Aon Benfield's Dominic Christian on reinsurance's friends and foes in a soft market
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SNL

The abundance of reinsurance capacity and the increasing prevalence of alternative capital are eating into the margins of one of the most profitable lines of business for reinsurers — catastrophe reinsurance. Nevertheless, growth can still be found, according to Dominic Christian, executive chairman of Aon Benfield International and CEO of Aon U.K. Ltd. He sat down with SNL Financial to discuss where he sees growth potential as well as what the new, more dynamic insurance cycle means for the industry and why we are yet to see the full effect of alternative capital on profitability. What follows is an edited transcript of the conversation.

SNL Financial: The soft reinsurance market is not only tough for underwriters; it is also tough for brokers — how is Aon Benfield tackling the market?

Dominic Christian: Of course, the industry needs growth to be successful — any industry does. So where is the growth going to be? One [key area for that] is this fantastic product we sell called catastrophe reinsurance. We have proven very successfully over many years — but most recently in 2011, with the claims recoveries that were made in the industry — that we can sell more of it. But we need to sell more of it to governments. We think there are at least 15 such schemes with various governments, where the private sector deals with risks otherwise held by the public sector.

When you are a company of our size and significance, of course you try and target these particular programs. Catastrophe reinsurance is very important to the industry in terms of its ongoing profit. Catastrophe reinsurance is a very high-margin business. Yes, the margins have fallen recently, but we are trying to develop activity in areas where there is a real margin. It also provides real societal value, so you get the real need for your product.

We are also able to develop business — and not many people are since they are not licensed to do so — in both the traditional and nontraditional markets. Aon Benfield Securities — which is nearly 20 years old — is able to transact business in that sector. Only a few brokers do [have similar operations] so we have this huge advantage in that we have expertise across the risk spectrum and can generate new activity. So clearly we see further developments in the alternative capital space and our role within it.

Another growth area is transporting good ideas in the retail sector to the reinsurance sector — using size and knowledge to develop products. We are a global firm, so we have to ask how [can we be] valuable. In the U.S., title insurance is sold very heavily but it's a relatively small market in Europe. We can look at how we can transfer these products across geographies.

We are always going to grow in three areas: Innovation; articulating the services we have in a more effective way [while] using our data in a way that helps clients; and dislocation. Most of the markets we are in are going to have a very dull time. We are talking about prices reducing, increase in capacity, etc. When you have dislocation you have more drama, more opportunity — these are classes that belie the ;usual trend of pricing in the catastrophe market. Dislocation tends to generate real value for both brokers and underwriters. We have got some classes that have dislocation — areas in aviation, marine, political risk, agriculture. There's also the whole area of health insurance in the U.S. and, in our case, our life insurance offering with our colleagues at Aon Hewitt.

The last time you spoke with SNL, you said retrocessional capacity could be a growth area in this market. Are we starting to see this now?

We have seen more retrocessional buying this year. I still think that in a sense we have an odd dynamic. There is limit of nearly $300 billion for catastrophe reinsurance and only about a $20 billion limit in retrocessional catastrophe. You would expect that number to keep climbing, but it only grew by a single-digit percentage this year in terms of limit. I would expect [the limit] to grow by about 10% next year. You still wonder why there aren't more secondary and tertiary markets, given this weight of capital that is attracted to the property cat business.

Do you see alternative capital as a friend or foe for the wider industry?

Anything that provides more value and opportunity for clients we would consider to be a friend. It does contribute to the challenge, as alternative capital has been principally supporting catastrophe reinsurance. Unless we increase demand for catastrophe reinsurance, prices will fall, which is great for clients. But that is the sector where we have such high margin and profit. In some portfolios, the underwriting of the high-margin cat business has supported other areas of the business. As that high margin in property cat falls, you have to ask what happens to these other classes which have not been so profitable. We have yet to see the real effects [of alternative capital] on the other classes I think. But we will.

To what extent do you think the soft market conditions, with all the extra capacity, are the new normal?

I don't think this is the new normal. Whatever happens there will be change — whether it is more capacity, more dislocation or we find other products we become more reliant on to generate premium. I do think the industry is in state of fairly permanent change. One of the big questions is: What is the most effective financial model to serve clients? And what is the most effective financial model to attract clients? There will be a lot of attention on that. Equity models will have their place going forward, as will collateralized models. They have been very successful in the retrocessional market, for instance. We have about 100 or so reinsurers on an equity-model basis, which support our clients' business. That number will change but not significantly in my view. There will be some M&A around it but nothing significant. We probably have about 50 funds that support our collateralized and ILS activity, and that number could grow substantially.

Looking at cycles, they will not follow the same pattern as in the past. They will presumably be shorter, because the business has become more dynamic. There will be a series of mini cycles — unless, of course, we have a series of losses that we can't understand, as we did in the late 1980s and early 1990s, and after 9/11. If we have something that fully surprises us, again you might find some sort of permanence to a hard market for a period.

There is also pricing pressure in primary insurance. Does Aon's broker facility with Berkshire Hathaway help you in these conditions?

We didn't set it up for that reason. The vast majority of facilities historically have been established to meet a particular need, not because there is a soft market. Our facility was strategic and material, and what we brought was Berkshire capital to a space it had not been involved in. It has proven to be successful for all the parties that have supported it. For us, the reality of it is good news, for clients and for Lloyd's of London.

Indeed, former Lloyd's Finance Director Luke Savage told SNL it had been good for the market, even after all the controversy.

Whenever you are first to do something, there is always concern. So are we pleased with its progress.

Do you see more broker facilities appearing in the Lloyd's market?

I do envisage more broker facilities but I don't know if they will be strategic or as specific to a market need.

Where now for Aon U.K.?

Aon U.K. represents retail insurance and reinsurance in this country. Our largest shareholder is Aon Plc. London is a huge part of what we do and we are moving into our new [London] building next year, which is very exciting. We want to be a better business for clients and we have three principle areas. [In] reinsurance, we have about 30% of the global reinsurance team in London, which says something about the importance of the London market. We have a very big business called the Global Broking Centre, which is our wholesale business. Then we have our retail business, which is obviously [primary] insurance. We have just acquired a company called Lorica, in the health benefits space.

Is there any appetite for further acquisitions?

If we can see the right culture fit, opportunity, mathematics and so forth, of course we are always interested.