Reinsurance Update:
Excess of Loss May Become an Excessive Loss

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Following a string of global catastrophes in 2011, many insurance executives predicted a looming hard market. At the time I was an individual investor that tracked dozens of insurance companies. I crunched the numbers, called my contacts, and came to the conclusion that purchasing reinsurers at less than 0.75X TBV was a good risk-adjusted investment. About a year and a half later I had sold all my reinsurers, believing that they had achieved fair value.

Something seemed odd though. Property catastrophe reinsurance prices had not rallied that much. Granted rates improved slightly, but the increase was nowhere close to the $60 billion impact predicted by some executives. As my research continued, I began to notice all the alternative capital flooding the space, a topic little discussed by reinsurance executives at the time. Slowly the puzzle came together and I realized this capital was not fleeting.

Asset managers of all kinds were looking for an investment that was uncorrelated to the rest of the market. This had interesting ramifications. First, it meant that many primary insurers whose largest cost component was reinsurance would see earnings expand as costs dropped. Dichotomy Capital invested in, and still has investments in groups like UIHC who will see earnings increase as reinsurance drops.

On the flip side, reinsurers are being challenged, except this time it's been partially caused by a lack of catastrophes. The typical model of reinsurance is to acquire premiums from other insurers and pay out claims when a disaster occurs. In the meantime that capital from insurers can be invested and will generate income. This is insurance 101, and has helped make Warren Buffett's track record look much better (float acts as leverage). What if, instead of investing that capital in stocks and bonds it was held in separate accounts as cash or short term treasuries? Clearly, investment returns would drop.

Holding capital in separate accounts is not a hypothetical consideration; this is the fastest growing segment of reinsurance. This segment, collateralized reinsurance products, currently account for $50 billion of capital in the reinsurance space, and by some estimates, will reach $150 billion by 2020. As of April 2014, worldwide reinsurance capacity is USD540 billion, and I estimate that it will be around $660 billion (3% CAGR) by 2020. Therefore, more than 22% of all capital will be tied up in collateralized vehicles, limiting returns from investments. Similar to other softening markets, reinsurers will expand their product offering and chase other risks.

The impact from this is basic economics: more capital chasing less demand will result in lower rates. This is why property reinsurance rates have dropped 5-20% in each of the past two years. As a reinsurer, you have one of two choices, hold your rates firm and lose business, or keep business by dropping rates and adjusting terms. While Warren Buffett has walked away from US catastrophe reinsurance, most reinsurers are following the pack and dropping rates. There is also a push to chase premium that is long-tail in nature and far out of the comfort zone for many insurers.

As concerning as declining rates are, this should not keep reinsurance executives up at night. If rate declines hurt, term changes kill. I have spoken with a number of property insurers who were amazed at the terms they were given. As one executive told me on a recent call "we can go in, guarantee that we'll place the capital, and demand whatever terms we want – all they (alternative capital) want is guaranteed placement." The deal referenced in those quotes was a catastrophe bond and the capital will protect the insurer for the next three years, a typical term for catastrophe bonds. Normally reinsurance is placed for a single year, now the horizon has expanded to three. Anyone who believes that this is temporary is ignoring the basic fundamental aspects of catastrophe bond terms

A considerable portion of my time has been spent analyzing individual reinsurers and their collateralized vehicles. Some of this analysis can be seen in Dichotomy Capital's Lancashire Holdings report, available on SumZero. I believe that this short is the tip of the iceberg. Recently, larger reinsurers have been conducting public offerings for fully collateralized vehicles that will invest in insurance linked securities. One group, Blue Capital Reinsurance Holdings (sponsored by Montpelier Re) plans to dividend out a majority of its income. Unfortunately for our income-loving shareholder, if a 1:100 year hurricane hits Florida, 25% of Blue Capital's equity would be wiped out. I am not sure who would take that type of risk, but investors can't seem to get enough.

On the long side, I see opportunity from smart and nimble primary insurers who can aggressively place reinsurance capital. I am currently finishing up research on one such name. This is a group that generates greater than a 30% ROE, sports an all-star cast (within the insurance world), has plenty of capital, and a multi-year reinsurance plan that will keep earnings robust no matter what Mother Nature does. For now, I will leave this group unnamed to protect the interests of my client's.

In conclusion, the reinsurance industry is undergoing a fundamental change that most market participants seem unaware of.

1. Alternative capital is flooding the market and driving down property reinsurance.
2. This alternative capital is being fully collateralized, which eliminates the advantage of float for reinsurance companies. Collateralized reinsurance may make up more than 20% of all reinsurance capacity in a few years.
3. Reinsurers are forming sidecars to take advantage of this collateralization, cannibalizing their own lines.
4. To achieve the same historical returns, reinsurers are taking more risk, moving into specialty lines, and loosening terms for cedants.
5. These terms and vehicles are long-term in nature and will not be leaving soon.

I believe the issues mentioned above will cause future returns in the reinsurance industry to drop dramatically, even if there are no catastrophic events. When catastrophic events do occur, many reinsurers will be left dramatically undercapitalized which could lead to potential insolvencies, or dramatic write-downs. On the flip side, it is a great time to be a primary insurer who cedes risk. Collateralized assets offer protection from insolvent reinsurers, decrease unpaid claim periods, and decrease risk exposures for less upfront money. I see many opportunities on both the long and short side of this trend.

I encourage anyone with questions or comments to reach out to me.