Talk is cheap; rates seem cheaper

Sebastian St John-Clarke looks at likely themes as renewal negotiations begin in the principality

"What good are your Monte-Carlo simulations?" was the exasperated cry from a US financial journalist a few years back, as he bemoaned an increasing reliance on modelled financial information to help guide investment strategy. The exclamation was a reference to those modelling methods that took their original inspiration from the gambling principality.

As the reinsurance world returns to Monte Carlo for the 51st Rendez-Vous to begin talks for the upcoming renewal season, the same journalist might well ask, (and quite apt in the increasing age of modelled reinsurance underwriting), "What use are your Monte-Carlo conversations?"

Timed to coincide bang in the middle of the hurricane season, the first serious gusts of wind over the Atlantic can make such conversations nigh on redundant. Yet it doesn't seem to dim the appetite and numbers continue to arrive in droves to talk through the key themes that will shape January's renewals.

This year a softening reinsurance market is likely to hold centre stage. How reinsurers, and indeed insurers, formulate their 2008 strategies to make the most efficient use of capital against a backdrop of declining rates and fierce competition will be the uppermost consideration for many. Competing for attention will doubtless be thoughts on industry consolidation; government backed reinsurance vehicles; the continued efficacy of catastrophe models; the (higher) cost of capital; and the growing profile of the non-traditional investment community.

Is the price right?

Inevitably the first exploratory discussions around how much cedants will be expected to pay in the January renewals will be the centrepiece of most talks.

Following on the back of benign losses in 2006, reinsurers did much to repair their capital bases and, despite a January renewals period which saw increases in catastrophe rates for loss affected areas of the US but prices generally dropping elsewhere, underwriting discipline was largely maintained.

But the universal opinion seems to be that rates across most lines will continue to fall. "Absent of any major loss, we will still see downward pressure on rates," says David Sinnott, chief reinsurance officer at Montpelier Re. Just how far and how sustainable the drop will be is usually the next question and some, such as Chris Sharpe, senior vice president at Hiscox, are already voicing their concerns. "Pricing trends in both US and international catastrophe reinsurance business are downwards. Rates for US exposed business are adequate but are less than adequate for international business," said Sharpe.

The message is echoed by Adrian Ballardie, chief underwriting office at Tokio Marine Global: "As a reinsurer conducting facultative property and engineering business we see rates consistently falling on original business. The rate reductions are global, but less marked for engineering business which tends to be a more disciplined market. Property business in the US has not been so much subject to decreasing rates, but in 2007 we have [even] started to notice reductions creeping in on this business."

What's good for buyers is not quite so good for sellers and the industry as a whole is suffering from declining profitability. As Michael O'Halleran, Aon Re's global executive chairman, points out: "Return on equity is going south pretty quickly for both insurers and reinsurers."

Seen against a backdrop of declining equity markets, as the sub-prime credit crisis wipes billions from asset values, there may be increased impetus to draw a line in the sand.

"It will be interesting to see what effect the recent slide in reinsurers'

stocks will have on pricing resolve," says Sharpe.

Recent UK flood losses are bound to occupy some thoughts, most are in agreement that they are unlikely to be a market-moving event and they had a limited impact on reinsurers. There are many factors in play, but the consensus is that competition for business in January will still be fierce and, provided there is no major loss of the Wilma or Katrina variety, further rate reductions will be possible.

In addition the market is seeing a revival of the retro scene. "Retro's been very expensive but is starting to become more reasonable. Capacity is there and people are looking to do deals," says Sharpe.

It is a view shared by Sinnott who commented: "My impression is that the retro squeeze is not nearly as severe as it was earlier in the year, with more capital coming into the sector."

Socialising reinsurance

With Monte Carlo one of the most conspicuously obvious citadels of "free market" enterprise, it seems odd that government intervention, most notably the Florida state backed Hurricane Catastrophe Fund, will provide the Rendez-Vous with a key theme of discussion. Just what the overall impact will be on the industry is still unclear, but the fears of those who predicted the reinsurance market would immediately suffer at the hands of the legislators look to be unfounded.

"The Florida Hurricane Catastrophe Fund turned out not to have anywhere near the impact predicted as Florida insurers are still spending the same amount on their reinsurance cover. If more US states decided to do the same thing it would obviously have an effect, but this is unlikely to happen," says Sharpe.

"This isn't the doom and gloom scenario (for reinsurers) that many had seen," adds Sinnott. "I don't see a national catastrophe fund happening. Unlike terrorism post-9/11, these natural catastrophe events are still perceived as a Florida or Louisiana problem - there doesn't seem to be a ground swell for socialising reinsurance."

Considering how well the industry has coped with the big loss events of recent years, are legislators simply responding to the whiff of political expediency? The big test, of course, will be in the event of a catastrophe.

"A massive loss may cause government to quit this type of scheme, as basically the funding comes eventually from the tax payer rather than from buyers of insurance," says Ballardie.

The industry could of course help itself by removing some of the volatility that characterises reinsurance pricing.

"One of the problems which leads to the setting up of this type of fund is the volatility in loss levels which is passed rather immediately back to the policyholders by the need for the reinsurance market to have 'payback'. If a smoother pricing were demanded by reinsurers, then in theory, original pricing levels could be smoothed, and consumers less vulnerable to massive pricing swings," concludes Ballardie.

Hedging your bets

From state intervention back to the free market, the non-traditional investment community will doubtless be a key topic of interest at Monte Carlo. It will be interesting to see what impact a softening market may have on their continued participation and pricing discipline.

"There is some evidence that the newer players backed by non-traditional investors have been entering the market aggressively, but they often insist on the use of sophisticated modelling as a backbone to their underwriting, which acts as a check on overtly low pricing," says Ballardie. So no great fears over discipline it seems but the great advantage they have is their mobility and the flexibility to move to where the best returns are. With the worldwide credit markets in turmoil, and sensing ripe opportunities away from reinsurance they may, as Sinnott points out, "pull up stakes and invest elsewhere".

So will the merger and acquisition community be feasting at Monte? Even though many companies are struggling to meet their budgeted premium targets, the prospect seems unlikely according to O'Halleran.

"Despite the inevitable speculation, I don't think there's going to be a lot of consolidation on the reinsurance or the insurance side – people are a lot more cautious, particularly about the possibility of picking up past liabilities," he said.

It is a view shared by Sinnott: "I don't think consolidation of the wholesale variety - and by that I mean a multi-line reinsurer acquiring another - is likely; the risk is too high." The exception to this rule of thumb could be in the purchase of renewal rights to books of business or in the Lloyd's market, which, with its open year problems solved, still has an attraction to those on the lookout to grow via acquisition.

Modelling at Monte

If not consolidation then, there will certainly be some mileage in extending the debate at Monte around the use of catastrophe models, the accuracy of which continue to exercise minds.

"Any time you have a loss there is an opportunity to recalibrate the models, but there is still a lot of uncertainty embedded particularly in the area of flooding for commercial exposures," says Sinott.

Hiscox's Sharpe agrees, but feels that people approach models from the wrong perspective. "The question is not do you have confidence in them, but do you have confidence in the way you use them? They get better every year but should be seen as only one of the tools in the toolkit."

Market forces

One of the great strengths, and perhaps weaknesses, of the reinsurance market is just that: it is a market. It is subject to the same supply and demand pressure volatility of any market and with competition fierce for the stagnating premium pool, rates look set to continue downwards across all lines.

"For reinsurers, the biggest concern (in the run up to the 2008 renewal season) is certainly too much competition for a limited volume of business. For prudent reinsurance buyers, the biggest concern remains the quality of security. There is plenty of capital flowing into the market but the problem is who those capacity providers are and what kind of security they represent," concludes Ballardie. Amidst such uncertainty, one thing is very clear; Rendez-Vous participants are unlikely to be struggling for good conversation.