A most unusual renewal

With the financial crisis still deeply affecting the market, 2009 might be one of the most interesting yet, writes **Peter Zaffino**.

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The imminent renewal is likely to be the most unusual in recent memory. The (re)insurance industry remains entangled in a global financial catastrophe, which makes any effort at forecasting the exact outcome very difficult. Cedents and markets are forced to navigate competing forces — all of which involve the availability of capital. Constraints in financial markets render cash difficult to acquire but balance sheets in our industry remain relatively healthy. So, while we expect pricing to remain within a range of expiring rates, conditions are changing daily. New developments could change market conditions quickly and drastically.

The market is being squeezed by several factors. Reinsurers are coping with a higher cost of capital and an increase in risk and catastrophe losses. Markets are generally reporting price increases for certain classes of business as we enter 1 January 2009. While these factors may cause reinsurers to push for higher prices, cedents are likely to counter that they have borne the majority of the year's catastrophe losses — as a result of higher retention rates.

While the capital held by both insurers and reinsurers appears to be adequate by many measures, both allocate more for certain perils and geographies. This fact — in conjunction with impaired investment income — suggests that reduced allocations will be among the leading indicators of a market change.

Implications for the market

A collection of primary market conditions have kept reinsurance rates leaning in cedents' favour. A year of above-average catastrophe losses has impacted insurer balance sheets, but insured losses have fallen short of a market-changing event, for example, of Hurricane Katrina's calibre. Natural catastrophe losses have chastened rather than punished, lending more credence to the notion that an event capable of turning the market is still a potential concern rather than an actuality.

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Nonetheless, the industry awaits final answers. The implications of 2008 natural catastrophe losses are still being tallied — particularly for Hurricane Ike. Immediately following the storm, loss estimates were lower than expected. In the weeks that followed, though, the range has been on the rise, with RMS publishing estimated insured losses of $13bn to $21bn, up from the original $7bn to $12bn. The latest estimates suggest that insured losses could be twice as high as originally expected. Most losses have been absorbed by primary insurers, because retentions have increased throughout the year. The exact ultimate net loss of Ike will not be fully known until all assessments have been completed, and this will not be concluded until 2009.

The financial catastrophe has been more powerful than the natural catastrophes that have occurred this year. The stock market's decline has led to total realised and unrealised losses of approximately $19.6bn for the first half of 2008 among primary carriers, with an additional $15bn estimated for the third quarter. Surplus dropped by an estimated $12.9bn for the first half of the year, with another $22.4bn expected in the third quarter. The implications for surplus have been notable, with some reinsurers and insurers reporting the loss of almost of a quarter of their capital in the first nine months of 2008.

Of course, a bit of perspective is important, particularly in light of the large loss numbers that have been discussed in our industry. Despite the billions of dollars destroyed by the financial catastrophe, the industry has been — and remains — well capitalised. Primary carriers' premium-to-surplus ratio is slightly below 1:1. While the losses that come from a decline in equity values are often viewed as temporary and can be expected to increase when stability returns, though, some companies may not be able to wait for a recovery.

Many of the financial pressures felt by primary carriers have been visited upon reinsurers, as well. Reinsurers face a higher profitability hurdle as a result of several years of strong earnings — along with increased competition and slipping prices. These factors, not to mention a general increase in the cost of capital, have created a challenging business environment.

Undoubtedly, reinsurer balance sheets have been damaged, and heading into 2009, there is little room for error. So far, the largest (re)insurers in the US and Bermuda have reported unrealised losses of $98bn since the end of the last catastrophe year, largely due to the sub-prime mortgage crisis and broader financial catastrophe. Yet, the premium-to-surplus ratio for the largest reinsurers in the world is slightly above 1:1, which indicates that the industry is well capitalised.

So, what about pricing?

The tension is palpable. The cost and availability of fresh capital, reinsurer earnings targets, and fears of a mega-catastrophe have converged on risk-transfer pricing. This will halt the year's rate drops and bring the potential for price increases. At 1 January 2009, it seems as though pricing is likely to remain within a range of expiring rates but prudent carriers are already thinking further into the year about capital solutions. In the near term, cedents would be prudent to get into the market early, particularly if prices increase through the first half of next year — while developing strategies to minimise exposure to higher costs of cover. re