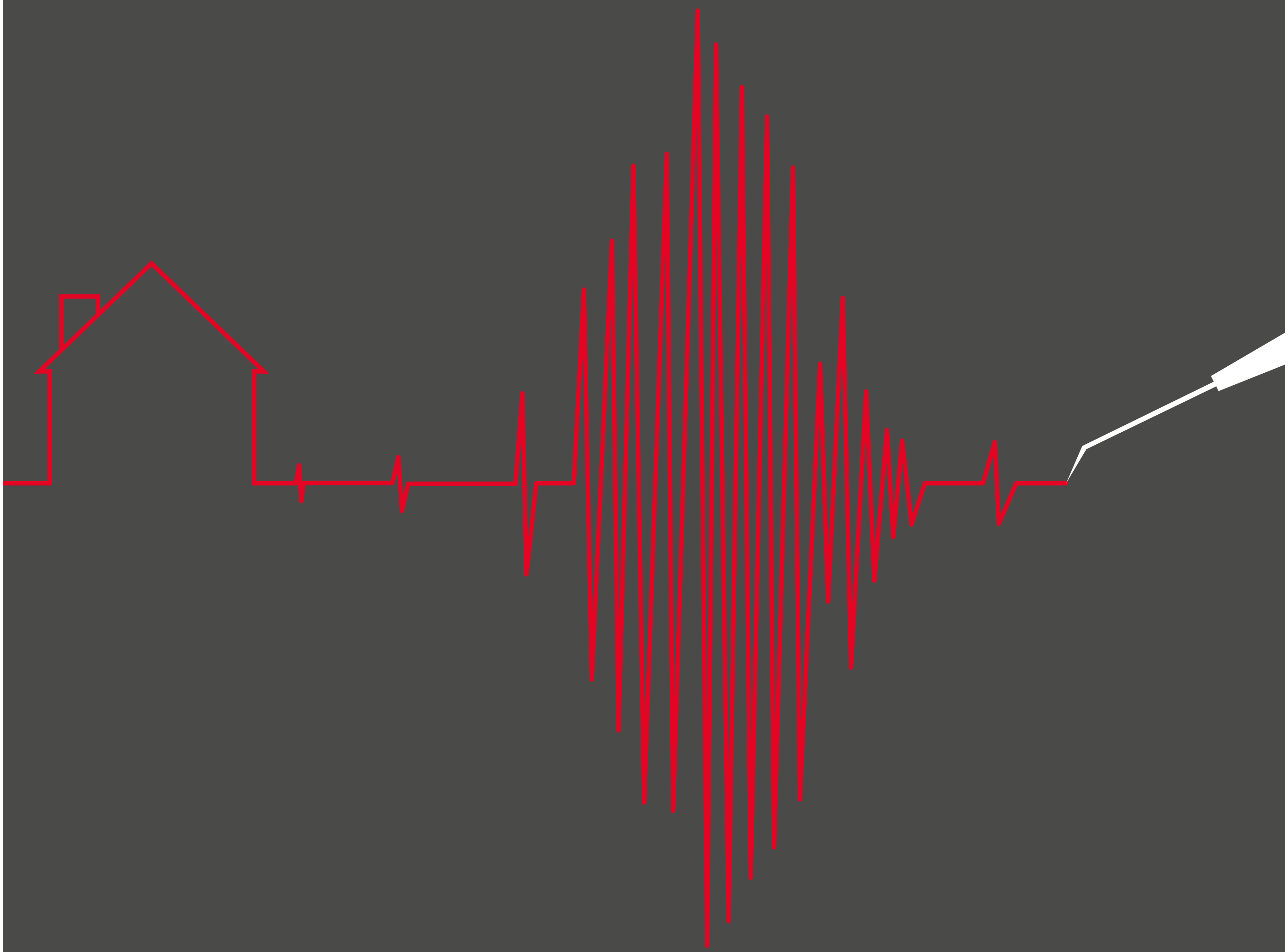
impact

ACTIONABLE INSIGHT FOR BUSINESS LEADERS / **REINSURANCE** / APRIL 2016



REINSURANCE: OPTIMISING YOUR STRATEGY

The non-life reinsurance sector has rarely been marked by such a difficult environment: intense competition on prices, changing considerations around catastrophe events, and low interest rates are all having an impact. So how can insurers future-proof their reinsurance strategy?

By Stuart Collins

In today's challenging insurance market, reinsurance is becoming an increasingly important area for insurers, and one where there are a growing number of options to find efficiencies.

Influenced by numerous factors – including business strategy, regulation, governance and market conditions – many insurers are now taking a much more sophisticated approach to reinsurance than in the past.

Increasingly, insurers are seeking bespoke reinsurance solutions to address a range of issues, from dealing with property risk accumulations to protecting reserves or achieving capital efficiencies under Solvency II. There is also a wider emerging trend towards more innovative internal and external reinsurance mechanisms, and a growing business case to bring certain reinsurance purchasing functions in-house.

"Despite an increasing complexity of reinsurance mechanisms, there are a number of factors leading insurance companies to internalise their reinsurance strategies, underpinning a sound and efficient decision process in terms of reinsurance," says Fabrice Taillieu, principal at Milliman in Paris.

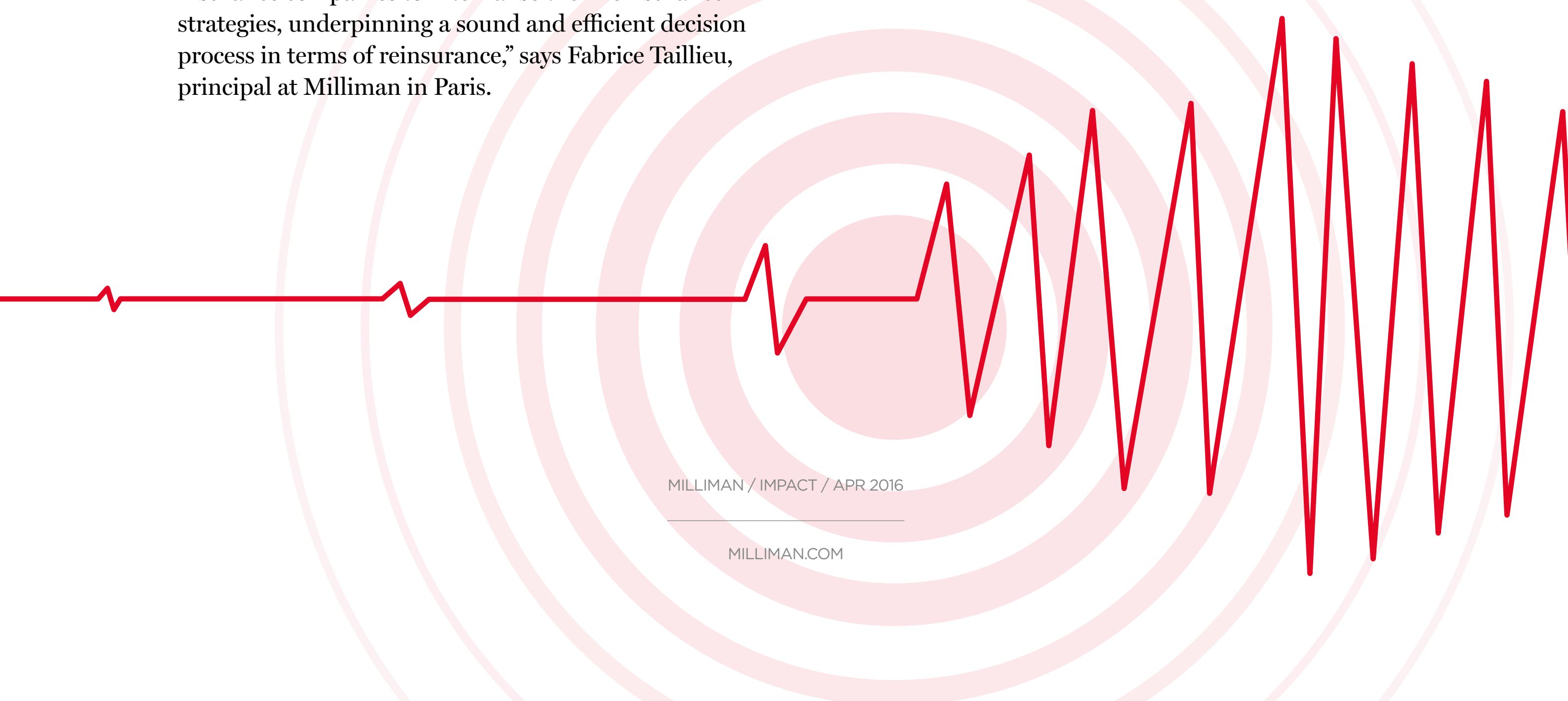
Determining reinsurance strategy

Reinsurance and risk diversification have been the cornerstones of insurers' ability to manage risk for decades. Fundamentally, reinsurance helps an insurer balance the need to generate earnings, while at the same time protecting solvency.

However, there are now many more factors influencing reinsurance purchasing than in the past, including investor considerations, regulatory requirements and ratings agency criteria.

For example, Solvency II requires companies to consider the impact of catastrophe events of up to 1 in 200 years' probability on the balance sheet.

Ratings agencies are also influencing reinsurance purchasing decisions due to the counterparty risk that is involved. AM Best is in the process of changing its Best Capital Adequacy Ratio (BCAR) model to apply a similar stress test to that of Solvency II.



> *To carry out an efficiency study on a regular basis, one needs to have a clear understanding of the company's global strategy, of the company's underwriting policy, and of its refinancing capacity and cost.*
>
> Fabrice Taillieu, principal, Milliman

Shareholders are another consideration when buying reinsurance. They will expect insurers to generate consistent earnings, and do not like nasty surprises. That is precisely what buying reinsurance allows for: smoothing return.

To serve the global strategy of the company, a reinsurance programme needs to be analysed on a regular basis and with a holistic view, modelling all the risks that the company is exposed to. This analysis needs to be performed on the whole book of business, not only by line of business or portfolio.

"Optimising reinsurance requires a sound knowledge of the underwriting risk of a company, but the analysis can't be limited to this risk," says Taillieu. "To carry out an efficiency study on a regular basis, one needs to have a clear understanding of the company's global strategy, of the company's underwriting policy, and of its refinancing capacity and cost," he adds.

Innovative reinsurance structures

With changing regulation, a shift to enterprise risk management by insurers, and the increasingly cross-border nature of insurance, a number of firms have sought innovative capital management and reinsurance frameworks to help enhance earnings and deliver on their corporate strategies.

Many of the large multinational insurance groups have now centralised their reinsurance purchasing, taking a more sophisticated and global approach. Typically, these groups use dedicated legal entities to more effectively manage risk and capital across the group through internal reinsurance agreements. They also use such entities to leverage their purchasing power, consolidating their reinsurance purchasing globally.

While these types of arrangements tend to be favoured by the large multinational insurers, there →

(continued on page 5)

> *There are now many options open to insurers looking to optimise their capital and reinsurance purchasing. More insurers are using internal and external reinsurance schemes to optimise and transfer capital at the group level.*
>
> Adam Senio, senior consultant, Milliman

SOLVENCY II

A key driver shaping many insurers' changing attitudes to reinsurance is regulation, most notably Europe's recently implemented Solvency II regime.

"The legislation has already led many insurers to adjust their reinsurance purchasing strategies, while the new regime is also encouraging increased transparency and reporting around reinsurance strategy," explains Fabrice Taillieu, principal at Milliman.

In preparation for the regime, many insurers in Europe have purchased higher limits of catastrophe reinsurance to protect against return periods of 1 in 200 years, while some insurers have reportedly used reinsurance to bolster solvency margins as they transition to the new regime.

However, Solvency II is likely to have longer-term relevance for how companies set their reinsurance strategies, and how this is communicated internally and externally, according to Taillieu.

"Transparent communication of risk is a key plank of changes to insurance regulation in Europe. Solvency II will encourage insurers to clearly articulate reinsurance strategy, while the board and C-suite will have to become much more engaged with reinsurance purchasing," he says.

In particular, Solvency II will require companies to produce an annual report of the actuarial function in which they will need to set out their reinsurance policy, and explain its goals and effectiveness. The person responsible for the actuarial function will need to understand the key drivers of the reinsurance strategy and their impact on earnings volatility.

Insurers will also be required to carry out, at least once a year, an Own Risk and Solvency Assessment (ORSA), a framework by which an insurer can assess and stress-test its capital and risk management processes for all the material risks it faces. "Reinsurance is a key driver of the assessment of a company's ORSA," says Adam Senio, senior consultant at Milliman. "A common practice consists of testing the financial effect of a stress test based on the reinsurance strategy of the company," he says.

Information and documentation relating to the reinsurance strategy will need to be in a format that can be understood by the board and stakeholders, such as regulators and analysts. In most cases, this information will need to be clearer than is the case today, either internally or with broker reports.

Finally, companies are beginning to see the cost savings and risk management benefits of taking a more global or holistic view of their portfolios, and how best to manage their capital and use reinsurance, explains Taillieu.

(continued from page 3)

are ways in which other insurers can achieve many of the same advantages, according to Adam Senio, senior consultant at Milliman in Paris.

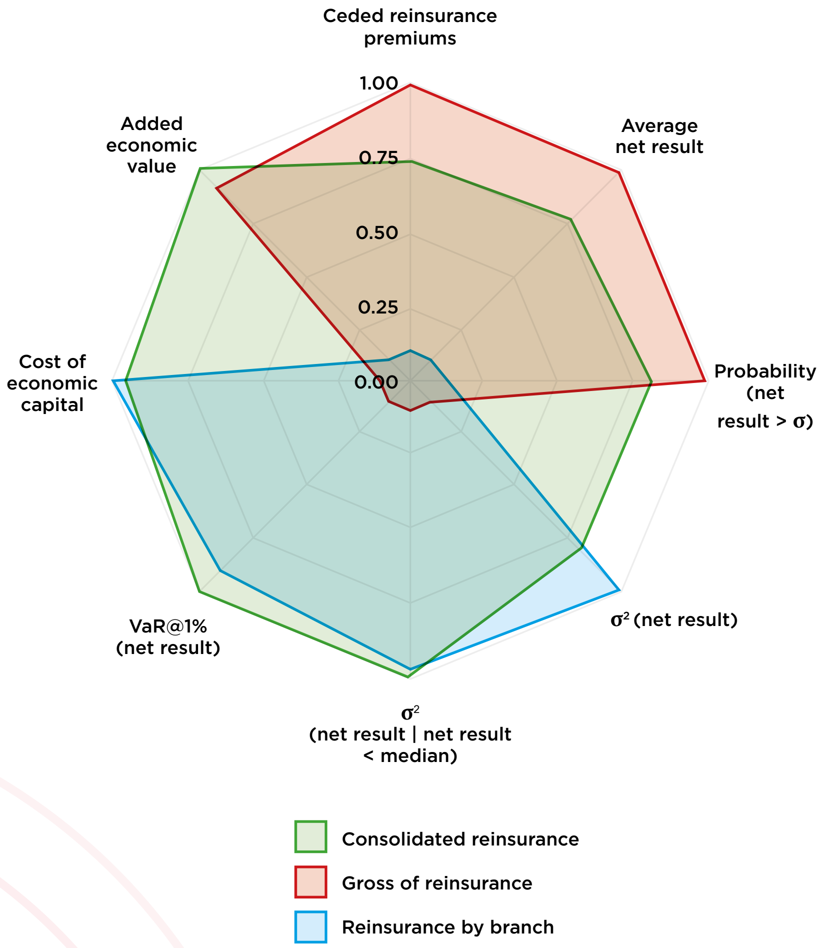
"There are now many options open to insurers looking to optimise their capital and reinsurance purchasing. More insurers are using internal and external reinsurance schemes to optimise and transfer capital at the group level," he says.

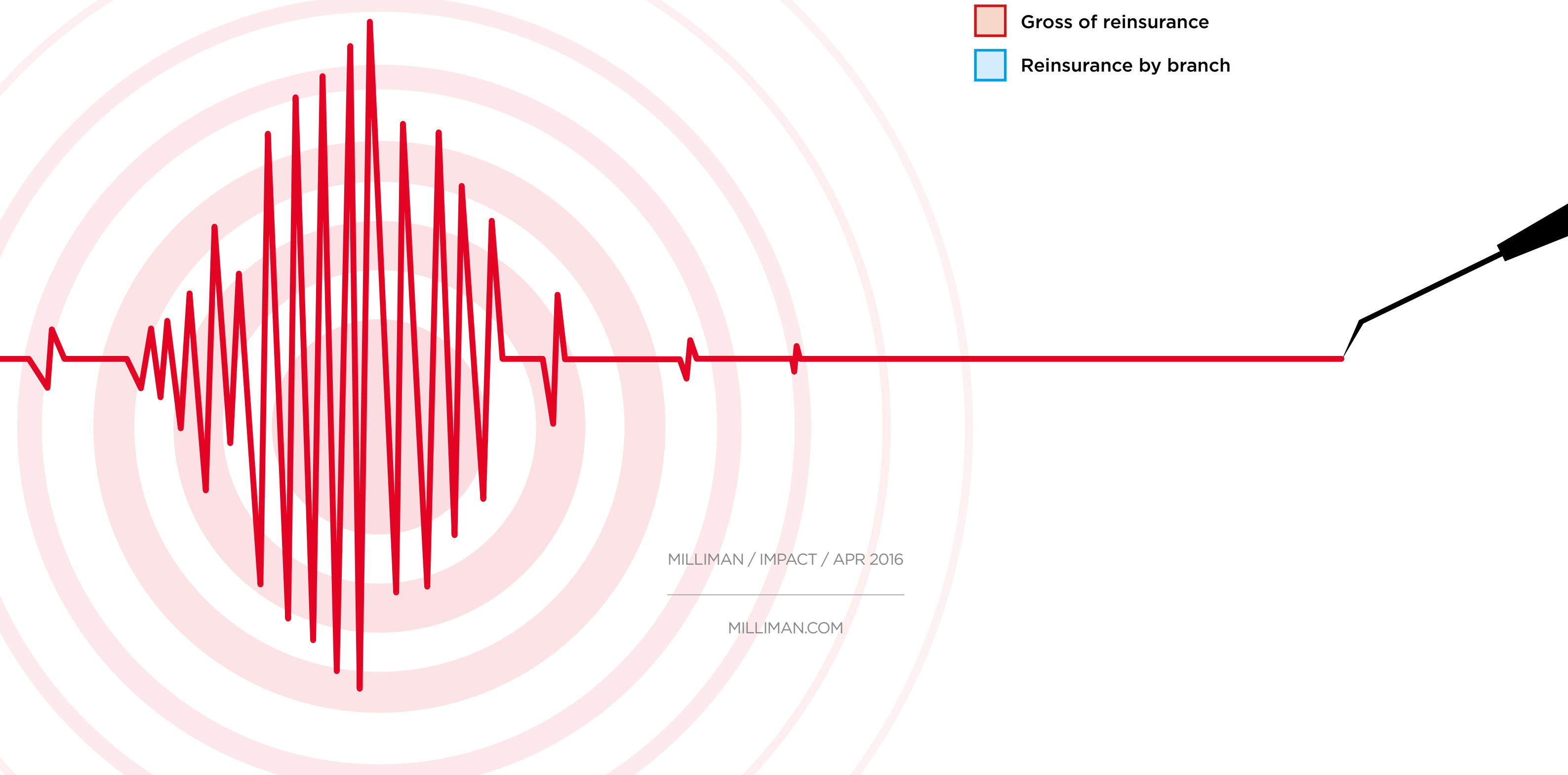
For example, Milliman has worked with a number of European insurers, helping them take a more global approach to reinsurance and establish internal reinsurance mechanisms that cede portions of portfolios from local subsidiaries back to the parent company, highlights Senio.

Internalising reinsurance

As insurers' risk management has become more sophisticated, and with the need for better governance and transparency, a number of carriers have also moved to bring certain reinsurance functions in-house.

FIGURE 1: COMPARISON OF REINSURANCE ALTERNATIVES





"The traditional ways of buying reinsurance are now far less suited to today's insurance market, which is characterised by much more sophisticated risk management, governance and regulatory needs. In practice, decisions need to be justified and quantified in front of a committee, which wasn't always the case before," says Taillieu.

"That is not to say that external reinsurance advisers and brokers do not have a role – brokers provide a valuable overview of market conditions and trends, as well as access to catastrophe modelling tools. However, there are many tasks involved in setting an optimal reinsurance strategy that could be internalised," he says.

Milliman has developed a reinsurance tool to help clients perform a number of tasks, including: projections of individual claims, curve fitting, simulations of statistical distributions, pricing of reinsurance covers and optimisation of reinsurance programmes. Today, many insurers outsource some or all these tasks to third parties.

Yet the modular structure of Milliman's reinsurance tool responds to a company's constraints on a case-by-case basis and allows a gradual internalisation and automisation of the process. "The trend for reclaiming the decision-making process in terms of reinsurance is moving forward," says Senio. "Our clients appreciate the possibility of being able to control the different steps of the reinsurance study, and were somewhat frustrated when these steps were externalised," he adds.

It takes some time to internalise reinsurance purchasing, explains Taillieu. "There will be a year or two of hard work but, once in place, an in-house reinsurance capability should help improve governance and better align reinsurance with the company strategy and business," he says.

Once in place, an in-house reinsurance capability should help improve governance and better align reinsurance with the company strategy and business.

Fabrice Taillieu, principal, Milliman

Internalising reinsurance may also help insurers as they navigate today's complex business and regulatory environment.

For example, an internal reinsurance capability should also help companies meet governance and reporting requirements under Solvency II, according to Taillieu. "Regulators and investors are demanding more information from insurers, and presented in such a way as to be clearly understood. It is easier to explain a reinsurance strategy that has been internally generated," he adds.

Find out more

Fabrice Taillieu
+33 6 87 30 69 92
fabrice.taillieu@milliman.com

Adam Senio
+33 6 38 74 92 35
adam.senio@milliman.com