Brian Tobben believes that the portrayal of third party capital entering the property catastrophe reinsurance market as temporary is misguided. The traditional market should accept that these newcomers are here to stay and seek to leverage the lower cost of capital they provide.

Main Attraction
The influx of reinsurance capital from non-traditional sources has escalated in 2013 and with estimates of around US$45 billion, it now accounts for some 15% of the property catastrophe market. In terms of products, collateralized reinsurance and catastrophe bonds are roughly equal in size. Side cars, once principally in the domain of the hard market, have re-emerged.

Low interest rates have played a part in the market’s growth as asset managers have had to search further afield to find attractive returns. Yield has, however, been only part of the story with the benefit of diversification providing the stronger attraction. Unlike most asset classes, catastrophe reinsurance returns are not economically driven. This, coupled with the relative outperformance of the ILS asset class through the credit crisis, has led to the recent surge in investor interest in catastrophe risks. While it would not be surprising to see temporary declines in investor interest in catastrophe, the overall long term trend is toward further growth in third party capital.

Initially, alternative capital focused on hard market opportunities through side cars. During the post-Katrina Rita Wilma (KRW) hard market, hedge funds and private equity funds dominated the investor slate. The market has now matured and is characterised by a different type of investor with a more persistent appetite and a lower return target – namely the pension funds, endowment funds and mutual funds looking to invest in catastrophe risk.

Fundamental Facts
Alternative capital highlights a key factor in the pricing equation - namely concentration of risk. US Wind is a peak zone in the context of the traditional reinsurance market and as such commands peak market pricing. But US wind exposures are not a peak exposure for the broader investment market. The global catastrophe risk market is roughly equivalent to 1% of global pension fund assets. Since catastrophe is not economically sensitive and is not a peak exposure, third party investors can accept lower returns than the catastrophe market has recently produced.

Contrary to some opinions, this new capital is not pricing catastrophe risks irresponsibly, but simply reflecting their lower cost of capital for a diversifying risk. Another way to think about this is capital impairment post event. A large catastrophe event will be a greater loss as a percentage of assets for the reinsurance industry than it will be for the pension fund industry.

Standing Still Is Not An Option
New capital markets structures and the growth of the catastrophe fund industry have streamlined access into the property market for third party capital. This has shortened and muted the catastrophe pricing cycle. The way in which traditional reinsurers face up to this competition may vary but standing still is not an option. By embracing alternative capital, reinsurers can leverage their underwriting franchise and enhance operational flexibility. Convergence offers three main opportunities for the traditional reinsurer. First, the cost of reinsurer capital for peak zones can be lowered by managing risk through the ILS market. Second, side cars can strengthen the relationships with key clients through larger line sizes. Finally, through an asset management model, reinsurers will generate fee income by leveraging their risk management expertise.

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1 A.M. Best Special Report: The Capital Challenge: Reinsurance Capacity Overshadows Market, 26 August 2013
2 Towers Watson, Global Pension Assets Study, January 2013: Guy Carpenter, Capital Stewardship: Charting the Course to Profitable Growth, September 2013
Role Model
Historically, third party models have played a central role in the development of alternative capital appetite for catastrophe risks. As the convergence markets expand from personal lines catastrophe risks to more complex commercial and specialty exposures, underwriting expertise will be essential. Reinsurers are well positioned to leverage their modelling, underwriting and research capabilities into value added asset management services. While asset management fee income may provide a vital new source of revenue, underwriting excellence will remain a key factor in the long-term prospects of any reinsurer.

Client Benefit
Importantly, the client stands to benefit most from these new market dynamics. Capital efficiencies coupled with the expertise and experience of a reinsurer in managing risk will result in new products better suited to meet cedants’ needs. A combination of the strengths of traditional reinsurance and the lower cost of alternative capital is the right way to go for the customer – there is a need for both.

GLOSSARY

Catastrophe Bonds
Catastrophe bonds, typically known as cat bonds, are securities which provide protection to the issuer in the case of a catastrophic event. Typically if the specified trigger conditions are met then the principal will be lost. Cat bonds offer the benefit of fully collateralized protection and mitigate the credit risk the issuer would have borne from rated reinsurance. The trigger types for cat bonds are indemnity, industry loss or parametric index and modelled loss. Cat bonds trade like other financial products in the secondary market.

Collateralized Reinsurance
Investors provide collateral for the full potential claim obligation under a traditional reinsurance contract. Collateralized reinsurance allows unrated entities (e.g. pension funds) to assume reinsurance risks without obtaining an explicit claims paying rating.

Side Cars
Side cars are special purpose vehicles that reinsure a defined book of business that determines the risk and return. Side car investors will capitalize the special purpose vehicle to a level sufficient to pay claims if they arise. The liability of investors is limited to these funds.

Industry Loss Warrantys (ILWs)
ILWs are triggered by a catastrophic event which caused losses to the industry in excess of a predetermined amount.