Reinsurers responding to innovation calls

Calls for the reinsurance industry to be more innovative are being answered with underwriters responding to the surfeit of capacity in the sector by amending terms and conditions and listening to clients' wishes.

With reinsurance capacity at record levels – Aon Benfield believes it stood at $570bn as of J une 30, 2014 – it has been suggested that underwriters need to differentiate themselves from their peers by being more open to new ideas and concepts when it comes to offering coverage.

As Bryon Ehrhart, chief executive for Aon Benfield Americas, explained, the industry has responded. Indeed, multi-year deals and increasingly broad coverages are just some of the ways reinsurers have responded to the increased level of competition that resides within the industry.

"Even with all the competition, the reinsurance industry still takes less risk per unit of capital than it ever has," said Ehrhart.

But, as Ehrhart explained, the reinsurance industry has a history of being innovative in times of adversity, and he expects the market to emerge stronger once it has worked its way through the current state of flux.

"Traditional reinsurance and alternative capital today provide $75bn to $90bn worth of coverage for one in 100 to one in 200 year events along the US East Coast," explained Ehrhart.

"That's up from 22 years ago when it was just $5bn to $6bn."

Over the last 22 years, this capital has entered in a variety of guises, whether it's private equity backing the creation of new reinsurers, so-called traditional reinsurers increasing their limits, the creation of private equity supported sidecars or indeed the current trend of insurance linked securities structures.

"We have as an industry innovated to solve the most important challenge, and that is the issue of capacity," Ehrhart said.

"I joined the business in 1994 – just 14 days after the Northridge event. That loss marked the second time in 18 months that our clients had lost pretty much every dollar they'd ever made on property business.

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Bryon Ehrhart, chief executive for Aon Benfield Americas

"People were desperate for capacity, and in the end our firm was able to get things placed. It might not sound very innovative, but at the time, when we were looking for capacity, we were doing everything to get it placed. And we did it."

At the same time, Ehrhart said his company's clients are happy because the excess of capacity means pricing has come down substantially and the range of options for clients has increased.

"We're now at reinsurance costs that clients thought we'd never get back to. And by reinsurance cost, I mean reinsurance premium minus expected reinsured losses. The cost of reinsurance is really now at generational lows, certainly the lowest since hurricane Andrew. It's now a time when clients can think openly about how they can best utilize reinsurance to reach their strategic growth goals."

US catastrophe reinsurance capacity plays an important role in allowing insurers to expand, Ehrhart said. That is because 70% of the US market growth has taken place in the US coastal states over the last three decades.

"If the industry isn't able to provide capacity for those coastal states, they are self-limiting their growth potential," Ehrhart stated.

The excess capital that currently resides within the reinsurance industry may be benefiting insurers, but it has also been positive for shareholders. Reinsurers are buying back shares and returning capital to investors simply because there is a lack of growth opportunities elsewhere.

Some in the industry believe the reinsurance market should focus on the vast quantities of uninsured risk that exist around the world if they wish to grow. But, as Ehrhart explained, the situation is not very straightforward.

"People talk about insured losses being half the economic losses in the US, but that's actually a higher ratio than in other parts of the world. The total loss can be four or five times the size of the insured loss elsewhere around the world because the insurance take up is so low.

"Even in a mature market like the US, we just have half the risk insured. There are some very strange US government policies that have actually driven us to that level, especially in the case of earthquake where our two biggest buyers of residential mortgages – Fannie Mae and Freddie Mac – don't require earthquake insurance on the mortgages that are taken out."

Both Fannie Mae and Freddie Mac do require wind, flood and fire coverage for the mortgages they issue, and Ehrhart believes "there would be a material reduction in the cost of hurricane insurance if Freddie and Fannie simply required earthquake insurance in the way they require hurricane insurance".

"It would make a more balanced business for insurers and reinsurers," Ehrhart stated.

One of the problems with the take up of earthquake insurance in its current form is the deductibles are so high, the coverage is largely irrelevant for many homeowners.

It is not uncommon to have deductibles around the 15% mark, and with houses in the state often valued in excess of $400,000, it is understandable why so many do not see the value in the protection.

"If Freddie or Fannie required it, the maximum deductible would be 5%, or maybe even 1% or 2%," said Ehrhart. "The insurance would then become a lot more relevant."