reinsurance

Convergence commands changes

David Spiller, president of Guy Carpenter, explains the looming culture clash as the investment community takes a more direct role in the (re)insurance business

David Spiller is president of Guy Carpenter.

Convergence in financial markets continues to increase. Look no further for evidence than the increased activity in catastrophe bonds, which directly link investors to insurance risk. In 2005, total issuance was a record $2bn, a 75% increase over the $1.14bn of issuance in 2004. And this momentum has continued in 2006. In fact, based on our knowledge of deals completed this year and those in the pipeline, total new issues in 2006 could be double that of 2005.

In terms of direct investment in reinsurance ventures, following the record losses from *Katrina*, new capital raised for (re)insurance entities exceeded $20bn, $8.5bn of which went to new start-ups.

Hedge funds increased their presence in insurance markets in 2005, investing in start-up reinsurers and other insurance vehicles, or 'sidecars', which were brought to the market after the 2005 hurricanes. (A sidecar is a special-purpose vehicle in which third-party private investors, such as hedge funds, provide extra underwriting capacity to existing reinsurers for property/catastrophe retrocession and other short-tail lines of business.)

Investors were attracted to reinsurance because of the potential for high returns, generated by the hard market for property/catastrophe reinsurance. Guy Carpenter estimates show that rates for catastrophe covers at the top levels of programmes have nearly doubled from the pre-*Katrina* levels. The retro market has been even more severely hit, with benchmark rates now at triple the pre-*Katrina* level.

As the need for capital increases, both insurers and investors will need to speak a more common language regarding risk transfer. In the insurance world, for instance, the roles of suppliers and demanders of capacity are well understood.

Products for customers' needs

For primary insurance, the policyholder is the demander and the insurer is the supplier, implying that the insurer designs a cover to meet the needs of the customer. Similarly for reinsurance, the cedent is the demander and the reinsurer is the supplier, and the reinsurance is designed to meet the cedent's needs.

In the investment world, the investors (as the providers of capital) are frequently viewed as the demanders, or the customers. Products are designed to suit their requirements. We see mutual funds of all kinds, annuity products, options, derivatives... all designed to address an investor's needs. Here, the supplier of capital is viewed as the customer, and products are designed to suit this customer.

The need to design insurance products from the perspective of investors can be expected to lead to a gradual evolution from index products to the wider acceptance of indemnity products that include individual company risk.

Today's investors in stocks are comfortable taking on company risk, for example the risk that a stock will perform differently than the overall market. The willingness to take on such risk is facilitated by two major factors: firstly, there is a substantial amount of disclosure by corporations, thus helping potential investors to discern the extent of the risk basis they face. Secondly, there are cadres of advisers ranging from newspaper columnists to professional stock analysts willing to provide guidance on specific stocks. Investors in newer forms of insurance risk do not have the benefit of this 'investing infrastructure'.

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Filling the gap

We expect that brokers and industry analysts will likely play a role in filling this information gap. An investor using their own resources would have great difficulty in quantifying the risk basis for, say, a portfolio of property risks in South Florida.

As more direct links are forged between the investment community and insurance risks, there is likely to be increased regulation and oversight by non-insurance government agencies, particularly in the US, where corporate governance has been subjected to more and more political scrutiny. Such regulatory oversight may come as a great shock to some insurers, who may not yet appreciate the extent and depth of securities regulations.

It is clear that brokers will play a key role in developing the necessary 'investing infrastructure' between the investment and insurance sectors. In the decade or so that Guy Carpenter has been involved in this area, we have committed resources to educate both the investment community and the insurance community, and to build a bridge between the industries. Since then, we and other brokers have supported research and development of new techniques for transferring risk.

Given our market segment's growing need for capital, we can anticipate an increase in such efforts as the insurance industry moves to benefit from the increased pace of convergence. re

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