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# Economic Insights:
## Alternative capital set to grow for peak risks

### Key takeaways

- Since 2010, alternative capital (AC) has more than quadrupled, and was estimated at USD 95 billion in the first half of 2018.
- AC, an established feature of the property cat and retrocession markets, is best suited for capital-intensive and transparent re/insurance segments.
- AC will remain a significant force in the fast growing natural catastrophe market.

### In a nutshell

Alternative capital (AC) proved to be a reliable source of capacity during the active 2017 natural catastrophe season. It is less viable for long-tail lines like general liability and workers' compensation where the claims process can be lengthy. We predict that AC will continue to grow and curb the volatility of the overall reinsurance underwriting cycle.

Over the last decade, alternative capital (AC)[1] has become an established feature of the property catastrophe and retrocession market, accounting for 22% of the total supply of property cat limits in 2017. The amount of alternative capital (AC), estimated at USD 95 billion in the first half of 2018, has more than quadrupled since 2010, and is currently supporting an estimated annual premium volume of around USD 5 billion. In contrast, global capital for the traditional reinsurance segment, which provides cover for all types of life and non-life insurance risks, was around USD 340 billion, based on an annual premium volume of USD 270 billion.

The main purpose of AC was to increase insurance capacity via the vast capital market and the securitisation of risks. AC remained niche until after the Great Financial Crisis when institutional investors became increasingly aware that insurance-linked securities (ILS) offered diversification benefits and attractive returns compared to similarly rated corporate bonds. Consequently, cat risks matured into a separate asset class.

Before 2017, some analysts doubted if AC capacity would remain active after larger natural catastrophe (natcat) events. However, the ILS market remained liquid throughout 2017 and investor capital was more than replenished. A mix of both established and opportunistic new investors have contributed to the segment's growth. Nevertheless, spread increases in January (and throughout 2018) have been disappointing, but remained quite attractive compared to similarly rated high-yield corporate bonds.

A series of severe natcat events in the second half of 2017 led to record losses for the re/insurance industry and in the AC segment. It was the first time that AC – specifically the fast growing segment of collateralised reinsurance – experienced difficulty in settling claims from large natcat losses, which can be complex, opaque, and sometimes disputed. Gradually escalating losses ("loss creep") from Hurricane Irma, for example, proved challenging for AC investors who wanted to roll over their investments into new ventures for the new catastrophe season, but could not because some of their capital was

**About Economic Insights**
Analysis of key economic developments and their implications for the global re/insurance industry.

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[1] AC encompasses all forms of re/insurance capacity as a) direct investment into specific insurance risks/perils, b) on a limited term and c) fully collateralised to provide security to policyholders. AC includes tradeable financial instruments, such as insurance-linked securities (ILS) and industry loss warranties (ILW), but also private deals such as collateralised reinsurance (CR) and reinsurer sidecars.

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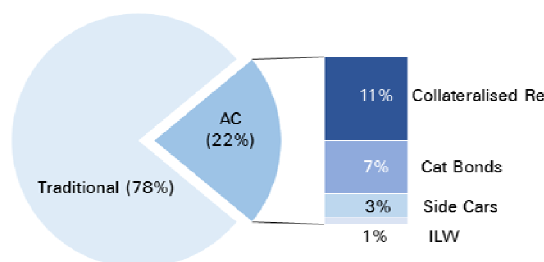
blocked. This was unexpected since one of the core strengths of AC business models is quick claims settlements.

After the rapid influx of AC contributed to the abundance of capacity in the property cat market, rates began to decline starting in 2013. We observed that the levels of AC in the market also exerted downward pressure on prices during the 2018 renewals. Looking ahead, we predict that AC will continue to curb the volatility of the overall reinsurance underwriting cycle. We believe that losses will be more widely spread with the help of institutional investor capital and the ease at which capital can enter and exit the AC sector.

**Figure 1**
Property Cat Limits Mix 2017 (estimated)




Note: Total property cat limits were estimated at USD 367 billion.
Source: D&P Analysis, Guy Carpenter

AC has not developed significantly beyond the property natcat, extreme mortality risks and retrocession segments. Those sectors play to the strengths of AC: they deal with capital-intensive peak risks that are short-tail in nature and that have become increasingly transparent and commoditised through the availability of advanced (third party) risk models. We do not foresee comparable advances in the modelling of casualty risks in the immediate future.

Traditional reinsurance has advantages, especially when insurance risks are opaque (eg, cyber, liability) and diversifiable within large portfolios (eg motor insurance, mortality risks etc.). AC is not well suited if the claims adjustment processes is lengthy and disputes tie up capital and collateral. Therefore AC is not viable for long-tail lines like general liability or workers' compensation.

AC has matured into an integral player in the growing market for catastrophe risks. Re/insurance demand will rise faster than economic growth due to dynamic industrial growth and urbanisation in emerging markets as well as the increasing value of assets located near coastal areas in mature markets, which are often vulnerable to natural hazards.

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