'A sidecar is like a hedge fund, where, instead of an investment, you have a reinsurance contract'

Will this summer's hurricanes mean big profits for reinsurers – or just blow earnings away?

THE HURRICANE SEASON has begun again, and Bermuda is still at its centre. The island's reinsurers are battening down their hatches and preparing for another stormy summer, with hedge funds set to play an ever-larger part in their preparation.

Hedge funds have been providing capital to the reinsurance industry since the first CAT bond was issued in 1996. However, recent convergence between hedge funds and reinsurers has accelerated, not least because of the succession of storms in the summer of 2005.

Last year's onslaught, in the form of hurricanes Katrina, Rita and Wilma (KRW), caused unprecedented levels of damage, not only to life and property but to reinsurers' capital reserves. KRW cost the industry a record $60bn. New capital did flow in, but reinsurers, hoping for a decent hike in property catastrophe prices during the renewal period of January 2006, were disappointed.

To compound their misery, the ratings agencies upped the amount of capital required to insure property for catastrophe risk. Many reinsurers had to reduce the cover they were able to offer in order to maintain their ratings, which meant insurers weren't always able to find the reinsurance contracts they were after.

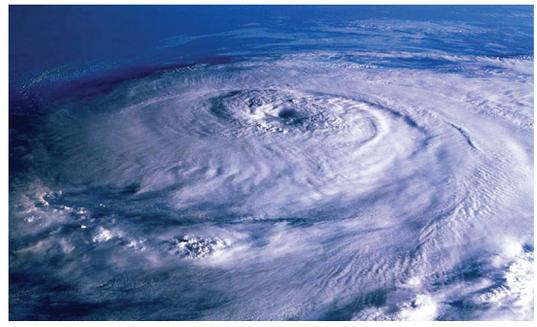
The much-needed capital this year has again come from hedge funds. Catastrophe risk is extremely volatile, shows good returns and is entirely uncorrelated to the markets – a tasty proposition. The so-called 'Class of 2005' – the rash of new reinsurers that set up on the island after the hurricanes last year – was funded significantly by hedge funds.

This happened in several ways. Bermuda's reinsurers came up with the idea of 'sidecars', which are essentially small reinsurance companies that reinsure one other insurance firm, as a way for hedge funds to underwrite specific risks in the short term. They are created by and 'bolted on' (hence the name) to larger reinsurers – and intriguingly they share several characteristics with their sponsors.

"In some ways, a sidecar is like a hedge fund, where, instead of an investment, you would have the reinsurance contract," says Neil Horner, senior corporate counsel at Bermuda law firm Attride-Stirling & Woloniecki. "The company seeding the insurance is almost like a hedge fund manager."

The influx of new capital is being welcomed, albeit cautiously; hedge funds are notoriously fickle. "In two or three years' time, insurance may not be such a good bet. At the minute insurance is obviously fashionable," says Horner.

NEIL HORNER, of law firm Attride-Stirling & Woloniecki, argues that sidecars are a testament to innovation. "The term is new, the concept is not. They tend to offer high-level coverage, so a hurricane Katrina or Rita would have to hit before the sidecar would be called upon to contribute. In a way, it is a specific product that meets a specific need of the market at a specific juncture. It shows the innovative nature of Bermuda, that it comes up with a product that is very much needed."



A STORM BREWING: Weather forecasting, hedge fund style

However, worries that this new source of financial support may be universally short term appear to have been unfounded in many cases. Some hedge funds have gone so far as setting up their own reinsurance firms, while a few have gone the whole hog and morphed into them completely.

One such firm is property catastrophe risk reinsurer and Class of 2005 member Flagstone Re, which was formed out of hedge fund West End Capital at the end of last year.

"We had made several investments in the reinsurance business in the past few years and our principals had a lot of insurance and reinsurance experience, so with the dislocation created by the events of last year, we decided it was an ideal time to enter a very attractive segment," says Brent Slade, Flagstone's principal.

"We had a large quantitative development group that did a lot of modelling in fixed-income securities, so there's a direct crossover with the reinsurance business."

He believes there is still plenty of room for hedge funds in the sector. Capacity is still running low and capital is still being sought. Slade is philosophical about worries that hedge funds only have short-term plans for the reinsurance sector.

"If there are good returns over the next 10 years for reinsurance business, then I see hedge funds staying," he says. "If the risk to return does not remain attractive, then I don't see why hedge funds would continue to invest and participate in the space. But that's not unique to hedge funds: any capital provider is going to make the same analysis."

Make hay while the sun shines, in other words. This summer may be the acid test, depending on the weather of course, but for the moment it seems as though hedge funds and reinsurance will continue on their convergent courses. ■ Simon Brandon