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Reinsurance market set to remain vibrant following recent catastrophe events

James Nash
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- Losses highlight effectiveness of reinsurance as capital protection mechanism
- Rational response from reinsurers expected at 1 January renewals
- Industry capital at an all-time high and clients are expanding covers

While the reinsurance product has delivered compelling balance-sheet solutions since its beginnings, recent catastrophic events in Mexico, the Caribbean and the United States have created a perfect opportunity for the market to showcase its ability to adapt solutions to the unique risk profiles of individual clients seeking to manage capital events, says James Nash, President, International, Guy Carpenter.

"The value of reinsurance as a capital substitute was very apparent during the 2008 financial crisis, when debt and equity financing was difficult for our clients to obtain," says Nash. "In its place, the reinsurance market demonstrated its ability to protect balance sheets, manage earnings and reduce volatility. Now, the recent series of catastrophic events – earthquakes in Mexico, Hurricanes Harvey, Irma and Maria – is reminding cedents that reinsurance is also one of the most effective ways to protect corporate capital bases from these events."

Recent loss events have the potential to make the third quarter of 2017 one of the costliest in the insurance industry's history. While it is still early and loss estimates will likely fluctuate, some analysts expect insured losses of at least USD 100 billion. According to A.M. Best, total catastrophe losses of USD 75 billion would mean a combined ratio of 106 percent for the world's top 20 reinsurers. Although there appears to be little risk to solvency, individual insurers' earnings will be impacted and in some cases excess capital positions and catastrophe budgets may be eroded.

"With a dedicated sector capital of USD 435 billion, the global reinsurance market is underpinned by record capital levels," he adds, "so in general terms the sector is well positioned to absorb such losses. However, the cumulative effect of the earthquake in Mexico and Hurricanes Irma and Maria will not fall symmetrically on the industry, and could create a capital event for some market participants."

Alternative capital has been growing at an annual compound growth rate of 18 percent for the last five years and now contributes around 20 percent of overall industry capital. "Much of this capital is supporting reinsurance companies through sidecars and other instruments," Nash explains, "and has not been fully tested in the event of a major market loss. Initial observations are that the alternative capital has responded well to client demands post event by raising new funds and supporting back-up and short-term contracts. What remains to be seen is the availability and pricing of the alternative capital market to support retrocessional contracts at 1 January."

"Despite years of low reinsurance pricing and low interest rates that have reduced the industry's profitability," he continues, "and uncertainty around the size of the ultimate losses from recent catastrophe events and the response of the alternative capital market, industry capital remains strong. As a result, we expect a rational response from the reinsurance market at the 1 January renewals."

"The earthquake and hurricanes also provide an opportunity to define the viability and effectiveness of the 144A product," Nash adds, "creating either a day of reckoning or a day of glory for the ILS market. We expect that these instruments will demonstrate their effectiveness and serve their intended purpose."

But assuming the ILS market responds to these catastrophes according to industry expectations, this capacity will likely remain an integral part of insurers' capital structures, even when interest rates rise, he believes. "Most ILS issuances define interest rates as a risk spread on top of return on U.S. Treasuries, so the asset class will remain attractive as interest rates rise. ILS is now very much ingrained in the overall risk community, creating a pool of diverse capacity collectively serving and supporting the (re)insurance industry."

Nash concludes, "Overall, we expect the reinsurance marketplace to remain vibrant and rational, and to continue offering a full range of products, supporting growth in reinsurance purchasing in virtually all its forms. Industry capital is at an all-time high and clients are expanding covers, and fully leveraging a broader array of solutions as the sector modernises in the face of technological innovation."