2008: softening sustained

David Spiller runs through the hard versus soft pricing debate's 2007 and 2008 incarnation.

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Every year, our industry asks the same question: will the new year bring a softer market? Well, 2007 is no different. Even with the same reference points, different conclusions are drawn. Some feel that rates will steady, while others see a continued downturn. Let's take a look at the volleys exchanged in this year's point-counterpoint debate.

Point: Reductions in capital market activity are likely to stabilise reinsurance prices. Proponents of this view see capital markets beating a retreat from the reinsurance market and retrenching. The influx of mobile capital that buoyed the reinsurance markets following the 2004 and 2005 losses was opportunistic. Traditional reinsurers have reloaded surplus, and capacity is no longer garnering top price. Expect capital markets to hang back… until a future catastrophe drives prices up and draws them back in.

Counterpoint: Supporters of the soft market thesis say that capital market capacity is not retreating. It's moving to the front lines with smarter, more creative approaches. Structures are being refined, and the industry is finding innovative ways to expand the range of risks securitised. Tranching is opening the door to new solutions — and to new investors. As a result of the groundbreaking transactions completed this year, parametric and insurance-linked securities should look more attractive to investors. Further, there is walking, talking physical evidence that capital markets are not stepping away. The large number of investment banks represented at Les Rendez-Vous in Monte Carlo did not go unnoticed. Perhaps they came for the sunshine and roulette but it's more likely they were there to investigate the reinsurance market further, with the intention of participating more heavily in the future. They weren't looking for the exits — they want more ways in.

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Point: Capital management techniques that were aspirational only a few years ago are now routine. The market has brought innovation into the mainstream, which should keep prices from sliding further. If the way models are calibrated does not change, rates shouldn't either. Right?

Counterpoint. Using sophisticated capital management techniques doesn't always lead to sound financial decisions. Investment banks and other financial institutions have relied on risk and capital management practices for decades, and major collapses still happen. Take a look at the recent debacle in the sub-prime mortgage market or the dotcom implosion a few years earlier. It's pretty easy to see how capital management alone is not enough. As for the argument that these models promote stability, the massive recalibration that followed Hurricane *Katrina* proves otherwise. We are still on the road to better modeling, we have not arrived.

Point: It doesn't matter if the primary markets continue to soften. Reinsurers are more disciplined than primary insurers. They won't allow falling rates on the primary side to drag them down too.

Counterpoint: Reinsurers may be more disciplined, enabling them to resist price cutting and other competitive threats. However, what about the pressures exerted by their customers? Primary markets can push prices lower via pro rata contracts and you can bet reinsurers will feel the heat from ceding companies, whose budgets already include substantial reinsurance costs.

There is one final point for continued softening. At the time of writing, the world insurance and reinsurance industry once again has been blessed with relatively low catastrophe losses and 2007 will go down in history as a 'normal' year, with higher flood and fire losses offset by lower cyclone losses in most parts of the world.

Overall, we see a continued decrease in reinsurance prices. Price reductions are likely to provide a haircut to reinsurer finances but do not threaten the financial stability of the industry. Further, we are not seeing much loosening in terms and conditions, particularly on the casualty side. As we know from the soft cycle years at the end of the 1990s, such grants of generous cover in the casualty lines can play havoc with reinsurer finances several years out from their initial granting. At this point, we do not see much evidence of the industry mortgaging its future through the granting of extra coverage. So cedents can enjoy the benefits of the softer market, without increased concerns on reinsurer credit quality.

Ringing in the new year, that's something we all can cheer. re

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