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For Reinsurers, Demand Is Up, Capacity Is Down, Alternatives Gaining

By Amy Friedman
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Whether in the U.S., the U.K., Bermuda, or elsewhere, the message from reinsurance companies is the same: demand is up, and capacity is down.

However, it is still a lively market, with alternative capital sources such as sidecars, catastrophe bonds, and securitizations gaining in popularity, according to the reinsurance chief executive officers during a panel discussion at Standard & Poor's Ratings Services' recent Insurance 2006: Rethinking Risk conference.

Edward J. Noonan, chairman and CEO of Validus Reinsurance Ltd., a reinsurer that began business after 2005's catastrophes, said many strengthening opportunities are possible in the market in the wake of the past two years' catastrophes.

"We might see players from the class of 2001 hook up," he said. "It would make sense for firms to do so with others with a different focus--it would allow them to ride out market bumps better."

Jacques Aigrain, CEO of Swiss Reinsurance Co., agreed, but cautioned, "You don't want to bet wrong on what business will be truly beneficial."

Recent merger and acquisition activity in reinsurance, however, has been "pretty dead," said panelist Brian O'Hara, president and CEO of XL Capital Ltd. There could be several reasons for this, but most fundamental, said the panelists, is that reinsurers have shifted what they choose to acquire.

Right now, reinsurers are looking to buy renewal rights more than businesses as a whole. This differs from a decade ago, when the merger and acquisition market was more vibrant. Reinsurers then sought to buy market share, and in doing so, several "bought bad and poorly priced businesses, which led to increased reserve strengthening needs," said Standard & Poor's credit analyst Laline Carvalho.

Recently, reinsurers have been more internally focused and have strengthened their risk management, and are now focusing on bottom line rather than top line. Reinsurance is also becoming less commoditized. Swiss Re, for example, received favorable terms and conditions (different ceding commissions, different brokerage and leadership fees, etc.) on 25% of its January 2006 renewals.

XL's O'Hara said, "If you have a higher rating, you'll see more quality business, especially in long-tail lines." However, he added that "the problem with higher-rated capacity is that everyone wants it."

O'Hara also noted a growing tolerance of lower-rated companies, at least in Europe, which are more willing to accept reinsurers rated slightly lower than the very tight 'AA' to 'A-' range within which most are rated.

"In Europe, it is easier for a 'BBB' rated company to succeed," said S&P's Carvalho, adding that a 'BBB' rating should be just as acceptable to an American company.

"The difference between 'A-' and 'BBB+' companies is very small, and the potential for a 'BBB+' to default is very low," she said. In addition, with some 'A-' companies, "one big shock could render it incapable of sustaining itself," said Aigrain.

The proliferation of sidecars and catastrophe bonds as ways to gain strategic capacity and deal with uncertainty has been "amazing to watch," said O'Hara, but as they are still untested, Noonan warned they "could add basis risk. In addition, with so much capital now needed to start a reinsurer, that has become a less viable option. Sidecars can provide the "strategic capacity companies need to have to make the market work," but "the market will have to work through how best to use them without adding risk," Noonan said.

Panelists were split about the collateralization requirement. Both . Aigrain and O'Hara clearly wish it would be done away with.

Aigrain characterized it as "delusion of protection," as the requirement does not collateralize non-U.S. risks between sign-up and occurrence. Noonan would rather see the requirement stay in place. "Although it creates a rather lumpy playing field, it benefits the market by creating a pool for reinsurers," he said. Relaxation of the collateralization requirement would not be a ratings driver for Standard & Poor's.

Ultimately, some post-Katrina start-ups may thrive, but it may depend on the type of investors backing the entities, said Aigrain. And while there is currently significant concentration of business, Noonan and Aigrain agree there is plenty of room for other players.

Source: Standard & Poor's

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