

Insurance Industry: Storming

June 1 brings the official opening of hurricane season. The predictions suggest an active season. The oil spill in the Gulf of Mexico increases the risks for this year too. Reinsurers will be watching the weather channel with even more attention this summer.

May 28, 2010

Star performance

The film industry's recent sojourn to Cannes, accompanied by all of the glitz, glamour and media attention is a good backdrop to the annual September gathering of the reinsurance business in Monte Carlo. The Rendezvous de Monte-Carlo marks the opening round in negotiations between insurers and their reinsurers on pricing for the renewals due for Jan 1, 2011.

Drivers of pricing

Reinsurance premiums are driven by losses. These have two effects. Firstly, it reminds the industry that there really is risk in the business and reinsurance should not be given away. Secondly, large losses impair balance sheets and reduce capacity as well as driving up demand. Reinsurance pricing has been under severe downward pressure as there have not been many major losses since 2005. At an estimated \$12.5bn, Ike (of 2008) created the 3rd largest insured loss from a US hurricane, but even this did not significantly dent the large accumulated capital base in the reinsurance market. However, 2010 has seen some major events.

Chile earthquake

On February 27, 2010 a magnitude 8.8 earthquake occurred off the coast of the Maule Region of Chile. The earthquake was so powerful that it is estimated to have moved the entire city of Concepción 3.04 metres to the west. Insurance penetration in Chile is moderate, so the economic loss is likely to be far higher than the insured loss. The industry standard catastrophe modeling firm, EQECAT, projected economic losses of between \$15bn to \$30bn with insured losses ranging from \$3bn to \$8bn.

Just a few miles from Cannes on the French Riviera, Monte Carlo hosts the reinsurance industry's equivalent of the film festival. The Rendezvous de Monte-Carlo held in early September each year is the place for the stars of reinsurance to see and (most importantly) be seen.

Deepwater horizon rig

The rig explosion and sinking in the Gulf of Mexico and resultant major oil spill has been major news from April. The final losses are still far from clear. In fact, as BP are in the process of trying to top-kill the well (or to use President Obama's words: "that damn hole") right now, the final outcome is still not

known. The chatter that the BRAVE partners hear suggests that the final loss will be tens of billions of dollars. Certainly the BP share price reflects this scenario.

The actual loss to the insurance market from this event is likely to be much smaller. BP retained most of the risk in its captive insurance company. Transocean, the rig owner, carried far more insurance and there has been some attempt to call on this insurance. The Lloyds market, where much of the Transocean insurance sits, has already initiated legal action in the USA seeking to prevent a call on this capacity.

A less publicised, but significant, event also occurred in May 2010; the Aban Pearl gas platform sank in the Caribbean Sea off the coast of Venezuela. This event did not have the same impact as the oil spill from the Deepwater Horizon. However, a second rig sinking so close in time to the first does highlight the dangers of deepwater exploration.

Crystal ball

As far back as December 2009, the 2010 hurricane season was predicted to be more active than average. Colorado State University, among the most respected of hurricane activity forecasters, are calling for between 14 and 18 named storms. The Tropical Storm Risk report, issued on May 25, predicted 16 tropical storms of which 8 would develop into hurricanes. The forecaster places a 74% chance on more storms than normal making landfall on the continental USA.

The impact of an active hurricane season depends on the ability of reinsurers to withstand the losses.

In 2010 reinsurers are less able to withstand losses as they have had years of declining prices and currently have dripping losses pushing up reserves.

Forecasts are just predictions and can be wholly inaccurate. 2006 was forecast to be an active year and ended up with no major storms making landfall in the USA. So, until a storm hits, 2010 could still be any sort of year.

Impact of an active hurricane season

The difference between 2010 and other years that were predicted to be active is that the reinsurance markets are less able to withstand the losses. Reinsurance prices in 2006 were at almost record highs following on from the highly active (and high loss) years in 2004 and 2005. However in 2006 capital has also flowed into the market, so that the reinsurers were well capitalised, but able to charge premium prices.

The market is different in 2010. A drop in demand and few large losses has pushed reinsurance pricing lower. The reinsurers are well capitalized (in many ways over capitalised) but some of this is due to the reduced demand and pricing. They are less well positioned to cope with large losses and a rapidly hardening market. Moreover, the losses that have occurred have been recent and some are still developing; meaning that the reinsurers have uncertain liabilities from Chile and the Deepwater Horizon rig to contend with.

A highly active hurricane season with several major storms making US landfall would increase losses and add to the uncertainty on reinsurer balance sheets. This would cause a retrenchment within the major players and cause a rapid hardening in the market.

Double whammy

Moreover, the impact of the hurricane season is less certain. Whilst BP is making progress in plugging the leak on the Deepwater Horizon rig, the Gulf of Mexico (GOM) is still full of the already leaked oil. It is tough to predict what would happen if a cat 5 hurricane goes through the leaked oil. One camp thinks that there is still a very low oil : water ratio, so the oil would have little impact. In fact a good storm could help to break up the oil and “dissolve” it into the water.

On the other hand, a significant storm surge could drive oil across a larger coastline and deeper inland, say up the Mississippi River. Hurricane Ike was so destructive because it followed a river deep inland. Our conversations around oil in Mickey Mouse’s ears in Orlando, Florida were, however, perhaps a little frivolous, but fun at the time!

Frivolity aside, the impact of the oil in the GOM is definitely a risk factor for the 2010 hurricane season. The BRAVE partners were told that there was no guaranty from the proponents of the: “lots of water, not so much oil” outlook.

Insurance linked securities

Insurance linked securities (ILS) transfer insurance risk to capital markets. Some reinsurers see them as competition and there is some concern on large amounts of “dumb” capital markets capacity destroying reinsurance markets.

The reality is a little different. The ILS market needs to compete with the traditional reinsurance markets. ILS transactions are more costly, more time consuming and more complex to put together. As a good friend at one of the major insurers recently put it: “I have designed a few tailor made transactions for ILS investors, only to see [Head Office] place it in the traditional markets in about 30 seconds.”

The credit crunch has widened credit spreads meaning that ILS pricing has risen to compete. At the same time, traditional market pricing has reduced. Right now the capital markets route is time consuming and costly, but a capacity crunch in the reinsurance markets will change that. An active 2010 hurricane season would reinvigorate the ILS market. Moreover, the issues with the oil in the GOM might help to bring some creativity to the ILS structuring houses.

BRAVE Partners’ services

The BRAVE partners have a track record of creating innovative structures for transferring insurance risks to the capital markets. The ILS market is depressed right now due to the conditions in both the

“In more frivolous moments with market pals, we have speculated on the impact of crude oil being blown into Mickey Mouse’s ears in Disney at Orlando, Florida. Frivolity aside, the unknown impact of a major hurricane hitting the oil in the Gulf of Mexico poses a special risk for the 2010 hurricane season.”

Christopher Cloke-Browne
Managing Partner
BRAVE Partners LLP

traditional reinsurance markets and the capital markets. The traditional reinsurance players are in a weak position right now. A strong hurricane season could trigger a wholesale retrenching that would reinvigorate the ILS markets.

BRAVE Partners can assist investors to analyse ILS risks and opportunities as well as assisting insurers and reinsurers in developing novel risk transfer structures and mechanisms.

Interaction

If you enjoyed this commentary and would like to receive a weekly update by E-Mail, then please contact BRAVE Partners on commentary@bravepartners.com

If you would like to comment on the content of this piece, then please send an E-Mail to discussions@bravepartners.com

- Hurricane season is upon us and 2010 is predicted to be an active year.
- With reinsurers weakened by falling rates and recent losses, this season will determine the reinsurance market trend.
- A rapidly hardening market will also set the tone for (and reinvigorate) the insurance linked securities market.

- BRAVE Partners can assist investors seeking the diversification of insurance linked securities or reinsurers looking to protect themselves through issuing ILS.

enquiries@bravepartners.com

www.bravepartners.com