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ACHIEVING OPTIMUM REINSURANCE PROTECTION:

The Thought Process

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Preamble

The very basic concept of solidarity and wealth saving has led to the development of the insurance and reinsurance products and tools which we know today; they vary from being simple and straight forward to sophisticated tools and solutions.

The essential idea of insurance and reinsurance is the dependency on the contribution of a larger group of peers seeking protection for a similar type of risk. This is established by creating appropriate reserves to finance future losses and accordingly provide security to the policyholders and shareholders.

Along with the development of the insurance industry, the reinsurance sector continues to play a significant role in the economic cycle and its stability, and due to its importance and necessity in many cases, we continuously see new products alongside the long-established traditional products.

Reinsurance protection could be a prerequisite to start committing future liabilities and it is also a tool of protection against existing live liabilities. In other words, reinsurance is to protect both run-off and future exposures and hence, how can we maximise this tool to find the suitable balance between present need to cover the legacy exposures and to accommodate future requirements at the same time?

In this article, the focus is not on the technicalities of reinsurance but rather on highlighting important points in the thought process and the areas which need to be considered in order to place appropriate reinsurance protection.

Doing the homework

Choosing a reinsurance product and extent of cover to be arranged depends on the risk appetite, financial strength, business plan and underwriting considerations. In order to be aligned with the market cycle and offering, the underlying portfolio needs to be protected in such a way as to ensure stable performance, timely loss recovery and ability to finance future cost.

From a reinsurance perspective, certain products need additional reporting requirements, advanced controls, the involvement of additional stakeholders like a third party administrator, an information technology system and development of resources. They have to be carefully considered especially at the initial stages to make sure that the proper setup and framework are in place.

Products can vary from very basic to complex coverage and from an annual to a multi-year agreement, which can protect both new and existing portfolios.

There is no doubt that the initial steps required to target a desired reinsurance programme are challenging, i.e. to find the potential reinsurers and brokers especially if they do not have much knowledge about the underlying portfolio and the company's business plan.

Some of the most important questions to be considered for successful offer preparation of a reinsurance programme are:

- Who are the targeted reinsurers and brokers and what is the best way to communicate with them?
- What is their level of risk awareness and understanding of the underlying portfolio?
- What is the cover needed, how will this be addressed and what benefit can be offered?
- Do the reinsurers really understand what we are looking for?
- Can the reinsurance programme and its administration be explained in a simple manner?
- Is there a need for any additional resources?

The most common practice is to appoint brokers who have experience in the market, can offer added-value services and who have leverage with the reinsurance companies. At the same time, the insurance companies should also contribute in order to develop the relationship with the reinsurers and the brokers by presenting the portfolio in a comprehensive way, sharing market specifics and insights, discussing constraints and solutions in order to conclude a successful deal.

Although the buyer carries the ultimate decision about the reinsurance programme's shape and structure as well as the responsibility to develop the underlying portfolio and implement necessary guidelines and controls, it is essential that reinsurers and brokers are equally responsible to develop and offer sustainable solutions and maintain a healthy supply chain that consists of reinsurers, insurers, brokers, policyholders and other stakeholders.

It is worthwhile to mention that any reinsurance programme or transaction should be within the framework set according to:

- The local law, jurisdiction and regulatory requirements
- Accounting standards
- Rating agencies requirements
- Strategy and business plan
- Internal policies and procedures

When reinsurance cannot work

Reinsurance protection is subject to a large array of challenges, many of which are frequently addressed in industry events, publications and studies. These studies reveal numerous problems with insurability, lack of data, adverse selection, correlated risks, high transactional costs and cash collection issues which make reinsurance challenging from an economic perspective.

Downscaling reinsurance and considering it as a benefit acquired in exchange for a premium per risk reflects a lack of understanding of the market as reinsurance is really all about particular products suited to protect present and future performance. It can also be that some insurance companies cannot afford to pay the minimum premium and might have fluctuating income and limited markets.

It would not be an easy task to change the situation to provide sustainable solutions due to many obstacles such as:

- Credible pricing of the original risks does not exist.
- Even if credible pricing is possible, the values at risk or sums insured would be so small that the acquisition and administration expenses would be a multiple of the premium.
- Individual risk underwriting would not be economically viable.
- Claims control on an individual losses level is simply not possible.
- Inadequate infrastructure in terms of services, legal system and clear regulation.
- Instability of political situation and the absence of transparency.
- Corruption, political influence, constraints on foreign currencies.
- Forbidding or limiting the access of international reinsurance and brokers to conduct business.

Reinsurance capacity

Despite the fact that reinsurance capacity varies from one class of risk/region to another and it is generally lower than direct insurance, in reality, reinsurance players accumulate their capacity for various reinsurance products which can be placed and supported by different reinsurance markets.

The objectives of capacity pooling are:

- To give reinsurance cover against named risks for a minimal premium.
- To create a risk-sharing mechanism and, at the same time, share the financial burden caused by any disaster with the international reinsurance markets.
- To reduce the financial burden on a single company or country.
- To ensure long-term funds accumulation for the indemnity of losses.
- To contribute to reinsurance awareness in markets.

The next issue to be tackled is answering the concerns of the insurance company regarding credit risks in terms of security uncertainty and whether there would be benefits from such ventures. For this, the use of an international, reputable, well-rated and experienced reinsurer will be of added value to provide an adequate security level and ultimately help companies in managing their risk and meeting their liabilities.

On the other hand, reinsurance should not be compulsory as long as pricing and reserving are adequate and each insurance company may decide whether or not to obtain reinsurance and what proportion of its book to reinsure. But they should consider reinsurance protection at the early stage of development of their portfolio to avoid volatile results due to unbalanced premium to exposure before the portfolio matures.

The role of the reinsurer

The reinsurance industry capitalised on economic growth and achieved good results. We have seen many companies taking the lead role in the market as well as some companies getting involved in the direct insurance market through direct investment or partnering with other insurance and/or reinsurance companies.

With the development of the insurance portfolio, reinsurance capacity is needed to maximise capital utilisation and diversify product offering. Therefore, the importance of reinsurance and its leading role in developing insurance can be outlined as follows:

- Reinsurers have a wider geographical spread and can support business in multiple territories.
- Direct policies are sold in large numbers with transaction costs kept low, these policies generate healthy profits for the insurance companies and hence, the reinsurer can help them to build a larger portfolio.
- Insurance companies can start their business by taking the role of intermediary or just as a producer to the reinsurers until they build the confidence to take retention on the risks.
- Immediate capital relief and long term financial impact.
- Build up assets and acquire wealth.
- Information Technology support to capture the required data and implement appropriate control.

The right reinsurance programme

Initial pricing and structuring of the reinsurance programme are very delicate. Miscalculated moves would put capital and reputation at risk.

In general, simple reinsurance products work best because they tend to be easier to administer and easier for insurance companies to understand. It also makes sense for reinsurers to start with a simple reinsurance structure.

To get the product right, reinsurers have to know what insurers need and what they are willing to pay for. It is also important to recognise that the reinsurance market is diversified, so it is wise to review and assess different reinsurance programme options as long as doing so does not overly complicate the structure.

A reinsurance culture has to take into consideration the characteristics of its target market. It should emphasise relationship building and added value services while ensuring the organisation minimises claim delay and rejections.

Also, for devising a regulatory framework of reinsurance business, there needs to be a significant investment in education at many levels. Policymakers and supervisors have to understand the risks and potentials of reinsurance and therefore know-how transfer and dialogue are the primary concern. It seems that somehow the regulator has to adopt a flexible approach, but if the regulator is not able to formulate proper regulations, the whole purpose of reinsurance will be defeated.

Reinsurers use actuaries and specialists to calculate future possible losses and their impact on finances. Thus, the reinsurer is sure that the rate charged and premium levels are adequate and sufficient to meet future liabilities compared to the available capital and accordingly the same tool should be used by insurers.

However, in the beginning, many reinsurers duplicated rates charged or used rates on similar reinsurance products without understanding the logic behind those rates. As a result, many products were either over-priced or underpriced which created a viability risk to reinsurance.

It is clear that one of the most important elements of any reinsurance product's success is a properly designed and well-maintained database and management information system for capturing and screening the data used in initial price setting or subsequent pricing reviews.

The premium rate is established by the actuaries using available experience data and/or modelling tools. To arrive at an adequate rate, specific data of the objects to be insured is needed since this will result in more reliable and accurate rates. In case the data is not available the actuary must then rely on observations of and assumptions about the portfolio to adjust the calculation of the premium rates.

Once the risk premium is set then we need to make sure that premium rates are sufficient to meet the obligations and operational costs in the long run and enough to support the product long term.

Several components should be considered in establishing final premium rates. Each component must be carefully calculated from the experience data and/or from other available information depending on the product type (expenses, inflation rate, profit margin, etc.).

The products' performance must be monitored by comparing expected claims to actual claim development in order to consider changes in relevant factors at renewal time.

Solutions

Having discussed many difficulties through this article, the belief is that there can be plenty of options for insurance and reinsurance companies to follow in order to operate and find their place in new markets or products and assist in development.

Nonetheless, any option or solution must take into account the below areas in addition to revenue:

- Establish effective communication channels and understand the needs of clients.
- Benchmark with available products.
- Understand reinsurance products and how they work
- Identify potential risks and plan for risk-handling activities for each project.
- Improve regulatory and legal framework to ensure smooth implementation and practice.
- Strengthen risk management in project development.
- Develop standards and operational framework with respective authorities.
- Conduct training programmes to review the current practice and build risk-based knowledge.
- Provide effective on-the-job training for employees with leading international and specialised companies.

Outlook

Looking to the future, insurers and reinsurers will always have chances to develop portfolios over the long term. The vision of good quality reinsurance products is attainable.

Successfully developing reinsurance requires coordinated efforts, activities and sharing of knowledge, and so it should be between insurers, reinsurers, intermediaries, regulators, and other parties to maximise effectiveness. The different parties should aim for a long-term sustainable solution while keeping a balanced approach to run profitable portfolios at the same time, and hence contributing towards socio-economic development and maintaining commercially viable operations.

Financial security is a goal of economic development. Therefore governments can play an active role in reinsurance development by supporting the development of required regulations and supervisory actions to create an atmosphere of security and confidence.

Due to the fact that there is plenty of scope for reinsurance to develop further, the following are recommended:

- More research is done on designing and pricing the right products and build the necessary database.
- Innovative solutions for processes that can be replaced or improved should be welcomed.
- Invest in promoting insurance awareness to raise insurance penetration and accordingly create long-term growth opportunities for the reinsurance sector.
- Reinsurers with their level of capacity, expertise, wide scope of cover, access to the international market, ability to provide catastrophe protection co-develop reinsurance programmes and offer capital support to insurance companies.

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