

Capital and finance: Cat O' one tale

There was a time when we used to say that behind every great insurer was great reinsurer. Times are changing and this is no longer true. BRAVE Partners comments.

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Stormy weather

A spate of losses are finally emerging from the string of natural catastrophes that took place in the first months of 2011. As BRAVE Partners has commented (see "Stormbringer") hurricane season is only just getting into full swing and it would appear that a number of insurance executives are sitting there with their fingers crossed. In fact a number of insurance executives, in contrast to Ozzy Osbourne, are probably sitting in front of the TV punching at the remote control yelling: "I can't get it onto the [expletives deleted] Weather Channel".

This year hurricane season will be crucial if, as BRAVE Partners believes, a number of carriers are running low on reinsurance from all of the previous events.

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Where there is much there's brass

But, you might ask, where are all the entrepreneurial spirits who in the days of yore would have seen this as a market opportunity. John Charman is reputed to have made some of his money from waiting until four major depressions were lined up across the Atlantic, then running round all of the cat exposed US primaries and selling XS loss cover at 50 on-line. All the storms dissipated or missed. "Gambling!" the cynics would say and it might well be, but it worked out for John Charman. In the view of BRAVE Partners it is a little smarter than gambling, as the pricing probably put the odds in Charman's favour. Of course it was a high risk strategy.

But 2011 is not producing the same flurry of activity. Even the usually plucky Berkshire Hathaway seems to be a little quiet. Those who have to place 1/7 reinsurance ahead of hurricane season report that pricing was up a little, but capacity was the main issue. When Charman was out and about, it was the other way round. Capacity was not a problem, so long as it was paid for.

The man from Del S&P says NO

Ratings, or to be specific ratings agencies, have to be an issue here. Following the major losses of 2004 and 2005, the rating agencies have become harder and harder on catastrophe reinsurance businesses.

This caused some to rethink their strategy. Renaissance Re was once a natural catastrophe specialist. Their particular forte was US Hurricane risk and they emerged from 2004 and 2005 in perfectly good financial health.

However, post 2005, the firm began a strategy of diversification and sought to develop specialty lines businesses. The management changed and the company today is very different to what it once was. It certainly does not put out as much cat capacity. The one tale in the cat reinsurance markets was of more capital requirements and ratings downgrades.

Platinum is the latest company to get itself into the cross-hairs of S&P following reports of natural catastrophe losses.

Diversification needs more

Certainly 2011 has to change the perception of catastrophe reinsurance. The business relied on some kind of global diversification. The primary businesses tend to be rational or national. They can diversify their attritional losses. Not every chip pan in Louisiana is going to catch fire every year. However, a hurricane will impact most of their coastal portfolio and this is covered by reinsurance. The reinsurer relies on diversification across risks and geographies. The exposure would be: US hurricane, US quake, Japan quake, US tornado, rest of world quake, etc...

Looking through the major risks over the last hundred years pre-2011, there have only been a few, counted on the fingers of one hand, years where two events have happened and none where three have happened. 2011 saw a Japan quake; the largest US tornado loses ever; at least two other rest of world quakes and hurricane season isn't over yet.

The ratings agencies started the process, but the reinsurance business model is changing. Reinsurance now needs to be more diversified, but this means less capacity for peak risks. The song remains the same. Pressure from ratings agencies and a changed perception of the risk profile in the market will shift traditional capacity away from the peak zones natural catastrophe risks.

Reuters (July 5, 2011) reports:
“An undisclosed Florida-based insurance company has sold a catastrophe bond to cover itself against losses from any future massive land falling hurricane in the state...”

Towers Watson Capital Markets (TWCM) ... sold \$11.95m of notes to capital markets investors via a cat bond called Oak Leaf re 2011-1 ...”

My name is bond

The peak risks need to be placed somewhere. Cat bonds and other insurance linked security structures are tried and tested. Interestingly one of the small Florida homeowners businesses recently issued a \$10m cat bond. The market is mature and cost effective. Moreover, BRAVE Partners is starting to see European pension money accept the benefits of investing insurance risks (see "Insure your pension fund") and flow into the sector.

So the one tale in the cat reinsurance markets is that there is a shift in deriving reinsurance capacity for peak zones risks. BRAVE Partners

believes that a number of smaller primary businesses will set up special purpose reinsurer as sister companies that can then issue cat bonds according to their needs. If this happens then, to complete the opening sentences: "Sisters will be doing it for themselves".

BRAVE Partners services

BRAVE Partners can advise insurers and reinsurers on the market appetite for and structure of cat bonds. The firm can advise on and arrange such transactions, as well as provide mentoring and advice on establishing the infrastructure and a presence in the market. Such advice can include the key terms of a cat bond and the major negotiating points to consider for each.

Interaction

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- There has been downward ratings pressure on pure catastrophe reinsurers since the major losses in 2004 and 2005.
- The recent spate of natural catastrophes has re-emphasised this pressure. Highly cat exposed reinsurers are on negative watch.
- BRAVE Partners believes that this will lead reinsurers to seek more diversification and offer less capacity in peak zones.
- Peak zone risk will therefore need to be placed into the Capital Markets.
- BRAVE Partners can:
 - Advise on the business strategy for a cat bond, or other capital markets placement of the risk.
 - Arrange a cat bond, or other capital markets transaction.

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