

# Reinsurance Market report

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## Everest Re moves offshore and buys Gibraltar Casualty

Reinsurance group Everest Re, the US market's fifth-largest, has moved to the next stage of its life as an independent company by redomesticating operations and buying back Gibraltar Casualty from its former owner, Prudential Ins Co of America.

The purchase ends a period of dispute between Gibraltar and Everest Re. Gibraltar's main function was to provide Everest Re, formerly Pru Re, with a fresh start when Prudential spun off the reinsurer through an initial public offering (IPO) in 1995.

As part of the IPO, Gibraltar provided Everest Re with US\$375mn in aggregate stop-loss protection and Prudential also provided a US\$775mn guarantee of Gibraltar's obligations.

However, the relationship between Everest Re and its former owner has not run entirely smoothly. During the first quarter of last year, Gibraltar disputed US\$63mn ceded under the agreement during the fourth quarter of 1998 and also disputed the level of reserves previously ceded to and paid by Gibraltar.

In all, Gibraltar argued that Everest Re's net reserves at the end of 1998 were overstated by about US\$155mn and that the cessions to the stop loss were excessive by the same amount.

Earlier this year the two parties reached a settlement by which Everest Re agreed to reduce the disputed gross reserves for 1995 and previous years by US\$67.6mn and reduce the relevant disputed claim to the stop loss by US\$60.8mn.

But Everest Re's disagreement with Gibraltar over another reinsurance contract continued. Gibraltar disputed US\$39.7mn ceded under a

1986 quota-share treaty through which Gibraltar assumed 100% of the liabilities related to Everest Re's direct excess insurance written prior to 1986.

This dispute was based on Gibraltar's disagreement with the level of incurred but not reported reserves for asbestos exposures which Everest Re recorded in 1998.

Gibraltar disputed Everest Re's right to establish and its obligation to fund these reserves, although it did not dispute its responsibility to pay the ultimate losses in accordance with the contract terms.

Now Everest Re has agreed to buy Gibraltar for its book value in a deal which is expected to close in the second quarter of this year.

Prudential's involvement in its former subsidiary Everest Re will not end completely because it will provide reinsurance to Gibraltar covering 80% of the first US\$200mn of any adverse development of Gibraltar's reserves at the closing of the deal.

Joe Taranto, chairman and chief executive of Everest Re, said: 'The Gibraltar acquisition makes excellent sense from a financial perspective. With US\$525mn of ultimate undiscounted reserves, solid supporting assets and the reinsurance coverage provided by Prudential, we expect that Gibraltar's addition to the group will be immediately accretive to earnings and will add appreciable long-term value.'

Rating agency Standard & Poor's welcomed the acquisition of Gibraltar, saying it 'will provide Everest Re with a greater sense of accountability for future reserve development and run-off of Gibraltar's reserves for prior-year liabilities.'

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# Reinsurance background

## ART 2000: trends in non-traditional risk financing

Dr Thomas Renggli, head of insurance marketing for western, central and eastern Europe at Swiss Re New Markets, considers some of the many recent developments in alternative risk transfer (ART).

### What are the features of ART today?

The market for ART has grown rapidly over recent years. ART is in fact a transfer of risks to non-traditional (capital) markets. These markets have been subject to three main trends.

Firstly, the range of investor categories has broadened to a degree that had not been anticipated by most observers. Besides insurers and reinsurers, pension funds, hedge funds, private investors and other more or less clearly defined or anonymous groups of investors have been entering the risk market.

A second trend has been the development of analytical tools for defining and pricing risks intended for alternative transfer. The traditional, actuarial, stochastic approach is being increasingly overshadowed by econometrical, non-stochastic analytical tools using capital market methods.

The analysis of time series, once considered difficult if not impossible, can nowadays be at least tentatively undertaken using new mathematical methods such as game theory. Weather derivatives are one example, as are insurance products which hedge stockmarket indices.

The expanding range of applications for non-traditional risk financing may be seen as a third major trend. Whereas 10 years ago only insurable risks were considered tradable, the providers of ART models now include non-insured or traditionally non-insurable risks in their projects.

Imperfect, non-liquid markets are being so widened by the

global networking of supply and demand that sufficient market participants can now be found to support a more or less thriving trade. In addition, the relevant data is made available and accessible to market participants practically in real time thanks to modern, efficient information technologies. The internet might be mentioned here as only one example.

The traditional definition of ART as 'alternative risk transfer' refers to securitisation, which has extended beyond what originally began as pure catastrophe risk transfer in the area of property insurance. Nowadays, both life and third-party risks, as well as risks from broadly diversified portfolios such as motor third-party liability, credit or weather are considered suitable for securitisation.

Furthermore, the uncertainty associated with such instruments is declining, along with the 'novelty premium' which investors had to bear. This factor enhances the efficiency and effectiveness of these new instruments.

### What are the major concerns of ART service providers?

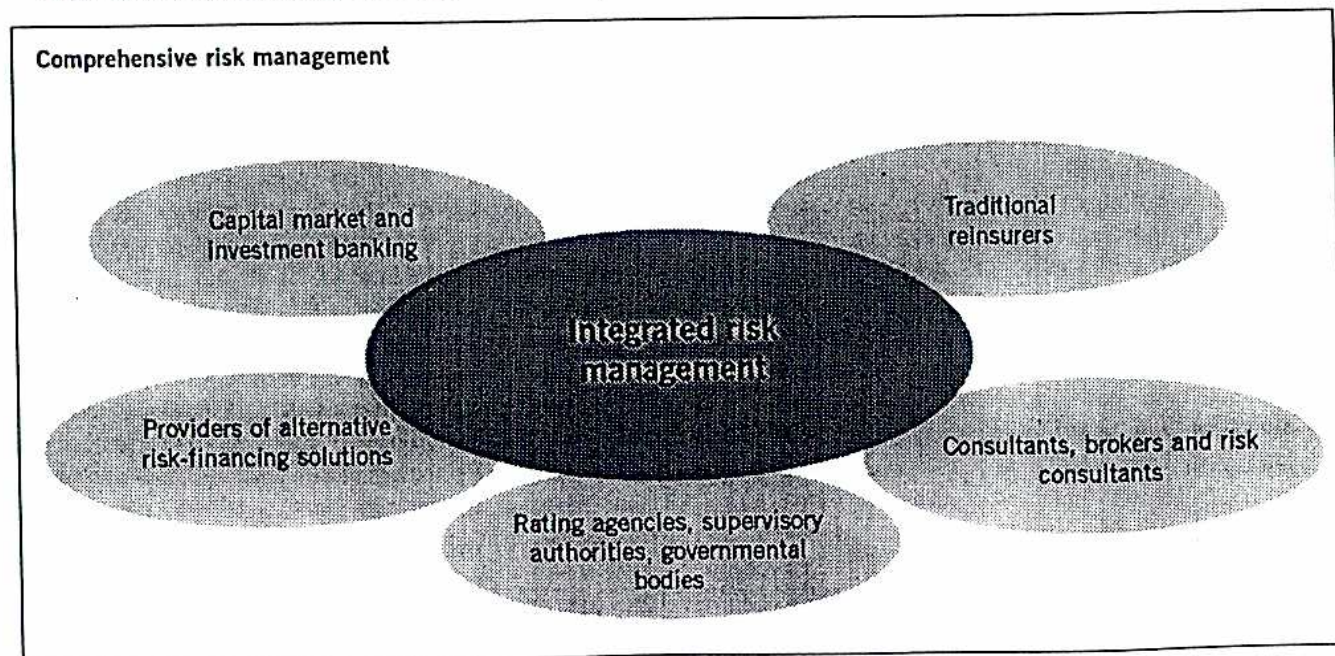
An increasingly important issue is that of efficiency. Will ART providers succeed in advancing the standardisation of ART processes to the extent that these might become profitable even for smaller transactions?

At present, non-traditional financing solutions still have to be individually analysed and structured in each and every case. This constant 'reinvention of the wheel' implies an inefficiency that allows only large transactions above a certain volume to be profitable for participants.

However, once ART providers' sales channels, analytical tools and internal administrative processes become standardised, it will be possible for their marketers to systematically open markets even for smaller transaction volumes.

This will allow even smaller companies to consider marketing ART solutions. The standardisation of ART products will inevitably lead to their becoming established, thus gradually losing their ART status.

Another problem facing ART providers involves accumulating knowhow from different sources to underwrite and structure complex, integrated risk-financing solutions.



This requires a combination of insurance, corporate finance and capital market techniques with the related knowledge of fiscal procedures, accounting standards and supervisory legislation. Medium-sized ART providers can scarcely afford to put together strong and effective interdisciplinary teams: this is where the sheer size and financial strength of an international concern certainly constitute an advantage.

Such things as joint ventures and mutual cooperation are possible strategic approaches which might also enable smaller ART providers to acquire the necessary knowhow.

The increasingly complex global economy is compelling ART providers to step up the pace in developing new products, whereby integrated work and cooperation between widely varied disciplines have been shown to provide a crucial competitive edge.

Critical mass and the access to specialised ART knowhow are thus major factors. An innovative provider offering either of these will have a competitive advantage that it can exploit until competitors understand and replicate its products.

By that time, the innovator must have completed development – financed by the premium which it, as innovation leader, can command – that will allow it to expand on another level or to another area. Only in this way can it maintain its competitive position.

The need to keep pace with development, however, makes it increasingly difficult for medium-sized providers to move assuredly in all market segments.

Major advantages are enjoyed by specialised niche providers who have joined to form joint ventures, as well as major international financial concerns who have the relevant in-house knowhow at their disposal. The illustration on the left shows how diverse areas of knowhow merge to form a new comprehensive approach to risk management.

### **Which ART areas hold the greatest development potential? Which will see the greatest demand in coming years?**

First of all, the catastrophe risk market: The large number of 'once-in-a-century' disasters (earthquakes, storms and floods) over the last decade and the somewhat pessimistic forecasts being voiced about global warming are exhausting the market capacity for extreme natural disasters.

In addition, the desire on the part of policymakers to see economic risks that are traditionally non-insurable such as clearance of woodland and roads at public expense or damage-limitation measures (such as the construction of dams) transferred to the insurance or capital markets, is leading to a new understanding of how to handle such risks. This issue will challenge the major reinsurers and politicians in particular. Other catastrophe risks can be transferred to the capital markets as well: plane crashes and genetic engineering risks are two major examples.

Secondly, there have been visible signs of increased demand from banks seeking to make better use of their capital base by ceding part of their credit portfolio.

Thirdly, there is a trend for industrial concerns to cede a portion of their entrepreneurial risks to insurers or the capital market (for example, residual value or weather derivatives).

Fourthly, there is a demand for restructuring the capital

base of finance companies (insurers, reinsurers, banks) through the use of hybrid capital instruments.

A fifth area of demand comprises rating capital support for companies which must keep a close watch on their rating (upgrade, downgrade, being on Moody's or S&P's watch list).

In addition, mention should be made of weather derivatives for companies whose economic success is particularly dependent on the vagaries of nature (for example, power suppliers, manufacturers of agricultural products and drinks manufacturers).

### **What factors most strongly influence the development of non-traditional financing instruments?**

Here, three main factors come to mind:

The first of these is less uniformity and weakening solidarity. The changing needs of clients are currently giving rise to risks which are ever more diffuse and individualised. At the same time, these clients, whether industrial concerns or insurance companies, are increasingly reluctant to participate in financing 'poor' risks.

However, risk managers have been following the constant changes in the risk landscape, and are generally much better informed on the possibilities of risk financing, ART included, than they were 10 years ago.

A second factor has been that the environment has changed markedly over the last few years due to competition and capital market globalisation. Strong, new competitors such as banks, major brokers or large international insurance groups are entering the field and generating much new capital looking for a place to be invested.

Finally, accounting standards, tax law and the supervisory authorities have changed radically to counter the new options. That which was possible only five years ago has now become 'illegal'. There is much insecurity with regard to fiscal and accounting aspects in countries such as Germany, given that there is as yet no clear legislative basis like the FASB standards in the US.

### **What factors are key in implementing alternative risk financing successfully, today and in the future?**

Of great importance is the clients' business mentality and dynamism. They must be willing to tread new paths if, in addition to the economic advantages, they are to acquire new knowledge and break new ground as market makers and shapers of opinion.

Other important factors are the client's decision processes and the degree to which they are influenced by external factors. The shorter the channels, the smaller the decision-making bodies and the less they are influenced externally by state and administrative authorities, for example, the simpler it will be to implement a non-traditional solution.

However, other outside forces – active shareholder groups or the increasing influence exerted by rating agencies – might favour non-traditional risk-financing solutions.

A client's financial strength and creditworthiness are two further very important factors which define the pricing of a transaction and its financibility, and thus decide whether and to what degree the transaction will be economically viable for the parties involved.

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Key external factors include the influence of the opportunity cost of capital on pricing, as well as the influence of capacity on the competitive climate and the provider's opportunities for arbitrage.

In continental Europe what we see is the capital markets just beginning to converge and the various approaches to risk management just beginning to develop. The example of the US may also show the way for Europe's risk managers. They will need, however, to take up the challenge presented by such models with even greater zeal in the future.