Standing their ground

While reinsurers are fighting to keep rates adequate in the softening market, capital markets competition could upset the applecart, says Kevin Stokes

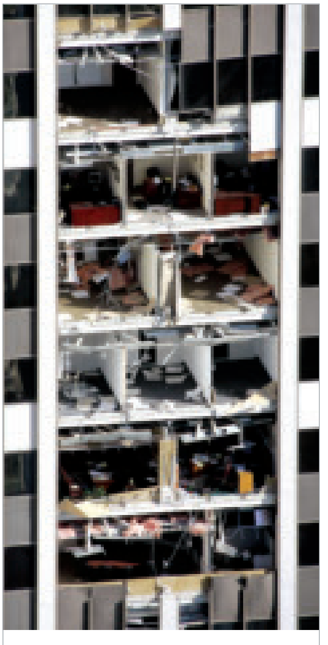
A lack of property cat losses of the level of those suffered in Florida in 2005 has led to rates sliding

If the central theme of global reinsurance markets in 2006 was increased demand, then the theme of 2007 is increased supply. Following record catastrophe losses in 2004 and 2005, compounded by upward loss-cost revisions by modellers, and rating agency pressure on required capital to support catastrophe risk, there was increased demand for catastrophe covers in 2006. This was particularly the case in peak zones. Major catastrophe losses in 2007 – notably windstorm Kyrill across Europe and the UK summer floods – added to this market pressure.

The increased demand outstripped 'available' capital, which led to a severe crunch during summer renewals, especially for the southeast coast of the United States. We say 'available' capital because there was no shortage of overall capital in the reinsurance industry. Rather, reinsurers were reacting to hurricanes Katrina, Rita and Wilma in 2005, with strict limits on their capacity allocated to support peak zones.

In 2007, 'available' capital increased, and the market imbalance was corrected. This reflected a less constrained view of North American coastal exposures, increased surplus of existing reinsurers, and the injection of new capital to the industry, including catastrophe bonds, new entrants and sidecars. For instance, the catastrophe bond market witnessed a record level of issuances in 2006, with 20 transactions totalling $4.69bn in risk capital transferred to the capital markets (*see page 33*). This activity doubled the previous record of 10 transactions in 2005 and, in terms of risk capital, represented a 136% increase over the previous record total of $1.99bn in 2005.

The increased capital inflow to reinsurance markets was aided by a low level of catastrophes. Following the record loss years of 2004 and 2005, losses in 2006 appeared more normal at $15.9bn. Indeed, when the final numbers are counted, 2006 is likely to be counted as the most profitable year on record for the reinsurance industry. Looking to the future, the fortunes of insurers and reinsurers are tied to the vagaries of nature and, unfortunately, man (in the form of terrorist acts).



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MIXED MESSAGES

So, if the theme for 2007 is increased supply, what are the predicted themes for 2008? The answer depends on the ▷

audience. For clients it might be 'the year of substantial declines', 'the year we rebalance the scales' or even 'the year we fight back the models'. For reinsurers we might envision 'holding on' or 'bend, don't break'. Let's take a look at each of these different perspectives before we make some predictions for the future.

Clients will be aggressively pursuing rate reductions in 2008. Back-to-back years of exceptional reinsurer profitability (assuming no major events at the time of writing) and renewed scrutiny on the science behind heightened hurricane frequency will leave clients looking for substantial recalibrations of their property catastrophe reinsurance premiums. Premiums that went up astronomically in 2006, after the 2004 and 2005 hurricane activity, reduced only modestly in 2007.

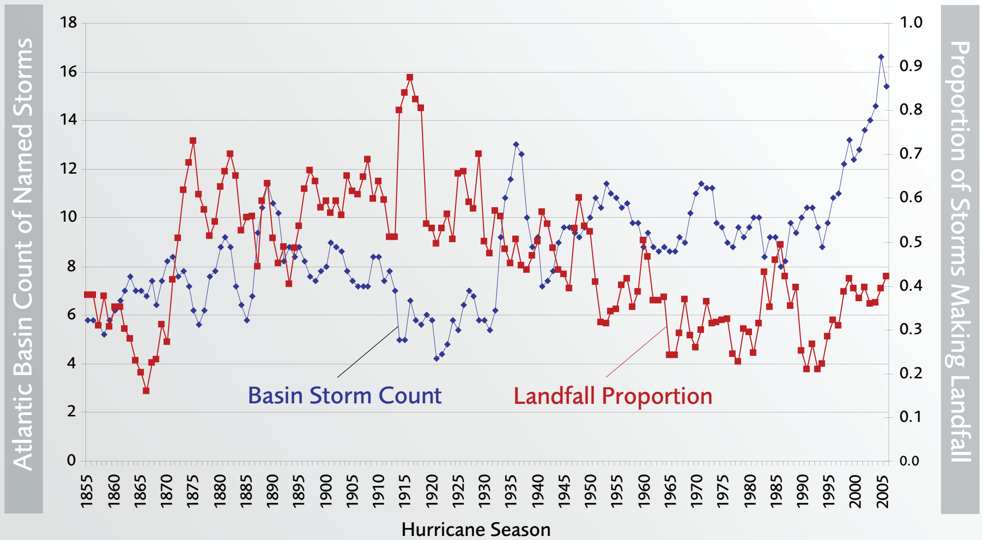
From a more fundamental perspective, there were two major forces that drove catastrophe premiums up so significantly in 2006. The first was the revisions made to the vendor models that amended both hurricane frequency and damageability and drove PMLs drastically upward. The second was the actions taken by rating agencies to reflect their new perspective that the industry


Windstorm Kyrill ensured a stormy start to 2007 for European re/insurers

was undercapitalised for catastrophic risk. In the latter part of 2007, both of these major forces have been somewhat tempered.

The damageability revisions developed through post-loss assessments, while dramatic, are difficult to dispute. The frequency, on the other hand, is more problematic in light of the last two hurricane seasons. The expectation was that increased sea surface temperatures would lead to more Atlantic Basin hurricane

FIGURE 1: ATLANTIC BASIN ACTIVITY VERSUS LANDFALL PROPORTION (5-YEAR MOVING AVERAGE)



Source: AIR Worldwide

activity and therefore more US landfalling activity. This position was offered and accepted using the dartboard analogy: more darts thrown means more hit the board. However, it now appears that this opinion may not be such a universally accepted position; AIR recently released a position paper arguing that history supports the inverse to be more accurate.

In the report *Near-term Hurricane Risk in the United States* it said: "Until recently, the primary focus of scientific investigation into climatological influences on tropical cyclones has been on basin-wide activity. It was only after the active 2004 and 2005 hurricane seasons that research into the relationship between basin activity and hurricane landfalls began in earnest. Even today, however, most research is focused on the analysis and prediction of basin-wide tropical cyclone activity rather than the frequency of landfall.

Without a careful analysis of the data, one might be tempted to assume a one-to-one correspondence between basin activity and landfall activity. That is, if basin-wide activity increases by 30%, one might assume that landfall activity will increase by the same percentage. However, the figure below reveals that this is not necessarily the case.

Figure 1 (*above*) shows both the number of named storms that have formed in the Atlantic each year since 1855 and the proportion of those storms that made landfall in the US. Note that upward spikes in basin activity are accompanied by downward spikes in landfall proportion. That is, an increase in the number of named storms in the Atlantic will not necessarily translate to a proportional increase in the ▷

number of tropical cyclone landfalls."

NO INDUSTRY IMBALANCE

The concerns around industry undercapitalisation of catastrophe risk have partially been remedied through positive experience. The exceptional profitability in 2006 and 2007 (yet to be fully determined, but there is reason to be equally optimistic) has gone a long way towards narrowing the rating agencies' perceived imbalance between catastrophe PML and the year-end 2005 capital that was available to fund it.

CONFLICT OF INTERESTS

In summary, from a cedant's perspective, the two major reasons for the premium spikes in 2006 have been ameliorated. The science that had supported undeniable increased hurricane frequency appears to be under some challenges, and the depleted capital position of the re/insurance industry has largely been corrected. Clients are emboldened to pursue premium decreases and bring prices back towards 2005 levels.

From a reinsurer's perspective, there are two major justifications behind holding the line on property catastrophe reinsurance pricing. One is explicit, and will likely be a topic of

Flooding dominated the headlines in the UK over summer

discussion around most renewal negotiations. The other will be a topic that may not be a front-page renewal story but will certainly be discussed in reinsurers' boardrooms.

The first is the fact that it is inappropriate to determine annual 'winners' or 'losers' in the underwriting of property catastrophe exposures. Pricing for high severity, low frequency events contemplates the large majority of years being loss-free. The fact that 2006 and 2007 did not produce the extreme event does not erode the validity behind the science. Scientists are better qualified than the reinsurance market to determine when we move in and out of the cycle phases of warming and cooling sea surface temperature. The annual movements of capital is the result of the positive or negative experience, but underwriting discipline must be maintained to preserve pricing integrity.

The second reinsurer justification for maintaining pricing discipline is the fact that the capital markets have fundamentally changed reinsurers' cycle management. In the past, the reinsurance market could allow premiums to trade below 'adequate' levels because they were able to enjoy the excess rates that resulted from the market dislocation after a major event. In other words, if a reinsurer was able to survive the event with its capital position intact, it was well positioned to take advantage on the upside of the market over correction. Since the terrorist events of September 11, 2001, and certainly evident from 2005, post-Katrina, the rapid introduction of vast amounts of alternatively-sourced new capital has severely tempered reinsurers' upside. As a result of the reduced benefit on the way up, the reinsurance market must be much more disciplined on the way down. While this will not likely be a topic of renewal negotiations, we must assume that this new dynamic will be factored into every reinsurer's budgeting and planning session.

What matters is market power, and in the current environment, market power is stronger on the demand side. For this reason, it is expected that cedants, generally, will be successful in driving down premiums for catastrophe reinsurance

NO RIGHT ANSWER

In summary, clients feel as though the desperate world of early 2006 has rapidly improved. Expected hurricane loss frequency has not materialised and the depleted capital position of the industry has been rectified. Reinsurers, on the other hand, will argue that the science needs time to play out and it is simply too early to declare winners and losers. They would also argue that now, more than ever, pricing discipline needs to be maintained. Not only are there ever-increasing values at risk as global coastal development explodes, but the post-event uptick has been substantially reduced by the speed with which capital now moves. Who is correct? The answer is both. Correct, however, doesn't have much of a place in the supply- and demand-led reinsurance market. What matters is market power, and we believe that in the current environment, market power is stronger on the demand side. For this reason, we expect that cedants, generally, will be successful in driving down premiums for catastrophe reinsurance. ®

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