefiting from the incipient union of the two sectors. Insurance companies have increased

choices, including fully collateralised protection by hedge funds and reinsurance backed by catastrophe bonds. Both markets learn from one another to bring the best, customised solutions to clients.

One possible road block to the continued progress in financial convergence could be in the regulatory arena. Apart from the cautiousness that insurance regulators are likely to have for some years, following the accounting and reporting questions raised in 2004 and 2005, insurance regulators may be knowledgeable in one field, (insurance, for example) but not the other (investments, say). This is likely to mean that they may be overly cautious, and this may hamper the experimentation and innovation that is essential for progress in developing new vehicles for risk transfer.

Overall, it appears that we are witnessing the emergence of a set of mechanisms for the direct transfer of insurance risk to the broad investment community. We are probably in the infant stages of this phenomenon, but given the expected growth in the demand for risk capital in the coming years, such a development appears both timely and necessary.

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**Annual subscriptions:** UK £225 Airmail  
Europe £242 (\$411) Airmail RoW £272 (\$462). Remittances by cheque or international money order to be sent with order and made payable to Timothy Benn Publishing Ltd. Overseas cheques should be drawn in sterling.

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Average net circulation  
from 01/07/2003 to  
30/06/2004: **9,202**



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Investments Ltd  
ISSN 0048-7171  
Reproduction: CTT, London  
Printer: The Grange Press,  
Southwick  
Member of the Audit Bureau of Circulations

