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Amid Abundant Capital, A New Reality Takes Hold in the Reinsurance Market

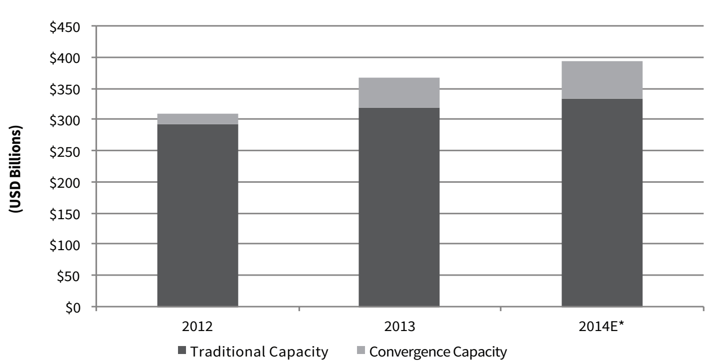
By Robert DeRose

The rapid pace of change within the reinsurance sector over the past few years has given way to the permutations of a "new reality" that is being shaped by abundant capacity from traditional and alternative sources. Additional contributing factors include the ongoing low interest rate environment and intense competition that is driving thinner margins as demand for reinsurance coverage diminishes. Many observers now believe these changes are more structural than the cyclical ones that have defined the reinsurance sector's past evolution.

Traditional reinsurance protection has historically been the primary source of capacity for cedents. That is clearly changing as primary companies retain more risk and increasingly utilize alternative markets for their risk management needs (see Exhibit 1). At the same time, the old playbook of private equity starting a traditional reinsurance company and then exiting via an initial public offering is growing less attractive.

Investors would rather put capital to work for a relatively short period of time (typically one to three years) as opposed to creating new companies that require longer-term capital commitments with a less certain exit strategy. Ease of entry and exit, among other things, is key to reinsurance risk functioning like a tradable asset class. This appears to be the ultimate end game, conceivably for all reinsurance risks, to be able to wait for the market to open, and trade in or out of various pools of reinsurance risk—even if there was an event the night before.

EXHIBIT 1



*Estimate by Guy Carpenter

Source: A.M. Best and Guy Carpenter

Alternative sources of capacity were drawn to the market by the increased reliability of risk models, diversification benefits and potential returns to investors. The low-yield environment in place since the 2008 financial crisis has made these types of investments all the more compelling for investors.

More recently, investors and users of this capacity are bypassing the traditional reinsurer and transferring risk directly to the capital markets. Lower interest rates have led to an increased inflow of alternative capital as investors look for uncorrelated ways to improve returns. This phenomenon has given rise to collateralized funds, unrated sidecars, more flexible forms of insurance-linked securities (ILS) and the birth of "Hedge Fund Re."

According to Guy Carpenter, today's alternative capital accounts for about 18 percent of total dedicated capital in the global reinsurance market compared with just 8 percent in 2008. As a result, competition for U.S. property catastrophe business has been fierce since third-party capital exploded into the market (starting in earnest around 2006). The pressure has since rippled to other classes and geographies as capacity is reallocated.

Given the lack of any major events in 2014, most reinsurers delivered underwriting profits and solid earnings. Combined ratios for most were below 100, driven in part by continued reserve releases and well-diversified books of business. The growth in capital once again outpaced the net premium revenue, which together with alternative capacity in the form of catastrophe bonds, sidecars and other structured products continued to fuel strong price competition. In 2014, US$8.79 billion in capital flowed to new catastrophe bond issues alone, and thus far in 2015 more than US$6 billion has been invested. It is estimated that there are now approximately US$25 billion in outstanding catastrophe bonds.

Recent estimates of the volume of alternative capital place the overall value at between US$45 billion to US$60 billion at year-end 2014. The growth in the ILS property catastrophe exposure market has been phenomenal given that it was nonexistent 20 years ago. The total cumulative issuance of property/casualty-related catastrophe bonds has grown to approximately US$63.3 billion from 1997 through June 30, 2015 (see Exhibit 2). Catastrophe bonds issuance related to property/casualty exposures have witnessed an average annual growth of approximately 24.4 percent from 1997 through 2014. The combined catastrophe bonds related to both property/casualty and life/health exposures saw an average annual increase of about 16 percent from 2006 through 2014 (See Exhibit 3).

EXHIBIT 2

Catastrophe Bond Issuance - P/C-Related Risks		
Year	Amount (USD mm)	% Change from Prior Year
2015*	4,354	n.a.
2014	8,298	13%
2013	7,314	24%
2012	5,878	37%
2011	4,279	0%
2010	4,299	26%
2009	3,398	25%
2008	2,729	-63%
2007	7,430	58%
2006	4,693	136%
2005	1,991	74%
2004	1,143	-34%
2003	1,730	42%
2002	1,220	24%
2001	985	-14%
2000	1,139	18%
1999	967	14%
1998	846	34%
1997	633	n.a.
Total / Average	63,329	24%

* Through June 30, 2015. Source: A.M. Best data and research

EXHIBIT 3

Catastrophe Bond Issues				
Year	Property/ Casualty Related Perils	Life/Health Related Perils	Combined Perils	% Change from Prior Year
	USD (mm)			
2015*	4,354	699	5,053	n.a.
2014	8,298	500	8,798	15%
2013	7,314	330	7,644	21%
2012	5,878	425	6,303	37%
2011	4,279	330	4,609	-2%
2010	4,299	425	4,724	36%
2009	3,398	75	3,473	23%
2008	2,729	100	2,829	-64%
2007	7,430	521	7,950	63%
2006	4,693	179	4,873	n.a.
Average				16%

* Through June 30, 2015. Source: A.M. Best data and research

The emergence of this market, which blends traditional reinsurance/insurance contracts with financial instruments, has generally been caused by perceived inefficiencies in the traditional reinsurance market, the insurance underwriting cycle due to pricing and major catastrophe events, the desire by holders of peak insurance exposures to diversify the source of reinsurance coverage and the emergence of enterprise risk management (i.e., credit risk reduction).

Most of the financial instruments underlying the convergence market have been patterned on asset-backed securities, futures and options, and other derivative instruments that provide direct access to the capital markets, which has greater capacity than the traditional reinsurance market. This process has led to the transferring of insurance risks from insurers/reinsurers to capital market participants.

One notable development in the cat bond marketplace is

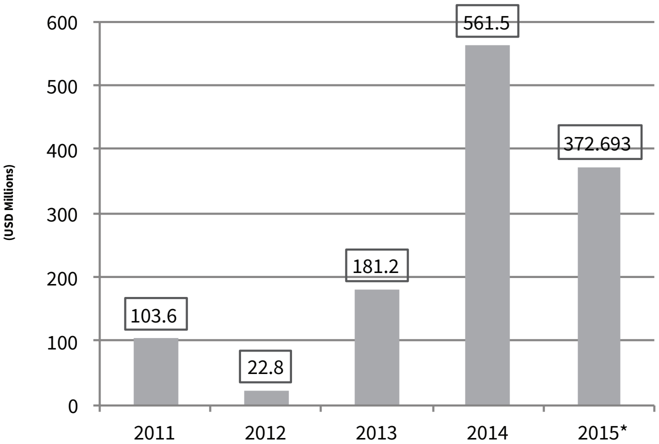
the evolution of "cat bond lite" transactions, which are gaining traction due to the efforts of the major insurance brokers, overseas insurance managers and the Florida take-out companies through the depopulation program of Citizens Property Insurance Corporation. An alternative to the traditional 144A cat bond offerings, cat bond lite are private catastrophe bond platforms designed to create an efficient way to fund smaller catastrophe reinsurance programs by capital market participants. Cat bond lite offerings, which are generally below US$50 million, witnessed an increase in dollar amount and number in 2013 and have been on a steady growth trajectory in 2014 and the first half of 2015 (see Exhibits 4A and 4B, pg. 16).

Cat bond lite provides the following advantages compared to the traditional 144A cat bond offerings: lower transaction and structuring costs; reduced and streamlined documentation, easy entry for small- to medium-size insurers and easy accessibility for small investors. The number of platforms, the number and dollar amount of cat bond lite issuance will continue to flourish.

Going into 2016, pricing is expected to remain under pressure for reinsurance and affect most lines of business. Rates for U.S. property catastrophe continue to decline more significantly than in other regions; however, the reductions are starting to spill over into other territories and lines of business. During the Jan. 1, 2015 renewal season, reinsurance pricing was down 5 percent to as much as 20 percent for certain risks. The subsequent April 1 renewal season saw pricing declines of 5 percent to 15 percent, and June and July renewals declined as much as 15 percent on average for some risks.

EXHIBIT 4A

Private Catastrophe Bond Issued through 2011 - 2015 (P/C Related Risks)



* Through June 30, 2015. Source: A.M. Best and Guy Carpenter

EXHIBIT 4B

Private Cat bonds Issued in 2015 as of June 30, 2015 (P/C Related Risks)

Platform	Amount ($ mm)	Issue Date	Maturity Date
Kane SAC Limited	27.53	1/2/15	1/12/16
Kane SAC Limited	16.82	1/2/15	1/12/16
Kane SAC Limited	26.68	1/2/15	1/12/16
Kane SAC Limited	54.81	1/5/15	1/15/16
Kane SAC Limited	20.70	2/20/15	2/3/16
Kane SAC Limited	18.80	5/28/15	6/22/17
Market Re Ltd.	6.70	6/10/15	6/7/16
Market Re Ltd.	70.51	6/10/15	6/7/16
Market Re Ltd.	24.38	6/10/15	6/7/16
Market Re Ltd.	10.00	4/29/15	5/1/16
Oak Leaf Re Ltd.	1.77	3/28/15	6/7/16
Oak Leaf Re Ltd.	47.00	3/28/15	6/7/16
Oak Leaf Re Ltd.	47.00	3/28/15	6/7/16
Total	372.69		

Source: A.M. Best data and research

Over the past several years, (re) insurers have voiced the need to remain focused on underwriting given the years of low investment yields and the expectation that favorable reserve releases will eventually end. The market is expected to remain extremely challenging and with that some companies may not be able to remain as disciplined as they need to be. Third party capital continues to pour into the market with no ease in sight as hedge funds, pension funds and other investors continue to look for yield and sources of diversification.

The cheaper sources of capital entering the reinsurance segment won't necessarily result in winners across the board. Those deemed winners at the end of the day must be able to walk away from bad business, have the capital and expertise to write new, more complex lines of business and provide the products and services that clients want in a global economy. Other factors defining success include the ability to both manage the inflow of third-party capital to their own benefit and participate in the new era of consolidation without being left out.

Further market consolidation is also a likely response to the current market environment as balance sheet scale becomes an even more important attribute to retain and win new clients. Broadly speaking, rated balance sheets are well-capitalized and capable of withstanding various stress scenarios. This strength may be eroded over time for some carriers as earnings come under increased pressure, favorable reserve development wanes, earnings grow more volatile and the ability to earn back losses following events is prolonged by the instantaneous inflow of alternative capacity.

All of these issues reflect increased concern that underwriting discipline, which until recently had been a hallmark for the reinsurance sector, is strained as companies look to protect market share at the expense of profitability. Given where rate adequacy is, it will continue to take optimal conditions, including benign or near-benign catastrophe years, a continued flow of net favorable loss reserve development and stable financial markets to produce even low double-digit returns. Such return measures would have been considered average or perhaps mediocre just a few short years ago.

In A.M. Best's view, companies with diverse business portfolios, advanced distribution capabilities and broad geographic scope are better positioned to withstand the pressures in this type of operating environment and have greater ability to target profitable opportunities as they arise. It also places increased emphasis on dynamic capital management in order for companies to manage the underwriting cycle and remain relevant to equity investors. ■

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