Move over darling

Jon Guy asks if former alternative risk transfer strategies may become mainstream tools as banks cash in on the latest market action

The banks are coming and this time they are targeting global insurers as they seek to move into what had traditionally been the home of the reinsurer.

That move is yet another clear signal that the days when the alternative risk transfer (ART) market was in its infancy are long gone.

Both the banks and the reinsurers themselves are alive to the fact that as global risks get more complex and the needs of the insurance market become more bespoke, the switch to the capital markets, which started as a trickle, is now a steady flow.

ART used only to rear its head when reinsurance rates started to rise and brokers believed there was a more cost effective option. When rates softened, ART was duly placed on the back burner to be wheeled out as a potential solution when the market hardened once again.

But no longer have the softening rates deterred the rise in alternatives. Many – including some of the world's most senior reinsurers – now take the view that the genie is out of the bottle and that the alternatives are not just here to stay but will play a significant part in the future of the transfer of insurance risk where bigger books of business and greater levels of exposure are testing the capital and resolve of the major reinsurers.

The arrival of hedge funds into the reinsurance market following the 2004 and 2005 North Atlantic hurricane seasons through the development of reinsurance sidecars was seen as a reaction on the part of the hedge funds to slim returns in the equity markets and the demand from those insurers with catastrophe exposure to find capital, where quite frankly little existed following the huge impact of Katrina, Rita and Wilma on the market.

Some saw the sidecars, with a limited lifespan of two or three years, as a gamble for hedge funds which could backfire if dire predictions of above average hurricane seasons blew through the Gulf of Mexico.

But the winds stayed away and while two Category 5 hurricanes have developed in the Gulf of Mexico this year, they have steered well clear of the southern US and the oil and gas facilities on its continental shelf.

But the hedge funds are looking to cash in their chips. There is a view that luck with the weather – the most unpredictable of things at the best of times – will run out sooner or later and with rates starting to drop, funds are looking at other areas of the risk market in which to invest rather than the high return but high risk catastrophe classes.

In recent years however the involvement of capital markets in the reinsurance sector has grown significantly. It seems like hardly a week goes by without the announcement of a new catastrophe bond and brokers are finding clients more receptive to the idea of a move away from the traditional reinsurance market offerings.

There have been however some concerns, with the issue of frictional costs mooted by some as making such deals too expensive.

It is not a view shared by Swiss Re chief executive Jacques Aigrain. He is one of the industry leaders who believe that the use of the capital markets has the potential to transform the fortunes of the reinsurance sector.

Speaking at the annual European Insurance Linked Securities Conference, hosted by Standard & Poor's in London earlier this year, Aigrain said the insurance and reinsurance market should look to the position the global banking market was at in the late 1980s, when it was blighted by low return on equity, as a similar position in which it now finds itself.

He said the banking market "took the situation into their own hands" negotiating with the regulators and carrying a new model which has seen banks now hailed as the stars of the financial services sector.

"This transformation was down to a number of factors but many are fundamentally available to the reinsurance industry," he added. "It is a case where plagiarism is a very good policy."

Swiss Re has been at the forefront of the use of capital market instruments and Aigrain said there was every likelihood that the market would continue to grow significantly.

"We are not suggesting the

traditional reinsurance products will simply dwindle away," he added. "They may still be the basis for the transfer of risk but what we do with that risk is key.

"It will not be a one size fits all solution and I think we are already seeing a range of new initiatives which fit somewhere along the line between the traditional products and a pure ILS solution."

He said the use of such capital solutions had the potential to revolutionise the performance of the reinsurance sector, adding that while there had been significant growth in the market over the past four years there was still a huge amount of potential.

However, there were a number of issues which had to be overcome if the market was to be given a chance to develop.

These included increased transparency, the recognition by regulators of the risk transfer involved with such products and the allowance of capital relief and a similar recognition of the risk transfer by the rating agencies.

But what remains clear is that while reinsurers are looking at how they can become more like banks in terms of their models and structures, banks are looking evermore as to how they can use financial instruments and their huge capital to provide alternatives to risk carriers.

Deutsche Bank has recently launched its own risk exchange, and it is not the first. Many banks are now looking at how they can become the facilitators for risk trading platforms, which bring the capital markets and the insurers ever closer.

Reinsurance brokers have not been slow in grasping the opportunity with almost all now at a point where they have built dedicated teams to look at capital solutions for their clients. And it is not just the mega-brokers that are setting up teams.

A case in point is Newman Martin and Buchan Limited (NMB), the independent Lloyd's insurance and reinsurance broker which has launched a capital markets division to operate alongside its reinsurance team.

Its new division offers a broad range of services including the design, structure, and implementation of bespoke capital market solutions. NMB, like others, has brought in expertise to operate the new unit and as such it has prompted something which, while it could not be called a scramble, is best described as keen competition between intermediaries for those current brokers and those in the banking sector which have capital market knowledge.

Brokers say the market has matured over the past five years and while it still has a great deal of growing to do, the interest in the use of alternative solutions is continuing to rise, both from the insurers and the capital providers.

The big attraction to capital markets may well be with the potential for significant returns, but it is also an opportunity to spread investments away from the equity markets.

But the big hurdle for many is the simple cost of setting up such deals.

While the insurance market in London has been battling to refine process and reduce costs, the capital market remains expensive to transact business despite a great deal of effort to streamline the process.

At present these types of capital ART's are viewed as longer-term deals. They are onto a simple 12 month fix due to the costs but insurers are looking at longer time frames which will reduce the one off set up costs proportionally.

It also means that a three or five year structure approach will enable the insurers to plan their strategy with a greater degree of certainty from the reinsurance point of view and this has become an added attraction of many.

While brokers would naturally say it, there is a general agreement that brokers have a very important role to play in the process if for nothing else but to act as an interpreter for the insurer and the bank.

The two sides will often call the same thing by different names and, as such, brokers say one of the most significant jobs is to simply talk both languages and ensure there is no confusion when it comes to the detail in the transaction

Brokers also have a key role to play in the facilitation of capital market involvement. One broker said: "Insurers are finding that there is an increasing need to understand and consider the options that are offered in the capital markets, and as such brokers need to be able to tell their clients that they have the ability to provide the information and the opportunities to do just that. It is not a case of working against the traditional reinsurance market, rather along side it."

The banks however have been keen to drive their involvement, and recent high profile movements of senior insurance-linked banking staff in the City of London has only fuelled the belief that 2008 will see a concerted push by banks for the business which has traditionally been the domain of the reinsurer.