Guy Carpenter Views

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The State of the Reinsurance Industry:
Looking for Calm Waters in Rough Seas

Seán Mooney, Ph.D., Chief Economist of Guy Carpenter, assesses the market.

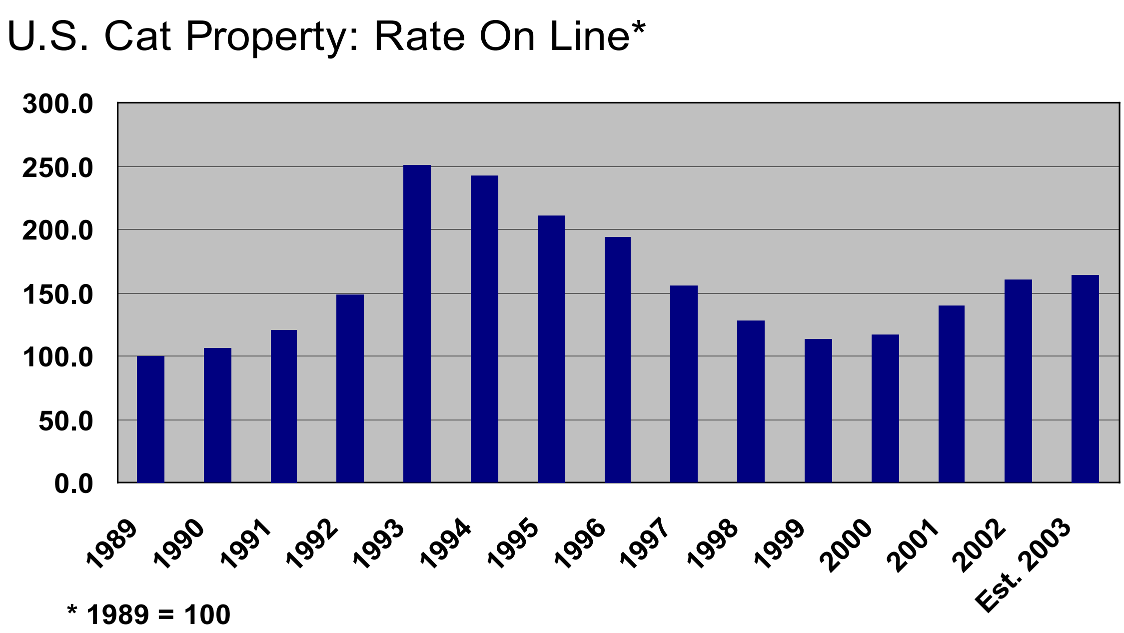
From a ceding company's perspective, the hard market of recent years has been difficult. Rising costs and the shortage of the reinsurance product are clear negatives for primary insurance companies. Further, the threats to the security of the reinsurance product are a major concern to cedents, both in terms of reinsurers making good on existing commitments for reinsurance recoverables, and in terms of the basic viability of the reinsurance risk transfer mechanism in the future.

From the perspective of reinsurers, the prolonged hard market should provide an opportunity to right their ships, strengthen their balance sheets and thus restore stability to reinsurance markets. At Guy Carpenter, we trace the current hard market in reinsurance back to mid-2000, when property catastrophe renewal rates began to increase following six years of decline. This upturn in the pricing cycle was accentuated by a number of factors, including: the losses from the events of September 11, 2001; the collapse of the technology stock bubble and subsequent meltdown in global equity markets; the worldwide economic recession of 2001 and 2002 and in its impact on interest rates; the corporate governance scandals and their impact on reinsurance casualty lines; and, the resurgence in asbestos claims.

From a reinsurer's perspective, the very factors that have prolonged and deepened the hard reinsurance market, have caused havoc to their finances. In accounting terms, price increases have helped reinsurers to right the revenue line of their income statement, while adverse factors have had a negative impact on practically all other accounts: claims, investment income, and asset values.

The Pricing Cycle

Prior to the onset of the reinsurance hard market, pricing had been declining for many years. For casualty reinsurance, the softness began in the late 1980s and continued uninterrupted until 2000. On the property side, Hurricane Andrew and Hurricane Iniki, both occurring in 1992, precipitated a sharp run-up in pricing, with catastrophe property rates tripling in many cases at 1993 renewals (see chart below). Following those years, however, pricing again became soft for property covers until the turn in 2000.



Source: Guy Carpenter

It is important to note that the upturn in pricing for reinsurance was preceded by an upturn in pricing for primary insurance, particularly in commercial lines. Further, the increases in reinsurance pricing were generally smaller than those experienced on the primary side, as compared to prior hard reinsurance markets. This meant that:

- Reinsurance pricing was not the main driver of the cycle on the primary side.[1] This is true of most reinsurance lines in major developed countries. However, in specialty lines and in smaller countries (such as the Caribbean Islands), which have a heavy dependence on reinsurance, the hard reinsurance market was a driving force behind tightening conditions in primary markets, particularly in terms of pricing and availability.

- In most cases, the upturn in primary pricing accommodated the increased pricing for reinsurance. Primary companies were not necessarily surprised that reinsurers were seeking more adequate rates, since that was precisely what they were seeking, and the higher revenues from higher primary rates more than offset, on the whole, the increased costs of reinsurance.

The Events of September 11, 2001

Prior to September 11, 2001, the reinsurance market could be described as firming. Price increases tended to be single digit, and capacity in general was plentiful. September 11 turned the “firming” market into a “hard” market, as a result of the large losses of that date. The insured loss on September 11 amounted to the highest insured catastrophe loss in world history. It is currently estimated at $40 billion, 60 percent of which was borne by reinsurers. In addition to the large losses, the attack on the Pentagon and World Trade Center triggered a fundamental re-examination of reinsurance company practices. The most notable impacts were:

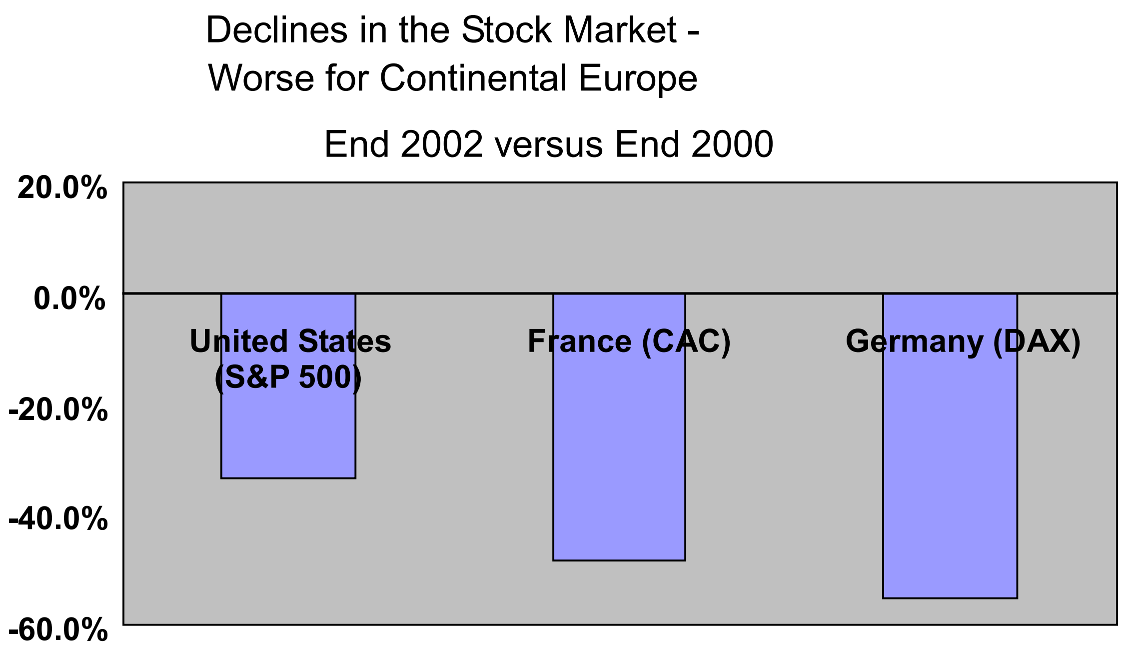
- An exclusion of the terror risk from most reinsurance contracts. Since 2001, a number of countries, notably the United States, France, and Germany, have created mechanisms to fill the void left by the exit of reinsurers from the terror peril.

- A concern by cedents over accumulations, in terms of both property and liability exposures. Guy Carpenter, working with modeling companies and others, has developed tools to assist cedents in tracking accumulations.

[1] The main cause of the turn in primary insurance was the prolonged soft market, which resulted in unacceptably low rates of return to investors.

Stock Market Meltdown

Global equity markets peaked in 2000, simultaneous with the burst in the technological bubble. Reinsurance firms in Continental Europe have been particularly impacted by the precipitous decline in equity prices, partly because they tend to have higher ratios of equities on their balance sheets.[2] A further factor impacting on Continental players was that European equities declined more than U.S. equities in the past two years (see chart below). This had a disproportionate impact on Continental reinsurers, who tend to hold a higher share of their portfolios in home country stocks.



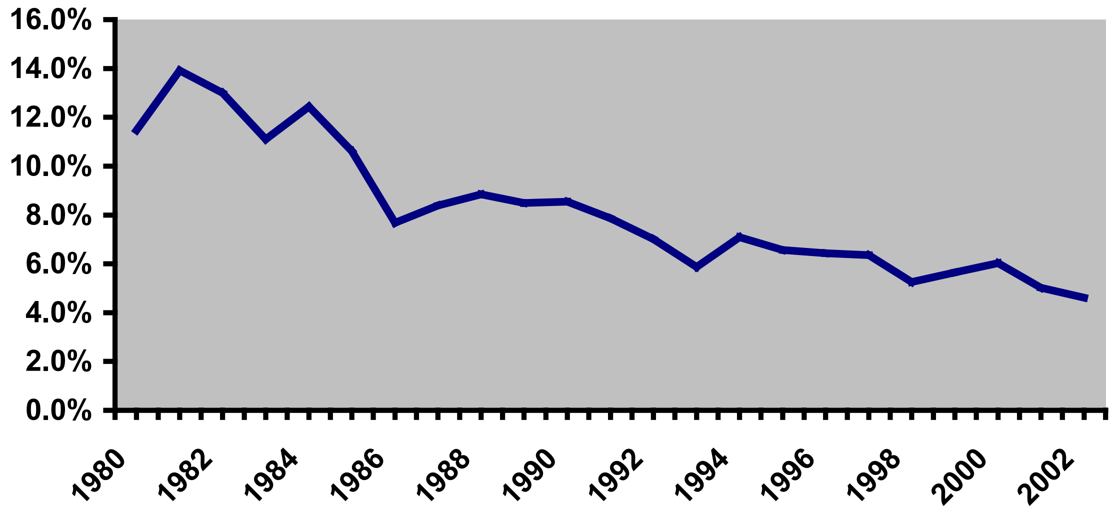
Source: Guy Carpenter

[2] It should be noted that Berkshire Hathaway probably suffered the largest loss of insurance-related corporations from the decline in equity pricing, reflecting its character as more of an investment fund vehicle holding a large portfolio of insurance stocks, than a mainstream insurance company.

Global Economic Recession

The economic recession in major countries, which was deepened by the events of September 11, pushed central bankers to pursue an aggressive reflationary policy on a global scale. The result has been a reduction in interest rates to very low levels, which has led to declines in investment income to insurers and reinsurers. Prospectively, if interest rates were to stay at current low levels, both insurers and reinsurers would have to record consistent underwriting results in the black, with combined ratios for some property lines needing to drop below 90, to achieve an adequate rate of return.

U.S. Bond Yields (10-Year Government Bonds)



Source: U.S. Economic Report of the President, 2003

Fallout from Corporate Governance Scandals

The corporate accounting scandals, including Enron, Global Crossing, and WorldCom, resulted in large losses in such lines as D&O and Professional Liability. For some insurers and reinsurers, the problems at these corporations packed a double punch. They precipitated losses in their investment portfolios as the value of their stocks and bonds evaporated, as well as triggered losses on the underwriting side. From a reinsurer perspective, the casualty losses reinforced a belief, created by the events of September 11, 2001, that reinsurance companies were dangerously overexposed to unforeseen events, and needed to fundamentally re-evaluate their underwriting and risk management philosophies.

A further impact of the corporate governance scandals was the increased pressure on insurers and reinsurers to move to more transparency in their reporting, and to avoid any measures that could be interpreted as financial engineering. It is reasonable to assume that these concerns led to lower overall reported income, although it would be hard to document the size of this impact.

Reserve Inadequacies

In a much-quoted study, Alice Schroeder[3] of Morgan Stanley estimated reserve deficiencies of United States insurers at $120 billion. This compares to industry policyholders' surplus of $285 billion at the end of 2002. About half of the $120 billion is estimated to have arisen from the under-funding of asbestos claims. Toward the end of 2002, a number of insurers reported radical increases in their reserves for asbestos.

The exposure of reinsurers to asbestos claims is of particular concern to cedents. As reinsurers are close to the end of the chain in the claim process [**injured party → lawyer (normally) → corporation (manufacturer or user) → insurance company → reinsurer → retrocessionaire**], it is more difficult for them to estimate their ultimate exposure. Standard & Poor's has raised concern over the discrepancy between large increases recently posted by primary carriers, contrasted with much lower increases reported by reinsurers. Some primary companies have reported gross additions to reserves that are more than four times the size of the increase in their net reserve. If the reinsurer estimates are accurate, this means primary carriers may be in deeper trouble than indicated by their net reserve positions. On the other extreme, if the primary carrier estimates are correct, then there may still be some shocks in store for reinsurers and their investors over the next few years.

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[3] Schroeder, Alice. "U.S. P&C Reserves: 80 Points in the Hole?" Morgan Stanley, Insurance – Property & Casualty, September 30, 2002.
See also: Schroeder, Alice. "U.S. P&C Reserves: A Drop in the Bucket" Morgan Stanley, Insurance – Property & Casualty, April 29, 2003.

The Outlook

There is evidence that pricing for property reinsurance covers is peaking this year. Some property covers have already experienced price declines at January 1, 2003. Casualty pricing is also expected to show weakness later in the year, though there was less evidence of price weakness in casualty business at January 1, 2003 renewals.

January 2003 Renewals			
Catastrophe Property			**Casualty Renewals**
	ROL Change		**"A Hard Market"**
Territory	Best	Worst	*[Price increases, particularly D&O and Umbrella Liability]*
Australia	5%	15%	**D&O**
Canada	10%	15%	- Capacity down, 50% for automatic programs
Caribbean	0%	15%	- Direct markets retrench; broker markets more stable
Central/South America	-10%	-5%	**Workers Compensation**
Northern Europe	10%	20%	- Cat covers flat to down
UK	0%	10%	- Risk layers firm (fear of medical inflation)
USA	-5%	5%	**US Terrorism Risk Insurance Act**
			- Terror covered (comparisons with 2003 difficult)
			- Exposure mapping and modeling critical

Source: Guy Carpenter

The signs of softening evident in January renewals were confirmed with the major wave of Japanese renewals on April 1, 2003. However, while there were price decreases in a number of lines at these renewals, there is no evidence of a general softness in the marketplace. Price decreases tended to be line and case specific, rather than across the board.

A concern has developed in the reinsurance industry regarding the issue of whether the financial difficulties faced by some reinsurers are giving rise to a slowdown by reinsurers in making payments to cedents.

Guy Carpenter ***Views***

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As a major reinsurance intermediary, Guy Carpenter handles claims for many of the world's largest insurance organizations and has been monitoring reinsurer claims performance for years. This process enables the company to view claims performance across borders and multiple lines of business. It also provides the ability to benchmark individual market performance against industry standards. Aggregated claims performance data allow the company to identify problem areas, and aggressively pursue improvements in the claims process, thus accelerating claims payments on behalf of our clients.

In years prior to September 11, 2001, Guy Carpenter's data indicate that payment performance among reinsurers was continually improving, thanks in part to industry-wide process improvements, efficiency gains, and our own vigilance in monitoring the market. More recently, overall reinsurance claim payment patterns have not materially changed, except among some reinsurers who have been placed into run-off. This issue among run-off reinsurers was exacerbated following the events of September 11. Still, we view this slowdown in run-off reinsurer behavior as a serious challenge, but not an unresolvable problem.

A more fundamental issue in the marketplace is a growing concern about the viability of the reinsurance mechanism for risk transfer. With the continuing financial travails of major reinsurers, *could we be witnessing the demise of the industry?*

The reinsurance industry can be expected to weather the current group of storms swirling all around it. The reinsurance mechanism for spreading risk around the globe has proven its value for centuries. In recent times, the best brains of academia and Wall Street have labored mightily to come up with capital market products to securitize risk, and thus present an alternative to the reinsurance process. Their best work product has been catastrophe bonds, which have significant issues in terms of pricing and risk transfer versus traditional reinsurance. Today, while catastrophe bonds constitute a sound solution to certain risk transfer needs, bonds represent less than one percent of the market for reinsurance risk transfer.

We anticipate that the shoring up in the balance sheets of major reinsurers observed in 2002 will continue in 2003. We may also see the use of credit market instruments to bolster the solvency rating of individual reinsurers.

The problems associated with declining asset values and inadequate reserves need to be viewed as legacy problems. Over time, a number of the "legacy-burdened" reinsurers may be reduced in size and influence. However, a number of non-legacy burdened start-ups are likely to take their place. There appears to be no shortage of capital in global financial markets. The only shortage is projects worth investing in, namely, enterprises that can be expected to yield a high return.

Following the events of September 11, 2001, over $20 billion in new capital entered the industry in less than four months. The inflow of this capital slowed in 2002. We would argue that this slowdown did not reflect a shortage of available capital, but rather a belief that balance had been restored to reinsurance markets, with returns at a relatively high rate, but not at levels sufficient to trigger much added investment beyond that which had already been committed.

A related viewpoint put forth in 2002 was that new start-ups had exhausted the qualified manpower available to run additional reinsurers. We question the plausibility of this argument. Even if it were possible for 2002, we do not accept it as a valid argument for 2003 and forward. The downsizing undertaken by reinsurers is likely to lead to the laying off of employees, many of whom will be eminently qualified and motivated to perform for new start-ups.

Conclusion

In the short term, we anticipate clearer skies for cedents as pricing moderates in reinsurance markets. In the long-term, we anticipate the continued viability and vitality of the reinsurance risk transfer mechanism. The reinsurance industry has seen some rough seas of late. Many reinsurers have been seen battening down the hatches, bracing for even rougher waters before calm is restored. Some have succumbed to the tough conditions. But the strong and resourceful survive, as they tend to, and we should see clear sailing again.

This brief overview of the many factors influencing reinsurance markets is based on a large number of external sources, as well as key internal resources, including Guy Carpenter's quantitative unit, Instrat®, and its Market Information Department. Clients seeking more information are encouraged to contact their Guy Carpenter broker. Guy Carpenter will also be holding teleconferences on these and other important issues confronting our clients.