Transforming (re)insurance risk

Over the past few years, the capital markets have become increasingly involved in (re)insurance risk.

The capital providers have participated in sidecars, catastrophe bonds and more recently in hedge fund-backed reinsurance companies and collateralised reinsurance vehicles. They also have considerable appetite for subordinated debt as they strive for additional yield in today's low interest rate environment.

The attractiveness of (re)insurance risk to the capital markets is clear. The sector offers higher yields and the opportunity for diversification into risks that are not completely correlated with financial market risk.

Capital markets players access (re)insurance risk either through investing via specialists funds or by setting up their own in-house teams to better understand and analyse (re)insurance risk.

So far, much of the offering from the (re)insurance sector to the capital markets has been concentrated on short-term and short-tailed catastrophe risks. Over the past five years, this has been a successful and growing market sector. Therefore, until now, the capital markets' participation has been focused on a very narrow segment of the (re)insurance market.

Meanwhile, insurers face a number of challenges brought on by the very low interest rate environment, falling rates across most classes of business and a tidal wave of regulatory scrutiny as the industry adapts to the Own Risk and Solvency Assessment and advanced measures of capital and solvency.

Insurance companies are looking for solutions to aid them in obtaining an optimal capital structure that mixes equity, debt, traditional reinsurance and insurance-linked securities. They are also looking to hedge some of their risks in the capital markets and gain the balance sheet efficiency that can be obtained when using the alternative sector for catastrophe risks. Indeed, many companies are asking the question: why can we only place catastrophe risks into the capital markets?

This question has led to many attempts to find a solution that works for all parties. There has been talk of the development of casualty catastrophe products but this has floundered due to the very nature of casualty catastrophes such as asbestos, which takes a long time to emerge and even longer to quantify and settle.

There have, however, been structures that tackle single classes of business. For example, the Axa motor securitisations of 2005 and 2007 were landmark contracts but they have not led to a flood of similar products, as they were dependent on both Axa's position in the market and its willingness to deal with the tail.

Axa's developments were also restricted by the financial crisis of 2008, which dampened demand across all market sectors. The current regulatory and economic environment is leading both investors and insurers to focus on how a market can be made to work in this sector.

So what is needed to develop this market sector for risks beyond property cat and to develop products that meet the needs of investors and insurers? Insurers are looking for capital that is prepared to give them protection and allow them to provide better returns to their equity holders while giving them the assurance that it is compatible with their regulatory framework and provides real protection in times of need.

Investors are looking for instruments where their exposure is defined, trigger events can be clearly identified and are difficult to manipulate by management, funds can be returned to them within a finite horizon, yield paid is commensurate with the risk taken and the interests of investors and insurers are aligned.

Investors also need to see the data, understand how the trigger points were modelled and replicate or put them through their own models. They also need an independent pricing mechanism that would allow them to mark their bonds to market on at least a weekly basis, allowing them to satisfy their investors, despite recognising that the bonds, at first, would probably be illiquid.

In Europe, the widespread use of internal models validated by third parties (including regulators) should provide a crucial missing link between (re)insurers and capital market needs.

The demand for additional regulatory capital and the need for efficient structures are set to continue and both are leading many companies to engage with this market to develop solutions that will tap into the non-catastrophe space. The recent purchase of Catco Investment Management by Markel and the proposed joint venture between Guy Carpenter and the insurance, non-catastrophe capital markets and risk transfer specialist firm Vario Partners LLP are early indicators of this trend.

These companies are designed to build solutions to satisfy the needs of insurance companies and investors. We are witnessing the birth of a new asset class demonstrating the dynamism and innovation within the (re)insurance industry.

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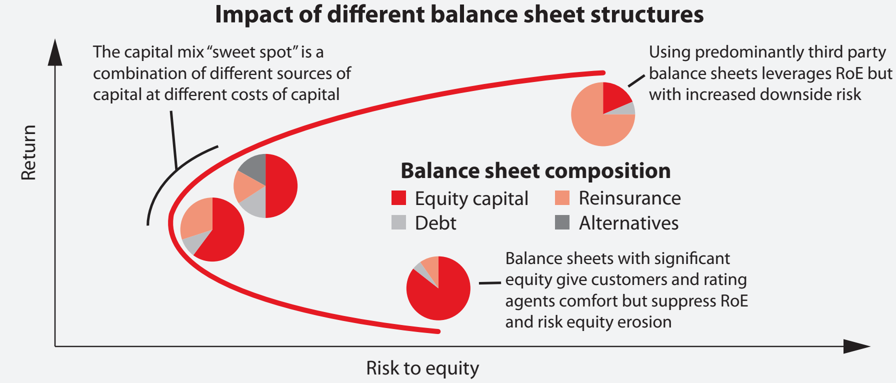
Insurer RoE efficient frontier



Source: Vario Partners LLP