THE TRADING FLOOR INTERVIEW

Twelve Capital partner John Butler tells *Trading Risk* why he thinks reinsurance needs to get closer to the finance world

What factors do you see currently shaping the market?

I think we're only at the start of the consolidation phase that the market is going through at the moment.

I don't see how standalone reinsurers will be able to find a way forward in the current market, unless pricing dynamics substantially change. The position they're in now is a result of the catastrophe pricing subsidy they've been using to support other lines – they've written a huge volume of long-tail business essentially at a loss, supported by profits from volatility business.

Now we see pricing pressure on cat business, there's a squeeze. There is no profit in the other business given the low interest rate environment, and they're just being bled dry. I don't see a point where the newer, more flexible and lower-cost means of bringing capacity to the market – the ILS funds – stop taking on an ever-larger share of profitable business.

Do you think reinsurers can compete by paring back their expenses?

It sounds like you're describing an inevitable march of the ILS funds.

I think it is an inevitable march of the ILS funds. I think reinsurers can make a saving today if they double the line size of every piece of business they have, but in an ILS fund you have only return expectations from investors plus a very minimal expense base on top of that.

You can't fight against that with the infrastructure of a reinsurer, particularly the larger reinsurance companies.

So how do you think this consolidation phase will play out?

I understand the mergers that take place between a reinsurance and insurance entity that are trying to balance their business across the market cycle. What I don't understand are the deals that are just about cutting expenses – it makes no sense in the long-term because you're still not being protected from the swings of the cycle.

At Twelve, we're active in ILS, we're active in debt and we're becoming active in the equity side as well. It enables us to position our investors across the insurance balance sheet to benefit from the best opportunities at any point in the various market cycles.

Do you think M&A activity will spread to the fund market?

I anticipate a wave of consolidation that brings us a smaller number of more specialist managers.

The standalone ILS funds have in some ways got the same problem as reinsurers – they're also living or dying by a single market cycle, if all they can manage is cat business.

If prices continue to decline, they too will struggle in due course because they won't provide attractive returns to investors at current fee levels and will find their expense base further challenged.

Where do you see the market heading in the future?

I see a point where there's less division between reinsurers and other types of finance providers.

Primary insurance companies will be much more adept at managing the balance of equity, debt and reinsurance on their balance sheet around the market cycles of those products.

What keeps you awake at night?

Fortunately my sleep is sound at all times! However, while it is of course good for humanity that the world has not seen a major natural catastrophe in the last few years, this has had a major impact on the reinsurance business.

My biggest fear for now is that we don't have a major event in the next few years – that we just keep on with a relatively benign market causing a slow lingering death of the current reinsurance model.

We need a shock to tidy things up and the event could just as well be further reserving or investment issues in the casualty market as much as a natural catastrophe. I would like to get people thinking about how to efficiently finance risk across the balance sheet rather than the current division continuing to exist and everyone meandering along producing ever-dwindling returns.

What do you think would happen after a shock loss?

There would be a hardening of rates but it would be gradual and reasonable. Then we'll see a filtering of capital in the market, as we determine whose expense base can support a business in what then represents a "hard market".

I think that would be the point where we lose capital. It wouldn't be immediately following the loss, it would be in the next couple of years as some people realise that the good times aren't nearly as good as they used to be.

What we will also see is insurers looking more closely at what is the efficient balance of capital for them – can they rely on quota share reinsurance in the volume they used to do, or are there other instruments that are more stable?

So you're not a fan of quota shares?

There is far too much reliance on quota shares at the moment. It's a short-term form of capital solving a long-term problem for primary reinsurers. For a well-performing company it would be more efficient to carry subordinated debt than to use quota shares. They have that capital for a longer period of time for more stable rates. This is the way to really build a long-term relationship with investors.

The quota share should become extinct!

But is it possible for ILS funds on their smaller expense base to access business in far-flung regions that they might otherwise get through quota shares?

Yes – if you have the right analytics and a team who can source the business.

So where does this leave the role of reinsurance?

Reinsurance is not the one-stop shop for everything.

There's a place for what we do on the ILS or reinsurance side, which is to cope with the years where you get abnormal loss ratios, for taking away volatility. For non-volatility business, other forms of capital are far more appropriate.