Trends in reinsurance buying: Property

David Priebe, president Guy Carpenter Europe

The major influence on property reinsurance buyers in 2004 was the softening in the market. Pricing for property catastrophe reinsurance declined in most countries in 2004. Guy Carpenter's index of global Rate on Line fell by 8.7 percent from the peak of 2003. This decline follows an upward trend in pricing that began in 2000 and was accentuated by the enormous losses of September 11, 2001 which, combined with other factors, led to the elimination of weaker players.

In general, reinsurers at 2004 renewals were rationally competitive, yet aggressive in pursuing business with targeted clients. Business that was perceived as adequately priced enjoyed plentiful capacity.

With pricing improvement on their original business yielding good results, cedents sought to hold their reinsurance expenditures constant. This led to some increased purchasing of higher limits as prices declined. In a number of cases, cedents retained more exposure at lower layers and used their savings to purchase higher limits of coverage.

A good illustration of market conditions is the market for windstorm catastrophe cover in Japan. As shown in the chart, cedents took advantage of reduced market rates to purchase additional capacity, which increased to ¥565bn (excluding co-insurance). This additional capacity was achieved through additional open market layers and reduced co-reinsurance.

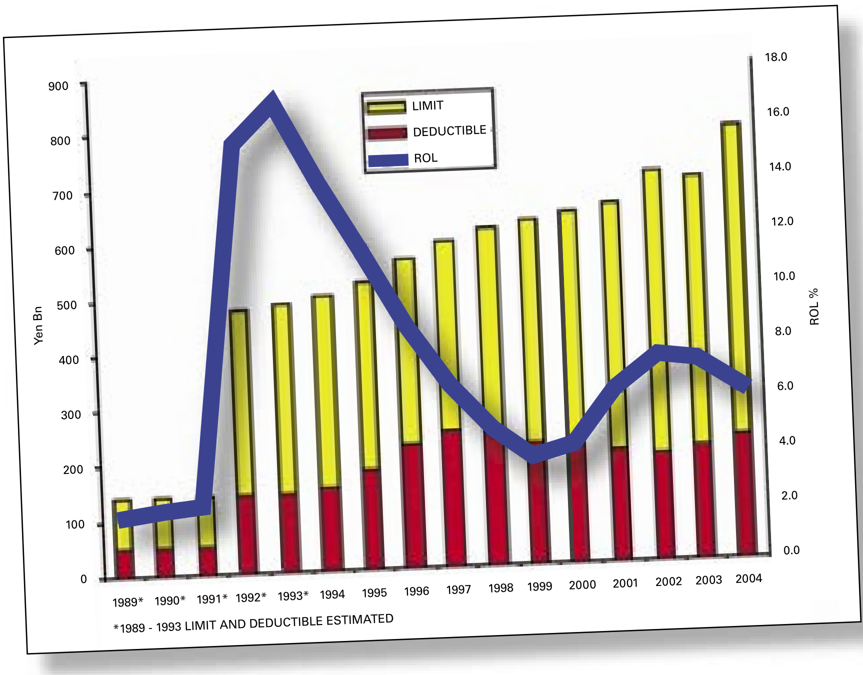
Market limit, deductible and ROL

In line with other major markets, the Rate on Line for Japanese windstorm decreased significantly. Structures remained similar to other years, with some modifications to maximise pricing advantage and to incorporate the purchasing of additional cover. Some covers were expanded at the top end, as indicated by the increased limit shown in the chart.

Property risk business was generally flat with some rate reductions due to growth in the underlying business and from competitive forces. Reinsurers remain disciplined in an effort to avoid possible over-accumulations in exposures, a lasting vestige from the underwriting changes caused by the losses of September 11. We anticipate increased demand for greater limits for per risk business, as insurers address the needs of their customers for more capacity. The facultative market continues to play an important role in satisfying these demands on specific risks/programmes.

Proportional business renewed at expiring terms, i.e., ceding commissions and reinsurers' margins in many countries. However, in regions where the underlying primary rates are viewed as inadequate by reinsurers, cedents' ability to achieve any improvement in terms has been limited. For example, in the Caribbean, where many pro rata programmes have established positive balances, terms and capacity have been stable with instances of expanded support. However, it is more difficult to attract support for new pro rata programmes. As a result many of these new programmes are being driven to convert all or a portion of their capacity to excess of loss structures. A few large programmes have been able to attract significant capacity from large reinsurers who are looking to maximise the utilisation of their capital in this geographic area. These deals have generally been predicated on original rate contingencies and event limits. In some cases, reinsurers have asked for guaranteed premium cessions.

The flight to quality continues as cedents remain concerned about the credit quality of their reinsurers. The massive increase in reserves for



workers compensation and other third-party lines posted by Converium this summer was a reminder, even to property reinsurance buyers, that, in spite of the recent improvement in reinsurers' underwriting results, reserve deficiencies are still an issue that can impact the quality of the reinsurance asset. Concerns on financial security and on reinsurers' willingness to pay will tend to dampen demand for reinsurance, as cedents look to identify those reinsurers that might appear to be attempting to write their way out of trouble.

The actions by rating agencies will also be an important factor. Even a one-notch downgrade may lead to serious questions about a reinsurer's viability, particularly where so-called downgrade clauses allow cedents to cancel contracts or to demand pre-funding of liabilities.

Catastrophe modelling continued to have an impact on program structure and pricing. There now exists broad acceptance of results from the revision to a number of the widely used models. This tends to narrow the range of reinsurer quotes for most perils on large diversified programs. However, for regional programs we saw instances of wide divergence in pricing depending on the peril, the geographic area and the cedent's loss experience. The year saw a number of instances of "cliff pricing." Contracts tended to be oversubscribed when priced at or above reinsurers' targeted profit levels, as measured by model results. However, capacity offered fell "off the cliff" if prices were perceived as inadequate. Companies either retained these exposures or increased the pricing to a level necessary to attract the desired amount of capacity.

In North America, updates and enhancements in several leading models led to significant upward revisions in worst-case PML estimates, which generated increased demand for top-end limit.

The market for terror cover was relatively stable outside the United States. In the United States, there was increased interest in TRIA-based terror protection, as insurers faced higher retentions under the federal government's terror reinsurance programme, as well as the possible sunset of the programme at the end of 2005.

The retrocessional market

The Retro market was stable in 2004. Looking at purchasing decisions by reinsurers to protect their own capital, there is little evidence to suggest that the retro market has been a significant factor in either expanding capacity or increasing pricing for 2004 property catastrophe renewals. This is partly due to strong corporate balance sheets, especially for reinsurers who are members of larger, diversified conglomerates.

While retention levels generally held firm, capacity was available at a cost of around 10 percent below the previous year, dependent on exposures. With most buying activity completed in time for the US wind season, the only areas where capacity became limited – and hence where pricing did not come down – were for Californian earthquake and Northern European storm exposures.

Improved exposure-management data have enticed some new providers in the retro arena, including some existing primary reinsurers, who up until now have preferred the "vanilla" exposure. It remains to be seen whether such capacity will prove resilient once a significant natural peril event occurs.

In terms of capacity, reinsurers will generally seek to manage for their 1-in-250-year event, which in terms of US industry loss would equate to about a US$50bn industry event today. At present, the traditional retro market is still unable to provide capacity for such a loss within cost-reasonable parameters. Capacity is supplemented by structured, parametric products or by accessing the capital market, where significant alternative capacity is available. This type of transaction is becoming increasingly popular with buyers wishing to spread their catastrophe volatility over a wider playing field.

US terrorism, for "noncertified" terrorism was a standard coverage offered within the property retro product.

Looking ahead

As we move towards 2005, assuming no major catastrophes, we see a continued "soft landing" …meaning single to low double digit price declines and some easing in coverage terms and conditions.

The softening market on the property reinsurance side, however, should not be viewed in isolation from the softening trends in the primary insurance market. There, some players, less driven by market share, 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, if primary rates drop to levels viewed as inadequate by proportional treaty reinsurers, this sector of the market will likely experience severe capacity shortages, as we observed in the Caribbean markets. Finally, in the later stages of the soft primary market, cedents may choose to reduce their purchase of reinsurance and retain more net.

The traditional retro market is unable to provide affordable capacity for so-called 1-in-250-year events, such as another incident on the scale of 9/11