Looking at a downturn?

Peter Zaffino looks ahead to the 2009 renewal season and the challenging market conditions

Peter Zaffino is CEO of Guy Carpenter

All eyes will be on 1 January 2009. As we approach the next renewal season, another round of rate decreases seems likely. The pace should be slower than it was through 2008, thanks to greater underwriter discipline than in previous downturns. Thus, even though the market has not been catastrophe-free, it has been able to absorb the losses, as the industry is well-capitalised. Fears of a mega-catastrophe and pressure from broader economic conditions should keep underwriters from assuming inadequately priced risk.

Impressive earnings

With the third quarter coming to an end, reinsurer capital remains plentiful, thanks to impressive earnings. For 2007, the global reinsurance industry reported a 19% return on equity (ROE), per the Guy Carpenter Global Reinsurance Composite. Further, increasing penetration of the reinsurance market by alternative capital sources — such as private equity and hedge funds — through vehicles such as insurance-linked securities (ILS) and sidecars, gives the feeling of a substantial supply of capital to the industry at the earliest sign of above average profitability. However, the unprecedented profitability of recent years is coming under pressure.

> We have not had the mega-catastophe that is universally feared but, in the first quarter of 2008, large per risk losses became more frequent.

We have not — at the time of writing — had the mega-catastrophe that is universally feared but in the first quarter of 2008, large per risk losses became more frequent. Reinsurers have had to address several costly events around the world, from flooding in the United States to snowstorms and earthquakes in China. Global economic conditions make maintaining the previous pace of earnings growth difficult.

In some markets, reinsurers have begun to withdraw capacity, especially if writing business would expose them to disproportionate levels of risk relative to potential earnings, as we saw in Japan earlier this year. At 1 April 2008 renewals, there was a reduction in the sign-down rate for this market, and reinsurers withdrew capacity from the marketplace because technical pricing seemed to be near the margin of profitability. Given the myriad factors with which they must contend, reinsurers are taking steps to protect their balance sheets and future earnings.

Underwriters are exercising noticeable discipline, a trend that should continue through the next major renewal period. Reinsurers will not want to put capital at risk unnecessarily, considering some business as being priced below acceptable ROEs. Conventional wisdom suggests that staying firm on underwriting prevents the purchase of future losses. While this is undoubtedly true, the implications reach much further than binary 'win/lose' thinking.

Post-loss, reinsurers may have trouble finding liquid capital, particularly given today's market conditions. Global financial markets continue to feel the rattle of aftershocks from the sub-prime mortgage market's collapse. In the wake of a major event, both primary carriers and reinsurers may struggle to replenish their balance sheets.

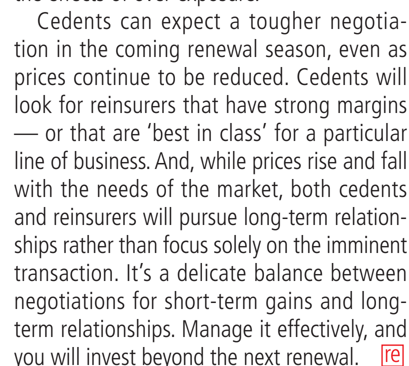
Alternative investment vehicles focusing on catastrophe risks are likely to remain reliable capacity sources, attracting investors who want risks not correlated with broader financial markets. However, 'catastrophe funds' are not impervious to global alternative investment trends. Inflows to ILS and sidecars in a post-loss environment may be limited by the constraints on credit markets and generally slowing investments in hedge funds and private equity funds. The days of easy money are over, and loss mitigation, rather than post-event recapitalisation, should be the top priority.

The effects of the credit crisis have stretched beyond access to capital, further squeezing reinsurers and emphasising the importance of cautious underwriting. Equity values have declined precipitously. Thus, investment income alone will not be enough to carry risk-bearers through current market conditions. The importance of maximising earnings from underwriting has increased. Every risk will be scrutinised as we head into 1 January 2009 renewals, with every reinsurer decision being driven by the potential impact on profitability.

Though reinsurers were generally quite profitable in 2007, they are burdened both with the obligations of success and an up-tick in insured losses in 2008. Beyond having a higher hurdle and a tougher market this year, there is another challenge that is far greater. Last year's underwriting results were supported by reserve releases, a finite source of capital that eventually dries up. So, a higher hurdle is raised by the loss – or at least reduction – of an important option.

Market momentum

For cedents, some market momentum can be expected at 1 January 2009. Rates can be expected to go down, though probably not at as dramatically as in 2008. Absent a mega-catastrophe, cedents will be able to take a hard stance on pricing, as one would expect. Yet, they may encounter some resistance, as reinsurers endeavor to protect themselves form the effects of over-exposure.



Cedents can expect a tougher negotiation in the coming renewal season, even as prices continue to be reduced. Cedents will look for reinsurers that have strong margins — or that are 'best in class' for a particular line of business. And, while prices rise and fall with the needs of the market, both cedents and reinsurers will pursue long-term relationships rather than focus solely on the imminent transaction. It's a delicate balance between negotiations for short-term gains and long-term relationships. Manage it effectively, and you will invest beyond the next renewal. re