How much is too much?

David Spiller wonders how reinsurers might be able to stay liquid enough to avoid expensive recapitalisations after big Cats but avoid the pedestrian returns of the over-funded.

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Following a year of 'near misses', reinsurers are flush with excess capital. That may seem to be an embarrassment of riches for those outside the industry. A closer look at 2007 shows how a few twists of fortune could have led to a much different outcome. Before continuing the flurry of dividends and buybacks that occurred last year, it may pay to take a look at what really is 'excessive'. To be ready for a fast turn in the market, excess capital may be just enough.

The problem of excess capital is front of mind for reinsurers when market conditions turn soft. It is neither surprising nor unusual. The industry continually struggles to find a resolution. Finding a destination for extra cash is always a challenge and few solutions seem palatable. Further, the need for liquidity complicates matters. Excess capital must remain available in case it becomes necessary.

Put in perspective

Nothing puts the need for sufficient capital in perspective quite like the near misses of 2007. Two category five hurricanes made landfall. Floods drenched the UK, making summer soggier than usual. Four earthquakes exceeding seven on the Richter scale shook the earth; the total almost reached five, with a quake measuring 6.9 striking Noto, Japan. Windstorm *Kyrill*, storms in Australia and wildfires in California and Greece continued the trend, and the subprime mortgage crisis could have been more severe than it was. Reinsured losses were few, despite increased event frequency and severity, because the calamities missed vital ground.

Clearly, the capital available to reinsurers would not have been so voluminous if a few of last year's catastrophes had had broader impacts. The close calls seem to have failed to shape reinsurer behaviour. Record amounts of capital were returned to investors in 2007. More than $9bn was returned to shareholders as dividends, and another $2bn was repatriated through share buybacks. Faced with the prospect of having to make excess capital productive, reinsurers were inclined to allow investors to find their own opportunities.

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The situation is immediately recognisable as precarious. More than $10bn left the industry at a time when a few small changes could have made that money quite useful. Had a few storms turned, we would have relived 2005, in which substantial capital repatriation was followed by more than $40bn in damage caused by Hurricane *Katrina*. In 2005, excess capital was not excessive after all.

So, did reinsurers give away too much in 2007, and what does this mean for 2008? Again, record profits and low reinsured losses have led to a soft market, and plenty of capital remains on the sidelines. What we have learned, though, is the importance of maintaining access to sufficient capital. This year, reinsurers will have to balance the obligation to make capital productive with the importance of ensuring that it is available if needed.

Keeping capital available will be fundamental to success in the coming year, especially because a single catastrophe can harden a market quickly. Each reinsurer has unique needs, resulting in different approaches to capital market investment in a soft market. However, the importance of liquidity is pervasive. In order to generate sufficient returns to satisfy shareholders while ensuring the liquidity of invested capital, it is probably best to select market opportunities for which risk mitigation is not difficult, for example, highly rated debt.

Investment quality and risk profile is only part of the equation. The other half is correlation. Reinsurers should consider the effects of a catastrophe on the capital market positions to which they deploy their capital. Certain cat bonds, for example, may be exposed to the same risks that the reinsurers have assumed through traditional risk transfer from cedents. The need for capital to cover claims would be constrained by a decline in the securities in which reinsurers have invested.

Focus on assets

To put excess capital to work effectively, reinsurers should focus on assets that are not correlated with the insurance perils to which they are exposed through the normal course of business. A few major catastrophes would render reinsurers' excess capital necessary, often on short notice. In the past, reinsurers would have had to recapitalise, typically an expensive undertaking. With uncorrelated assets, reinsurers recoup most of the cost of capital. Instead of underwriting a new issue, access to capital is restored merely for the cost of trading through existing positions, which is substantially less expensive.

The problem of excess capital is exacerbated by the cost of recovering it when markets harden. With new developments in capital markets, a new approach to capital management in a soft market can bolster reinsurer performance without sacrificing liquidity. For a change, capital can remain cheap, available and productive at the same time. re