



Capital markets products have long been vaunted as a way of smoothing the exasperating traditional market cycle. So are they? Guy Carpenter's **David Priebe** examines the issues...

## Navigating pricing peaks and valleys

The capital models for (re)insurance risks are evolving. Over the past 15 years, alternative sources of capital have become increasingly important, particularly in the cash-constrained environments that follow major catastrophe events.

As expected, capital market vehicles such as catastrophe bonds and sidecars have brought additional capacity to risk-bearers when they need it most, alleviating price pressure as a result.

While alternatives to traditional reinsurance have been viewed by some corners of the market as too small to have a transformative effect, post-catastrophe reinsurance trends suggest that tools such as catastrophe bonds and sidecars have smoothed pricing.

Of course, pricing has not become flat; that is unlikely to occur, except in theory. Spikes and drops still happen, but they have been mitigated by the engagement of the choices – and depth of resources – that capital markets afford.

The Guy Carpenter World Rate on Line (ROL) index shows a flattening of reinsurance pricing since Hurricane Andrew struck in 1992.

From a level of approximately 250 in 1992, the World ROL index spiked, approaching 400 the next year. Through the rest of the decade, it dropped roughly to 1992 rates.

In 2002, following the attacks of 11 September 2001, the World ROL index jumped again, but it only reached 250 – approximately the same point at which rates stood before Hurricane Andrew.

Hurricanes Katrina, Rita, and Wilma hardened the market again in 2005, and rates increased in 2006, as expected. But, the World ROL index only approached 300; it did not surge as it had in 1993.

From Hurricane Andrew to the attacks of 11 September 2001 to Hurricanes Katrina, Rita, and Wilma, the effects on pricing were contained – at least in part – by the availability of alternative sources of capital. The wide adoption of catastrophe bonds in late 2001 and 2002 signaled the market's commitment to newer forms of cover, as well as the price management that this approach could have.

The market implications of alternative

capital sources were even more pronounced in 2005 and 2006, the watershed years for capital markets solutions. Of the \$34bn in new capital that reached (re)insurers following Hurricanes Katrina, Rita, and Wilma, a third came from sidecars and catastrophe bonds – 13 percent of the total from the former, 20 percent from the latter (see chart).

Catastrophes have clearly shaped the tools available to (re)insurers and the ways in which capital enters the market. Capital inflows have increased following each of the three major events of the past three years, and at the same time, peak ROLs have come down. Meanwhile, the amount of alternative capital – as a percentage of total post-loss inflows – has grown substantially.

Although the market has been calm for the past three years, there is evidence that capital markets capacity can continue to protect cedants from future post-catastrophe price increases. The means of post-loss capitalisation are maturing, addressing more closely the challenges that (re)insurers face.

Catastrophe bond shelf-offerings, for example, can set a foundation for access to future capital with minimal transaction costs. With this approach, the issuing carrier pays for the transaction once and can issue future bonds (via take-downs) using a pre-existing structure.

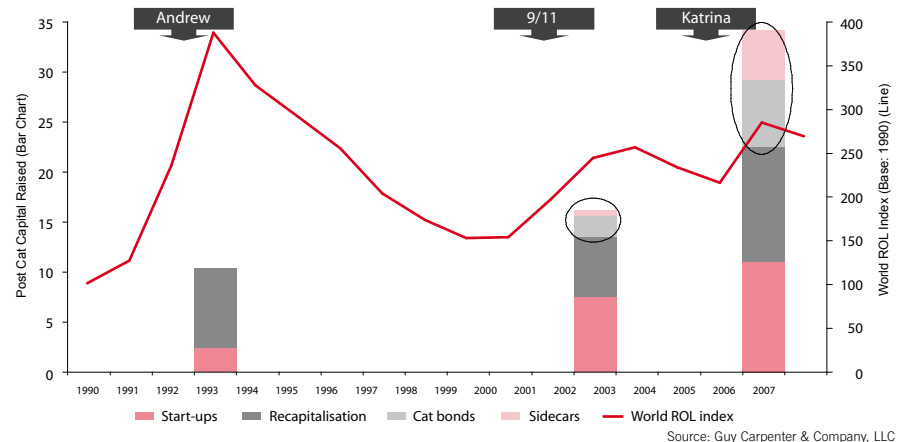
Sidecars, through collateralised quota share structures, reduce credit risk and reinsurance recoverable capital charges. As a result, risk can be managed with greater precision, because risk can be transferred off the (re)insurer's balance sheet to prevent disruption resulting from an infusion or withdrawal of capital.

In the past, alternative sources of capital were viewed strictly as means for bringing new cash to carrier balance sheets quickly. Their role has emerged, however, to contribute to strategic capital management. In addition to bringing fast capital to depleted balance sheets, these alternative sources are being refined to help (re)insurers manage their portfolios more effectively in a post-loss environment.

The impact of these vehicles on reinsurance pricing, consequently, has grown. As post-catastrophe price swings have narrowed since Hurricane Andrew, the continued maturation of capital market solutions appears to be having the desired effect.

The (re)insurance market will never flatten completely. The very nature of risk entails years with unanticipated serenity or severity. Fortunately, the goals of most risk-bearers are a bit more modest. Alternative sources of capital may not lead to a perfect market, but they can keep reinsurance pricing manageable.

### Evolving capital model for insurance risks



Source: Guy Carpenter & Company, LLC

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