Ready for an atomised market?

Edmund Megna describes the multiple ways the river of capital flows into the sea of insurance risk and advocates sound management of this

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As we all learned during Hurricane *Katrina*, the mighty Mississippi river splits up into multiple channels in the coastal lowlands of lower Louisiana and Mississippi, forming a delta with many outlets to the sea. In an analogous fashion, there are now many channels for investor capital to flow to insurance risk.

First, there is the traditional stock purchase method. An investor can purchase outstanding stock of an insurer/reinsurer or participate in a new stock offering of an existing insuer/reinsurer. In regard to the latter, we calculate that $12.5bn in new capital was raised by existing companies after *Katrina*.

Second, investors can participate in start-ups — we saw a burst of this activity in the last few months of 2005, adding $8.5bn to insurance capital.

Third, an investor can purchase catastrophe bonds. In 2005, capital allocated to these instruments almost doubled to $2.1bn in at risk capacity.

In recent years, we've seen investor capital supporting reinsurance risk through "side car" facilities, where risk capital is available to individual reinsurers.

Finally, we have the emergence of what we call 'converters' — facilities that can readily transform insurance risk into capital market risk. Hedge funds have shown the lead in this field. And soon we can expect more customised investment channels to emerge, notably in the active trading of 'strips' or packets of relatively homogenous insurance policies.

All these added channels mean the inflow and outflow of capital to the industry will likely be much more fluid than in years past, leading to some basic changes in industry structure and performance.

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Easy flow of capital means hard markets will be shorter, as higher pricing almost instantaneously attracts investors. Indeed, the hard market of 2002/2003 now seems far away.

Management manoeuvres

We can also expect that the quality of management will increase. Companies that are mainly or somewhat dependent on hard markets to cover their overall lack of profitability will tend toward extinction. And better management is likely to mean more discipline. This will probably lead to fewer instances of cutthroat price competition and, thus, less-severe soft markets.

As sound management responds to the demands of the newer investors, they will be more financially focused. They are likely to drive the business toward even greater quantification. The quality of data will be improved and analysed with increasingly sophisticated tools. Companies that don't understand this change in the business, or who do not have the resources, are likely to find themselves behind the pack, and will soon be headed for the exit door.

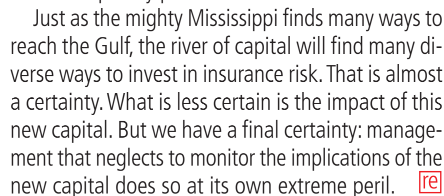
A potential by-product of being more data-/analytic-focused is the probability that the public's opinion of the industry may deteriorate. A normal output of better data will be the identification of better and worse risk pools. As the worst risk pools begin to be charged higher prices, their issues are expected to attract the attention of publicity seekers in the political and media worlds. This attention is not likely to be countered by advocates for policyholders receiving lower prices — a sad but honest reflection on human nature. In the US, we observed this morality play in the controversy over the use of credit scoring for auto and home insurance.

Look for increased segmentation by line and geography, as newer investors demand a "stick to the knitting" strategic focus.

More speculatively, it is possible that the industry will become nearly atomised, with carriers specialising not just by line, but also by state and even by regions within states. For example, the Florida homeowner market might end up being served by many local companies, with each company responding to the investment needs of its owners. This could result in much diminished power for the regulator in terms of rate-setting.

If rates are suppressed, exit for such small companies is much easier than for large, national, multi-line carriers, since they do not need to uphold a national reputation and would tend to have proportionately less capital exposed. Also, the regulator does not have to require the licenses of all other lines of business as a condition of exit from the inadequately priced homeowners' market.

Just as the mighty Mississippi finds many ways to reach the Gulf, the river of capital will find many diverse ways to invest in insurance risk. That is almost a certainty. What is less certain is the impact of this new capital. But we have a final certainty: management that neglects to monitor the implications of the new capital does so at its own extreme peril. re



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