New capital: A blessing or a curse?

Investors have flooded the catastrophe reinsurance market with $35 billion in new capital. Bill Keogh weighs up the pros and cons.

Until recently, the reinsurance business operated virtually unchanged for centuries. But in the space of a few short years, the reinsurance market has been stood on its head. For this new state of affairs we can thank a massive influx of capital from a new class of investors seeking high yield in a low interest environment coupled with the attraction of risk uncorrelated to other investments.

While we have seen new capital enter the market at previous inflection points, the volume of new capital is significantly higher. According to Intelligent Insurer, investors have flooded the catastrophe reinsurance market with $35 billion in new capital, a 30 percent increase over last year. Alternative capital already accounts for about 20 percent of the market and is expected to top 30 percent by the end of this year.

Hedge funds are starting their own reinsurance companies, entering into joint ventures with reinsurers, investing in sidecars, catastrophe bonds and collateralised reinsurance products.

Pension funds, although allocating only a tiny fraction of their funds into cat reinsurance, are already among the biggest investors. If they were to increase their allocation to just 1 percent, that would result in an inflow of $150 billion in new capital. Alternative capital would account for 50 percent or more of the total market.

Needless to say, this kind of money will cause upheaval. So, is this new capital a blessing or a curse? Well, it depends.

It's certainly good for reinsurance buyers. Despite a series of catastrophes over the last several years (including hurricane Sandy), the new capital is increasing competition and pressuring rates down. This translates into lower reinsurance costs and/or buying more limit.

With this flurry of new entrants, traditional markets are being forced to compete. While some traditional reinsurers are risk-averse and perhaps set in their ways, they are being forced to reevaluate their strategies. New entrants, on the other hand, are more open to new product ideas. Without any preconceived ideas about how reinsurance contracts 'should' be structured, they are open to new concepts as long as they can be quantified analytically.

Bill Keogh

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In addition, for new capital, cat risk is only one asset in portfolios that typically contain a wide range of assets. It may make sense to take on more risk for better yield.

Some of the traditional markets may lose ground as the nature of competition is changing quickly. Competition will force the traditional reinsurers to consider new products and multi-year transactions to stay competitive.

But before we write off the traditional markets, we should remember that they have been through upheavals before and that they have an advantage: reinsurance is their business and many markets have been at it for decades or longer. It will be a long time before the new markets will be able to compete in terms of experience.

On the other hand …

All this new capital is great. But what happens when there is a huge loss—as there inevitably will be. Will hedge funds and pension funds reload lost capital? Will they flee? Will they double down? Only time will tell.

What happens if bond yields suddenly improve? Will investors return to sectors they're more comfortable with? Worse still, will some of them sell off their reinsurance obligations or put them in run-off? Who will then own those obligations? Is this the so-called 'hot' money?

Despite these concerns, there seems no end in sight for new capital investment in cat risk. And as they get comfortable with cat risk, it is likely they will expand their interest to other lines of business, creating new competitive dynamics and creativity in those lines.

At TigerRisk, we believe the convergence of insurance risk and investment risk is good for our clients and the market as a whole. It is forcing competition, the creation of new products and greater innovation. However, the new money has brought with it sophisticated—and sometimes unorthodox—capital market approaches never before applied to reinsurance. Our role is to help our clients safely navigate that complexity, seize the opportunities and dodge the risks posed by new capital. ■

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