N.43434
R.42090

HOW TO FINANCE REINSURANCE

NICK JONES

IT is more than likely that the years from 1975 to 2000 will be compared by economic historians with the period of liberalization in the mid-nineteenth century. They will identify deregulation and freedom of competition as well as a shift from protected producers to sovereign consumers — in fact, an era when the foundations of the world's leading industries were revolutionised. We are all familiar with the profound effects from the liberalization in aviation and communications, besides witnessing successive governments turn over the ownership and management of nationalised industries to the private sector. As the millennium approaches, the same process is going on in financial services — and especially in the sectors involving risk such as reinsurance, insurance and banking.

RISK MANAGERS' OPTIONS

	Pay before event:	Pay after event:
Pay outside own group	Insurance	Bank line of retrospective insurance
Pay inside own group	Captive or trust	Pay as you go

In some respects, these changes were in play before the last quarter of the century. For the banking industry, the appearance of money market mutual funds destroyed the protected haven of cheap deposits on the liability side of their balance sheet, while the commercial paper market in turn disintermediated their best assets (risks) into commodity markets. In Britain the fire tariff was abolished after the war whilst the spread of the industry's secondary market, namely reinsurance, exposed domestic tariffs in other countries to the flow of free competition. Initially, the line of least resistance to these forces exposed the American insurance industry to the new discipline of managing risk and the growth of the captive insurance market: corporate risk managers' focus became the management of their total cost of risk or the sum of their voluntary and involuntary deductibles, fronting charges and captive management fees as well as the cost of transferring pure risk.

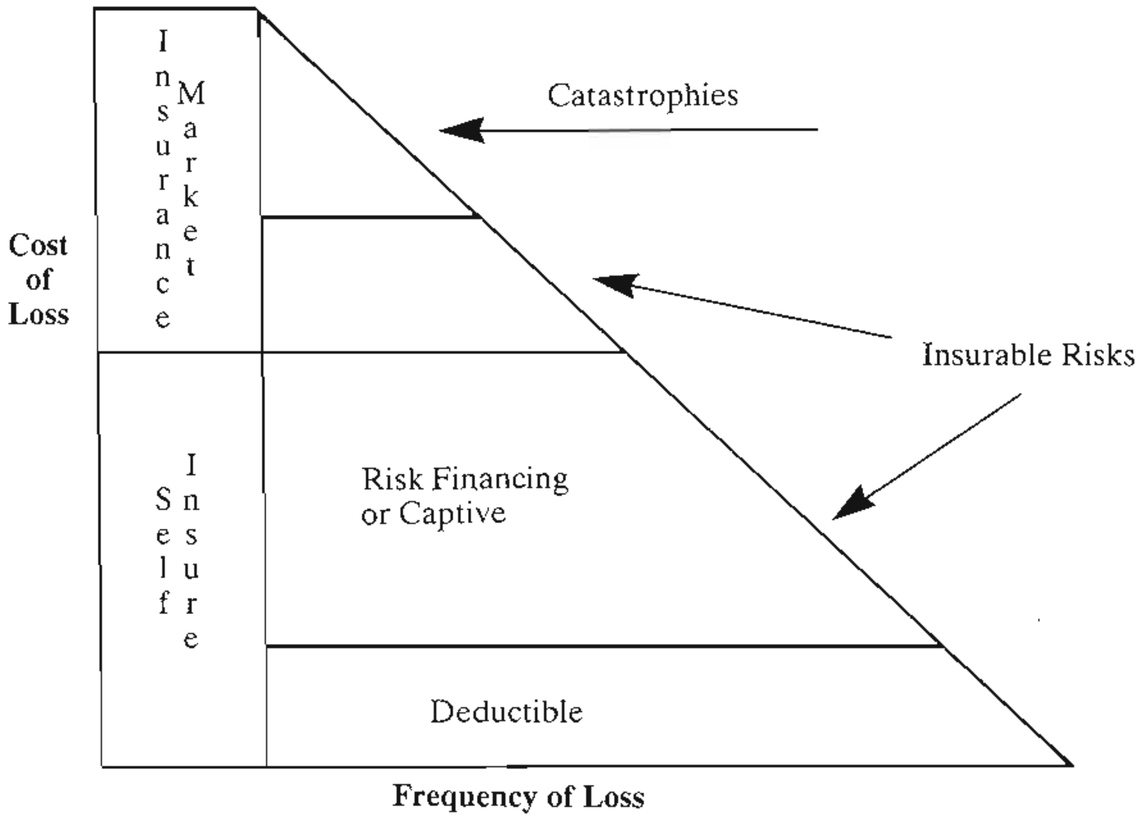
In this new paradigm, the objective became the optimisation of four alternative options for funding the corporation's losses. Losses can be financed by paying an external agent in advance (insurance); by funding the losses in advance but within the economic family (captive or trust); or by financing the losses after the event has occurred either externally (by a bank line of credit or retrospective insurance) or internally (by paying the deductibles out of operating income). See the table opposite.

Today, some estimates put the total flow of alternative risk mechanisms from the American market at some $40 000 million a year which in turn has not only spawned a whole new sub-sector of the insurance industry in the form of captive managers, pools, associations and highly specialised suppliers of services, but has also developed a momentum of its own in the form of financial reinsurance. Small, incremental steps of innovation have punctured the mysterious bubble surrounding both banking and insurance and are now set to make a revolution as this gradual, exponential change alters the *status quo* of warm and cosy protected markets on which reactionary regulators and hide-bound management will finally turn out the lights on the industry if they do not adapt to the new realities.

Our economic system is essentially a (re)search and discovery mechanism where, most often, outsiders attack other industries and businesses from a different set of criteria and assumptions. Some fail, some find a small niche which is sustainable against the established players. In the insurance and reinsurance industry we see a similar trend. If we compare two commercial languages, it is quickly apparent that the economic reality of two separate industries is the same:

Banking:	**Insurance:**
Make deposit	Pay premium
Receive interest	Receive policy-holders' dividend
Receive maturing deposit	Receive claims experience rebate

Donación de AGERS al Centro de Documentación de FUNDACIÓN MAPFRE



The only critical distinction in this comparison is that one vehicle is tax deductible and has no liquidity or capital constraints on its assets (risks). For a sophisticated insurer buyer, the ability to buy global, aggregate covers to sit on top of such a risk-financing scheme would be relatively easy, particularly if the true risk transfer were retroceded to the relevant catastrophe market. Claims adjustment and 'negotiation' would disappear as insureds merely received back what they had paid into their policy-holder reserve deposit account. The loss of 30% of premium (expense ratio) would be confined to the charges for accessing and transmitting messages across electronic terminals. The averaging or rating of the buyer's risk around his peer group (loss ratio) would evaporate and be replaced by the true burning cost related to the quality of the insured's risk management programme. Involuntary deductibles or planned self-insurance limits could be financed efficiently in advance. Investment income on the premium payment paid annually in advance would then accrue to the benefit of the policy-holder. In short, it is an insurance mechanism totally stripped of profit except for an outsider not land-locked by existing portfolios.

Can this happen to the reinsurance industry? The long-term profitability of any industry is usually determined by, first, the ease with which outsiders can both enter and exit the market, and, secondly, the sustainable comparative advantage that derives from the control and use of the scarce resources which are essential ingredients of the product. If we analyse the reinsurance industry from these viewpoints, it is clear that entry to the industry can be achieved with a relatively small cost: $25 million in capital, a small team of professionals, an office

Donación de AGERS al Centro de Documentación de FUNDACIÓN MAPFRE

© JOHN BURKE

Exchange Square houses money-movers in Hong Kong

close to Lime Street in London, a little courting of the international brokerage community and a sign which reads OPEN FOR BUSINESS.

As the run-off or development of the portfolio deteriorates and the grand scheme does not materalise the sign on the front door is turned over and now reads CLOSED FOR BUSINESS. In such an environment, there will always be a tendency towards volatile and excess capacity particularly as the cost of selling the product is not known for several years and when exogenous benefits, such as higher interest rates, or exogenous costs, such as inflation or an intransigent legal system, alter the terms on which the original product was sold. It is little wonder that some major reinsurance groups have striven to balance their overall portfolios with more direct business rather than be totally reliant upon pure reinsurance.

If, moreover, we extend the above model of financing risk to the reinsurance industry's product, we can see that the disintermediation of reinsurance 'manufacturing' has probably already commenced through the financial or finite reinsurance market. Today, the bundled reinsurance product is being broken down into the individual components of added value, namely the risks from event, timing and interest rates. Pure event or insurance risk, is retroceded to third parties while the risk of when the event occurs and the risk of what level interest rates will be, is hedged through the financial markets using derivatives, swaps and options. To the carrier of finite risk this is a fully hedged position with only a secondary risk of default from the retrocessionaire or bank. The recent, although as yet unsuccessful, attempts at developing insurance futures contracts and catastrophe derivative policies built around the Swiss Re catastrophe log would appear to represent further possible avenues for profound and revolutionary change in the reinsurance industry.

In such an environment of creative destruction how can one survive? In the short term, language, custom, tradition, policy form, price, existing distribution mechanisms and strength of balance sheet will provide a temporary haven from the ravages and turmoil of competition. In the medium to long term, the continuous process of spontaneous discovery will, like the flow of water, find holes through tariffs, establish new channels of distribution, and create new products which satisfy the voracious demands of those averse to risk. In the end, our livelihoods will depend on the human computer, namely our ability to learn how to learn, to create opportunity from chaos and descontinuity, and to maintain a relentless pursuit of excellence in everything we do. ■

Nick Jones BSc(Econ) is a vice-president of Citibank NA and the senior banker responsible for its relations with (re-)insurers in Britain and Bermuda. Since graduating from the London School of Economics, he has spent the last 17 years with Citibank as a banker to the insurance industry. Now based in London, he has also worked in Tokyo, Hong Kong and New York.

Donación de AGERS al Centro de Documentación de FUNDACIÓN MAPFRE