reinsurance

Three cheers for mobile capital!

Just a few years ago, a difficult year like 2005 would have meant a hard market for the loss-free and loss-prone alike, but not in 2006. **David Spiller**, president and chief executive of Guy Carpenter, hails the new spirit of maturity and discernment pervading today's reinsurance market

David Spiller is president and chief executive of Guy Carpenter.

The day is 1 June 2005. The hurricane and typhoon seasons have just gotten under way. A fortune-teller reveals to you that the insurance industry will suffer a record $83bn in catastrophe losses in 2005,following the record loss of $48bn in the past year. At this point a pesky insurance reporter appears (though not one from this fine publication) and asks for your forecast for reinsurance renewals in 2006.

You, like practically all industry observers, would probably predict that there will be a difficult market at the 1 January 2006 renewals, with soaring rates for property/catastrophe covers worldwide and price hikes for nearly all lines as cedents cope with a capital-depleted panel of reinsurers. You think back to the World Trade Centre event in 2001, to Hurricane *Andrew* in 1992 or even the liability crisis of the mid-1980s. You 'know' that record losses in reinsurance are a sufficient condition for a hard market. When losses explode, rate hikes follow.

Now, a year later, you feel the need to re-programme your crystal ball. For despite the enormous cost of losses in 2005, the market did not react in classic fashion with across-the-board rate hikes.

The market in 2006 was discriminating in its approach. Stable-to-soft conditions persisted for lines unaffected by 2005 catastrophes. In most areas, issues tend to be internal, generated by conditions specific to each market. For example, in many countries flood has become an increasing concern, reflecting recent large losses from this peril.

Within the property/catastrophe arena, the market distinguished between North American exposures and those of the rest of the world. Guy Carpenter analysis shows that for most of the rest of the world outside North America, there was on average only a 2% increase in rate for 2006, versus a 76% increase in the US. Even within the US, the market was discriminatory, and many non-coastal-exposed programmes experienced stable conditions.

Factors and figures

A number of factors explain the current market. Importantly, 2005 was a strong year for non–catastrophe-exposed lines, which helped to offset against catastrophe losses. In fact, Lloyd's reports that all non–catastrophe-exposed lines had an underwriting profit in 2005. Furthermore, the global increase in interest rates helped investment income, even though this impact was felt mainly at the short end of the yield curve. Taxes also played a role, as reduced income lowered tax obligations.

In short, given all these factors, Guy Carpenter's analysis indicates that the reinsurance industry ended 2005 with a positive gain in capital instead of the massive loss that might have been expected post-*Katrina*, *Rita* and *Wilma*.

Beyond the lucky fact that the reinsurance industry — exclusive of catastrophe — was in a relatively prosperous condition in 2006, there is a more fundamental force at work: namely, mobile capital. As of 30 December 2005, new or existing companies following the hurricane season raised more than $20bn in additional capital.

The catastrophe bond market in 2006 is already at record levels, both in terms of number of transactions and risk capital. In 2005 we also witnessed a more prominent role for 'sidecar' investment vehicles, which constitute an efficient way for investors to participate in a rising market*. (For those not yet *au fait* with this development, a sidecar carrier essentially attaches itself to an existing reinsurance writer by providing capacity to the reinsurer.)

Going mobile

It has been seen that mobile capital brings a new flexibility to reinsurance markets.

Looking at casualty lines in a hard market, reinsurers would have sought to raise rates to rebuild their capital base traditionally. But if there is no compelling economic reason to raise rates in casualty, attempts by markets to hike rates will be frustrated by existing and/or new competitors, fuelled by easy access to relatively low-cost capital.

Conversely, turning to property markets, if there is a compelling reason to raise rates — such as a belief that increased storm activity in the North Atlantic will lead to substantially increased losses — it is likely that we will see an outflow of capacity until rates adjust to the newly perceived higher level of risk.

This measured response by markets has to be viewed as a strong positive development. Instability in reinsurance pricing has been a complaint of cedents for many years, and has driven them to more expensive alternatives.

A more stable and discerning reinsurance market bodes well for the future. Mobile capital markets are bringing us closer to this vision, as they allow for a more textured response to changing market conditions.

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