Reinsurance buying: a harder market

In a reinsurance market trifurcated by loss experience, geographical zone and product line, buyers face very different experiences as they look to tick off their shopping lists for 2012 cover. IQ investigates

Buyers hit by a new paradigm of frequency and severity of loss in 2011 are presenting fresh demands to reinsurers, as they seek affordable solutions to protect earnings, capital and ratings.

But their success depends on a reinsurance market that took around half of the estimated $105bn+ global catastrophe losses last year, and which is now looking to redress the balance in loss-struck areas of its underwriting portfolio by re-pricing to reflect increased exposures and perceptions of risk.

The result is a much greater change in the environment for buyers and sellers than those created by previous market dislocations.

Instead of the broad insurance and reinsurance market turn that was triggered by 9/11 and the grinding underwriting losses that preceded it, the 2012 version offers a market operating at multiple speed settings.

As we discuss on page 12, the key 1 January renewals presented a picture of a fragmented marketplace.

Rate increases for US cat were in line with mid-year 2011 renewals, reflecting unusually high losses outside of traditional peak zones and the impact of the RMS Version 11.0 wind model, while rates on Australian and New Zealand accounts surged.

But away from loss-affected zones and in other product lines, pricing was broadly flat for reinsurance.

At the same time, month-by-month pricing trends are showing improvement in the underlying US commercial insurance sector.

So what does that mean for reinsurance buying trends in the US?

For the second year in a row the Japanese renewal is the focus of intense scrutiny. Many, though, continue to view the US market as the bellwether of reinsurance buying trends – and in particular the mid-year property cat renewals ahead of the North Atlantic hurricane season.

Demand surge?

According to Aon Benfield, in the decade up to 2011 US insurers “decreased their reliance on reinsurance”.

The percentage of US gross written premiums ceded to reinsurers had declined from a peak of around 17 percent to 12 percent in 2010 (see chart page 12).

But as we explore on page 14, that fall in the cession rate has largely been driven by casualty business.

Property reinsurance, as Aon
Benfield observes, is a value proposition for insurers that “remains strong globally”, with buyers and sellers “well positioned to grow this relationship”.

As a rival leading US reinsurance broker tells IQ, a turn in the US commercial insurance pricing cycle could stimulate reinsurance demand.

“When pricing goes up on the underlying business, most clients typically buy more reinsurance. It’s kind of counterintuitive when the market’s improving and they’ve got more premium to manage the risk. But just because rates are improving, that doesn’t mean loss activity drops, and when insurance rates go up a carrier’s overall reinsurance spend as a percentage of premium drops,” he explains.

Consequently, insurers are able to buy more reinsurance protection for a lower proportion of their original premium.

However, with a turn in the US P&C pricing cycle very much in its infancy, Aon Benfield’s chief strategy officer Bryon Ehrhart believes budgets will remain tight.

“There’s nobody out there saying let’s spend more on reinsurance. The margins on the original business, despite rate increases that may be coming through, are still really tough,” he says.

The view is echoed by Munich Re America’s president of regional clients John Vasturia, based on the reinsurer’s experience on 1 January.

“We saw mixed success among insurers being able to get price increases on the underlying exposure, so rates weren’t moving enough to offset increased reinsurance cost.

“In many cases the pressure was to try and allocate the reinsurance spend based on changes to retention or limit and some mixture thereof,” he recalls.

### Quota share return?

Another discernible shift in reinsurance buying behaviour appears to be a modest rise in the use of quota share (QS) solutions to complement excess of loss (XoL) programmes.

Although it would be premature to herald a reversal of the trend where XoL has dominated in recent years, insurers are increasingly turning to some level of proportional support for a variety of reasons.

In high profile cases such as State Auto, the QS option was taken out of necessity.

Decimated by tornado and other frequency losses, the US regional insurer signed up three unnamed reinsurers to take a surplus relief QS of its homeowners’ book of business.

But other insurers are using QS from a position of strength.

Neuhaus explains that over the last couple of years more clients in a “healthy financial position” look at QS reinsurance as a “flexible substitute for capital,” enabling them to increase writing by setting up a new arrangement or expanding an existing QS which can then be scaled back if the market softens again.

“This model is most attractive for clients in the excess and surplus market, who can be flexible by moving in and out of the market, increasing rates and reducing exposures,” he says.

And Archambault suggests that part of the growing demand for QS is the restrictive nature of XoL.

“XoLs are most often complete with bells and whistles like loss corridors and limited reinstatements and occurrence caps that they become unpopular or inefficient for some buyers.

“If it’s possible to buy some modicum of QS cover that isn’t quite as restrictive then that’s attractive. One important issue with the QS is whether you can cover your expenses with commission and that’s always a very tough negotiation,” he says.

### Balancing act

So for carriers with a limited budget, their buying strategy depends on finding a balance between the two dominant themes emerging in 2011: frequency of actual loss experience and the higher modelled severity exposure resulting from changes to the RMS wind catastrophe model.

At 1 January, the response in the market was mixed, with different behaviour displayed by national carriers and regionals.

According to Guy Carpenter, regionals purchased around 10 percent more limit in the aggregate at 1 January.

But the firm says demand for increased protection was “driven as much by loss activity and application of this experience to future scenarios as model version change”.

Regional players such as Cincinnati Financial – which bought an extra $100mn limit at the top of its programme at 1 January, but also raised its retention – saw profits and in some cases capital severely depleted by record tornado and hail losses and other so-called non-peak zone cat loss events.

The increase in limits bought by

### Decreasing reliance

US gross written premiums ceded to reinsurers

![Graph: Decreasing reliance US gross written premiums ceded to reinsurers]

Source: Aon Benfield Analytics

www.insiderquarterly.com
Private placements stir debate

Another reinsurance buying trend to emerge at the recent renewals was the growing use of private layers and differential terms in programme structures.

At 1 January – as with 1 June and 1 July last year – there was evidence of shortfall covers and private layers in property cat placements.

In part, the trend reflected the fragmented marketplace, with a wider differential existing between high and low quotes, as reinsurers responded to model changes and different views on exposure. This left brokers with the tough job of identifying a market-clearing price and reinsurers with the option of either re-pricing a whole layer, or seeking private placements at different terms.

But buyers have also pursued private placements as a way of securing a slug of capacity to give them a head-start in building their programme.

For a buyer, such as Ironshore’s Andrew Archambault, the appeal of private placements is obvious as they enable an insurer to complete a placement without having to re-price in the open market.

“It tells you that there is only so much capacity available at the market price, but there is likely more capacity available if you’re willing to pay more than that market price. We’ve not done so, but we hear at each major renewal date that private placements are being executed.”

“Private placements are now more common today and more accepted in the market than I’ve ever seen. Part of that is because collateralised cover has become more common, more accepted,” he says.

Swiss Re’s Schiffer adds that the availability of private layer capacity reflects the fact that reinsurers have different appetites for layers in different parts of a reinsurance structure.

But a reinsurance broker tells IQ that there could be negative consequences for the market if the use of private layers becomes widespread – particularly in the context of shortfalls.

“If it morphs into giving preferential deals to certain reinsurers I worry that the market gets trained to wait for the shortfall deal.

“They then say ‘I won’t respond to the firm order, come and see me when it falls short,’ and you never get the market clearing price,” he cautions.

However, Archambault says one key is for buyers to be transparent with their reinsurers about using private placements.

“Concurrenty [of terms] has been a cardinal rule of the market for decades, but the world is changing, the amount of risk cedants and reinsurers alike are willing to accept is changing and the amount of coverage reinsureds need to buy will likely be met with or without full placements at lead market terms,” he tells IQ.

Greg Schiffer, head of property and specialty at Swiss Re America, agrees, noting the multi-model approach that insurers have gravitated towards.

However he adds that ratings agencies – particularly AM Best – may still play a key role ahead of the mid-year renewals.

“One factor that might influence buying is the view of ratings agencies when they evaluate an insurance company’s catastrophe protection and the models they’ve used to determine reinsurance buying behaviour.

“Some insurers have already topped up on cat purchases, but it’s on a case-by-case basis depending on ratings agencies, companies’ boards and other factors,” Schiffer comments.

Carriers have also shed risks from their books – especially where they have been unsuccessful in increasing deductibles or price.

The aggregate mismatch

Much of the conversation in the

Rate change by segment

<table>
<thead>
<tr>
<th>Business segment</th>
<th>Price change</th>
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<tbody>
<tr>
<td>Global property catastrophe reinsurance</td>
<td>Up 5% to 15%</td>
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<tr>
<td>Global marine and energy</td>
<td>Up 5% to 15%</td>
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<tr>
<td>Global aviation and aerospace</td>
<td>Flat to down 5%</td>
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<tr>
<td>Global credit, bond and political risk</td>
<td>Flat to down 20%*</td>
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<tr>
<td>Global life/accident catastrophe reinsurance</td>
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<tr>
<td>US property catastrophe reinsurance</td>
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<td>US casualty loss</td>
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<td>US workers’ comp catastrophe</td>
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<tr>
<td>US directors’ and officers’</td>
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<td>US medical professional liability</td>
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<td>US surety</td>
<td>Down 5% to 10%</td>
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*Based on individual performance

Source: Guy Carpenter

Andrew Archambault, global head of reinsurance, Ironshore

Greg Schiffer, head of property and specialty at Swiss Re America, revealed in January, Chartis significantly revamped its property cat programme, pulling four partially placed $500mn layers from the market – although it did also place $500mn with Nephila’s private market county weighted industry loss (CWIL) product.

Meanwhile, Liberty Mutual cut $400mn from the loss-free top layer of its cover.

Ironshore’s global head of reinsurance Andrew Archambault, who renewes the insurer’s programme at 1 June, echoes Guy Carpenter’s scepticism about the impact RMS 11.0 has had on reinsurance demand.

“Version 11.0 is certainly not the only determinant guiding insurance companies on what to buy or whether they need additional cover. Some buyers look at the model changes at face value and buy accordingly, but others will retain more at the bottom and buy more at the top, so the net effect may be zero,” he says.

“I would think that it’s also made AIR and Eqecat products more popular, more utilised. A lot of buyers are looking at a combination of different models for validation when looking at risk and reinsurance needs.”

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The aggregate mismatch

Much of the conversation in the
lead-up to 1 January focused on how buyers would address the unprecedented level of non-peak zone cat losses in 2011, driven by a record tornado season.

The loss ratios of US insurers ranging from giants such as Nationwide and Allstate to regionals like State Auto were battered by so-called frequency events.

“The question is can there be a proper cat retention set where you don’t just take every one of these tornado, flood and minor cat losses net throughout the year?” Archambault asks.

But although the topic dominated the PCI and Baden-Baden events last autumn, finding an agreeable price for aggregate-style covers to guard against frequency losses was often an insurmountable challenge.

Demand and supply for the product is often out of kilter because aggregate cover is seen as an expensive luxury when it isn’t triggered, and then becomes unaffordable when reinsurers increase loadings after a string of losses, boosting the price.

Market sources suggest that where there were existing covers in place that experienced 2011 losses, renewals were achieved, albeit at a significantly higher cost.

But new covers in the market from loss-struck US insurers met with an unfavourable response. Martin Neuhaus, president of national clients at Munich Re America, tells IQ: “There were requests for quoting lower cat layers or frequency protections from clients, but in most cases they didn’t materialise because of the price the reinsurance market was charging.”

Ehrhart adds that the industry is beginning to accept the level of loss activity from frequency events to become the new norm.

“If management teams believe they can solve this problem by putting through rate increases without losing market share, then we won’t see more demand for reinsurance. But if they believe there is potential market share loss, reinsurance becomes more of an option,” he predicts.

However, Schiffer suggests that Swiss Re was successful in meeting clients’ needs to cover frequency as well as severity at 1 January, and says the reinsurer has seen increased demand from regional companies since.

And a leading US reinsurance broker executive tells IQ that his firm has been working closely with reinsurance buyers to combine occurrence with aggregate cover.

“You run the risk that an active first two quarters uses up all the cover on the aggregate and you have to then go out and buy more occurrence.

“But companies that are struggling with their combined ratios are prepared to take that risk if they can find affordable reinsurance that satisfies ratings agency requirements and affords them adequate cover,” he explains.

Buyers and sellers of casualty await change in dynamics

Cessions of casualty premium from insurers to reinsurers have fallen significantly in recent years as primary P&C companies have retained increasing amounts of their books of business.

Reinsurance broker Aon Benfield says that despite a historical track record of providing “real value” on casualty during the last decade, reinsurers missed out on “a very profitable opportunity” by failing to align with insurers on “key assumptions about declining frequency and reasonable severity.”

“The lack of alignment destroyed material demand for treaty casualty business,” the firm suggests.

There are signs that change might be on the way, however.

As the chart illustrates, US casualty lines are showing underlying exposures that range from stable to increasing, according to Guy Carpenter.

At the same time, the decline of premium bases slowed down in the second half of 2011, in part as a result of the stabilising economy, while renewal rates on almost all casualty lines are now either flat or up – signalling the start of a market turn.

Whether this will translate to a near-term change in casualty reinsurance buying strategies is debatable. Martin Neuhaus of Munich Re America says the key is economic recovery.

“If the economy returns to its normal growth path that will automatically increase demand for casualty reinsurance. In the meantime we have a long-term trend for big primary casualty players to increase retentions.

“It’s not a shortage of reinsurance supply, just discipline by reinsurers only offering capacity at a certain price. If insurers are not willing to pay that then reinsurance volume goes down,” he says.

Andrew Archambault of Ironshore agrees that reinsurers are maintaining discipline, which is limiting the amount ceded.

“Generally, I don’t think casualty treaty reinsurers see empirical evidence yet of a material market turn to be ready to pounce. This is tough to say, but I think reinsurer discipline has been good, which puts us as buyers in a position of not being able to buy what we want.

“The major casualty treaty reinsurance sellers – Swiss, Munich, TRC, Hannover etc. – are being prudent with their capacity and trying to hold the line,” the reinsurance buyer observes.