The rollercoaster heads down

Although reserve pressures remain, softening markets in 2004 may be the result of market competition, explains Edmund Megna.

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For most lines of reinsurance, the market softened in 2004. The market softening was not restricted to rate declines, but also included an easing of terms and conditions.

The softening in the market reflected increased competition by reinsurers. In 2003, reinsurance was a highly profitable business. The combined ratio of US reinsurers was reported at 100.5% by the Reinsurance Association of America. For the Bermuda market, 17 of the top 25 reinsurers in Bermuda came in with a rate of return above 15% for the year, while the Lloyd's market declared a combined ratio of 90.7%. These results were achieved in a year of average catastrophe losses globally. With this level of favourable results, it is clear that the pricing in 2003 was more than adequate.

Adding to profitable pricing, capacity improved for a number of players. Practically all reinsurers benefited from the global bull market for equities in 2003, and there were a number of instances of significant replenishments of capital, particularly by legacy players. In 2004, equity markets have been flat to slightly down, with little overall impact on the finances of most reinsurers.

As we move towards 2005, assuming no major catastrophes, most observers are predicting more of the same: single to low double-digit price declines for most lines and some easing in terms and conditions. Why? The surface answer is that it is normal. Reinsurance is a highly competitive business with ease of entry.

Beyond this basic impact of market competition, a number of particular factors are at work, with a net balance pointing toward a gentle softening of the market.

Factors pointing towards softening include:

- Cedants continue to be concerned about credit quality. The massive increase in reserves posted by Converium this summer was a clear reminder to the market that reinsurance does not come with a government guarantee. Concerns on security would tend to lead to less demand for reinsurance protection, particularly for long-tail casualty lines. On the other hand, if there are further major reserve surprises by reinsurers, then capacity will be restricted, leading to the opposite result: a hardening of the market.
- Quarterly results reported by individual reinsurers so far in 2004 suggest that profitability is more than adequate in most areas, implying increased demand for market share by reinsurers.

However, these forces are likely to be somewhat offset by:

- The declared pledges by some of the new players in the marketplace to not chase premiums in the down phase of the cycle. These pronouncements may be viewed as more than attempts to talk the market up, because in the current post-Enron world, CEOs are much more careful to match words to actions.
- The older Bermuda class of 1993 appeared to show reasonable restraint in soft markets, and hence, since the class of 2001 was set up under somewhat similar management and investor expectations as to price discipline and capital deployment, one might expect them to show similar restraint.
- The legacy players may also be expected to show discipline, since they need to convince cedants, the rating services and the equity markets that they are not straying from the straight road to financial recovery.
- The persistence of reserve pressures, as dramatically evidenced by Converium's actions this year.

Given this general market view, cedants can be expected generally to seek to maintain their reinsurance expenditures at a fairly constant level. The softer market will enable them in a number of cases to reduce their retentions, moving back towards levels maintained before the hard market.

The softening market on the reinsurance side cannot be viewed in isolation from the softening trends on the primary side. Some players may step to the sidelines in the soft market, and move to return capital to shareholders. In some situations, they may use reinsurance to 'replace' that capital. On the other hand, when primary rates drop to levels viewed as inadequate by proportional treaty reinsurers, this sector of the market may experience severe capacity shortages, as we have currently observed in some Caribbean markets. Finally, in the later stages of the soft primary market, cedants may choose to economise their purchase of reinsurance and retain more net.

And the impacts can go the other way, from reinsurance to primary markets. For example, the current softening in the facultative market is putting pressure on primary pricing. An opposite effect is that in markets where pricing is more than adequate on the primary side, such as property in a number of regions, the reduced cost of reinsurance provides an added incentive to expand market share.

Guiding a company through a soft market is a true test of an industry leader, both in the primary and reinsurance sectors. In a hard market, when prices are more than adequate and capacity is scarce, making a profit is not a strategic challenge. But managing an insurance or reinsurance company in an environment where prices are falling and holding the line on rate means saying goodbye to some of your oldest and best customers: that is where the mettle of today's CEOs will be tested.

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