bms.

A Eulogy for Concurrency

The Good Old Days

It seems like just yesterday. The broking team was assembled in the conference room with the quote tracking sheet on the big screen and our London colleagues on the spider phone. There was a healthy 15% spread from lowest to highest quote. The market clearing price was up for debate. In soft markets it hovered around the lowest quote and in the hardest of markets it floated up to just above the average quote.

That was when firm orders were viewed with finality – it was when gamesmanship stopped and stamps went down. The vast majority of programs were completed with the first and only firm order. The goal for authorized lines was to be somewhere between 95-105%, knowing that a little begging may be required to get a deal home. Landing in this small window meant no money was left on the table.

While we remember those days with fondness, the industry is in a period of change. The single firm order system has certainly suffered flesh wounds over the years, but this renewal season marks the official demise of concurrent pricing for catastrophe reinsurance programs. Concurrency across the board, even on non-catastrophe placements, is faltering; but that is a topic for another day.

How Did We Get Here?

Perhaps we should have seen this coming. The signs were there. Looking back, we see three main steps that spelled the end for concurrence.

1. The Shortfall Cover

Brokers packaged the shortfalls on multiple layers and sold them for a single price. This was used sparingly but grew in popularity post 9/11; especially when brokers began refusing to accept "most favored terms" language on authorizations.

Pricing discussions with clients shifted from a goal of determining the lowest market clearing price to a goal of finding the lowest price to get to 85%. Then the broker would go to the shark tank for the final 15% at differential terms. The sharks were well known to brokers – their authorizations came with a phone call reminder that they were around if you need a bit of help getting to 100%. While seemingly an innocent strategy, it ultimately led to the game theory being played on the streets of Bermuda today.

2. The Rise of Capital Markets & Private Placements

Private placements have been around forever but became more prevalent starting with the hard market of 2006. We are referencing the type of private placement that formed part of the original placement architecture rather than a last minute effort to finish the placement.

The market suffered two horrendous hurricane seasons in a row in 2004 and 2005 followed by the new RMS version 6 that doubled modelled losses in some areas. The hard market that emerged characterized by substantially higher rates and increased capacity demands led to an increase in capital market participation in the catastrophe reinsurance market.. Some markets used fronting paper, but the majority still wrote reinsurance on a single shot, collateralized basis. Brokers re-designed placements to carve out layers that hit the sweet spot for these markets. The traditional markets facilitated this strategy by allowing the single shot layers to inure to the main placement tower ala the FHCF. Private deals were often placed before the submission even hit the open market. This concept continued to evolve and eventually led to entire placements with cascading coverage, where the upper layers would drop down when the layers below were exhausted.

3. Multiple Firm Orders by Design

This was the most awkward broking strategy of the lot. The first firm order was generally below market terms. After capacity was exhausted, a second firm order was put into the market but it only applied to new capacity and did not change the price for capacity previously authorized. Imagine calling a market and saying "we just bound your $5m at 10% ROL and now we can offer you an additional $5m line at 13% ROL if you are interested".

We witnessed one account where a single market had three lines on the same layer at three different prices. This was clearly an unsustainable strategy because it discouraged markets from offering capacity at the initial firm order pricing. This strategy belongs in the "you can get away with that once" bucket. It is safe to say the brokers who promulgated this practice contributed to reinsurers' desire to move away from the firm order placement system.

What is Different About 2020?

Iterations of these partial non-concurrent approaches have been around for a while, but this year something is vastly different. The quoting process produced a wider range of pricing than average. This was to be expected given the large number of natural catastrophes, loss creep from prior years, and a general sense of uncertainty around COVID-19 and its long-term implications. What was not expected was the strategy change of key markets at the same time.

To be clear, clients were prepared for rate increases. Firm order terms generally reflected a fair risk-adjusted increase (by historical standards). Some markets accepted reasonable firm orders and offered new and renewal capacity. But many markets, especially those with the largest capacity, balked at firm order terms and would not budge from their quoted price, which was generally beyond fair by historical standards.

In past hard markets, unreasonable asks could be tempered with a reasonable firm order and some broker therapy, at which point they reluctantly came to the table. Often, they realized they could only push so far if they are not in tune with their peers. After losing a few renewal lines they would soften their tone. As a side note, if there was enough public data available, the catastrophe reinsurance market would be an excellent economics lesson on market behavior of oligopolies!

The end result of this strategy is placements with two or three slips bearing different firm orders being sent to particular market segments and then up to 20 other slips, each with a single market and a unique price.

There are exceptions to this phenomenon. Long-term purchasers who are not particularly cat focused and enjoy great reinsurer relationships were generally spared, especially if they made it clear from the start they are going concurrent and will not accept any game-playing.

What This Means for the Future

The long-term impact of this strategy remains to be seen. It is not out of the question to think the reinsurance market will go the way of the shared and layered property insurance market, which has been (almost) completely non-concurrent for years now. Further, if this is the way we are headed, what is the optimal placement model to achieve the best result for our clients? Economic texts on game theory and auction market theory are flying off shelves!

The new companies entering the market are not fools, they will do their best to avoid dragging prices down. But they cannot outfox the laws of supply-and-demand, so this should have a tempering effect on rate increases going forward. The balance of power may have tilted a bit towards the reinsurer in 2020, but with new capacity and new placement strategies for 2021 already being discussed, we expect it to be short lived.

A final question comes from 2006. If markets pushed too hard in 2020, could we see some of the effects witnessed in the post KRW market? There was a general consensus in 2006 that rates needed to move up. However, some markets, and in particular some Bermuda markets, unashamedly threw their technical worksheets in the bin and set prices using the "what is the most I could get for this risk" theory. By the time the next renewal cycle came along, in 2007, insurers did everything they could to reduce the amount of catastrophe reinsurance they had to buy. This included cutting exposure, turning to the cat bond market, adding to capital and simply assuming more risk net. Demand went way down. Thus, it seems that in 2006 reinsurers won the battle, but lost the war. Time will tell if 2021 will be a repeat of that outcome.

Jeff Irvan

Chief Property Officer

Jeffrey.Irvan@bmsgroup.com

Mobile: +1 215 518 5989