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COMMENTS ON THE FUTURE OF REINSURANCE

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I wish to thank the organizers for inviting me to this Meeting. Being Chairman of a Reinsurance Company does not confer the quality of reinsurer, and least of all at CORPORACION MAPFRE, mainly a holding company, with own funds which could double for 1988 its gross reinsurance premiums.

I am fundamentally an insurer, but the story of reinsurance is closely linked to that of insurance, and this is stressed in modern markets that demand very large units, set up multinationally and with some functions until today under the domain of reinsurers.

In any case, reinsurance is always a tool used by insurance companies, very specially by the small ones.

In reinsurance, we have not stressed enough the importance of maintaining a regime of effective and dynamic "market competition", that prevents large insurance companies from stagnation in the satisfaction of a monopoly situation, whether by fact or by law, to which tend all stable financial institutions. This is the reason, important to bear in mind, why after fifty years of experience in national reinsurance monopolies, and already far from the political or nationalistic passions which led to their establishment, it is accepted that their influence has

been negative in many cases, that being the reason why in some countries insurance has not reached the size it should have obtained in a free market, nor the political and economic importance that is the key to stable economy and social peace.

In this paper I will comment on three aspects which normally fall under "reinsurance": "reinsurance treaties", "reinsurance markets" and "reinsurers".

We must speak of the future. It is convenient to plan, but not to be very sure of success. Years ago I commented in a seminar that one of the reasons for MAPFRE's "technically balanced and self-financed high growth" was that we had never had a planning department. This looked like a "boutade", but it was not, and I justified it saying that a few years before, the three most powerful industries in the world: automobiles, oil and steel, with hordes of economists, projections into the future, and business and sectorial plans, had suddenly found themselves with brutal crises they had not been able to foresee. To avoid this situation our line of action has been defined as the "strategy of chaos" (now somewhat in vogue), with very thin and flexible structures to "jump" on opportunities, even against any strategy we were following or actions which ten days before we had considered convenient.

I am going to tell you that I sincerely feel "can" happen within reinsurance in the next decades but without the least confidence in my being right, and I am warning you to take precautions against my predictions, as well as against any other you might hear.

1. To speak of the future in reinsurance, we must speak of insurance, since it will be greatly influenced by the evolution of the last one, which, on the other hand, is not a uniform institution, neither geographical nor sectorial, even eliminating the Life Branch. This last one, has increasingly less participation in Reinsurance, a fact which should teach us a lesson, since in the same manner as in Life, reinsurance can also lose relative importance within the remaining branches.

The insurance industry is the social key piece in the industrialized countries or countries with advanced economies, while their presence is weaker in the remaining countries, where to the contrary, reinsurance has more relative importance.

In industrialized countries, insurance is undergoing a double transformation process:

- It is going to be more institutionalized, concentrating in leading insurance companies with a very deep-rooted presence in social and economic life, which tend to dominate a large part of the market, 60% to 90%, and which have available a dense territorial network, with general agencies or direct

offices, or a mixture of both. These leading insurers are mostly national and have efficient methods and economic means ample enough to compete in EDP, advertising and general development. This is why they dominate the markets and in many cases, they saturate them, and this demands expansion abroad as the only way to grow. This is the typical case of the Dutch market, and a few years ago, the Nordic. In these last years, we are reaching a new stage with possible concentration on a single Scandinavian or Nordic market, with coordination or merger of the present leading insurers in the different countries.

- In some degree, as consequence of the above, and also of the gradual integration of Europe, insurers tend to become international, not like in the 19th century, with relatively small agencies or branches, which found it difficult to compete with local insurers, but rather taking over companies of varied sizes or through international combined action agreements, creating large groups, although these may have units with a national legal personality.

This double process is not always clear, the case of United States, but we may consider Japan a typical example. this trend starts in all industrialized countries with a generally slow process, even though it has accelerated in these last two years, in every case, the market maintains small and medium size insurers, both foreign and national, active and efficient, who provide dynamism to insurance and effectively compete against the leading "dinosaurs", although in many cases they

end up in some manner associated to other insurers or taken over by the leaders of other countries desiring international expansion.

There are other factors which surely affect the transformation of direct insurance:

- Concentration of large brokers who dominate technical and industrial insurance and new risks with decisive influence in many cases, because they rely on the need for protection, at reduced costs, of the large national and international industrial companies. The function of these brokers in many cases includes simultaneous placement of optional reinsurance and even of proportional treaties.
- Greater possibilities in Europe since 1992 for Lloyds and some English insurers very flexible in adapting to the new situation, which will preoccupy the continental leaders who feel menace to their oligopoly supremacy, at least in some sectors.
- Countries, markets and companies coming together as consequence of the revolution under way in computer communications at reduced transmission prices which modify substantially the modus operandi of many service activities, such as insurance.

On this situation, and most of all, on the inexorable tendency to concentrate on direct insurance, is where reinsurers move,

although so as to compensate this effect that limits their field of action, they see disappearing in a large manner, the nationalist obstacles which emerged after the Second World War, giving birth to reinsurance monopolies or to overprotected national reinsurers.

With these preliminary observations, I go on to comment on the foreseeable evolutions in the three great branches of reinsurance I mentioned earlier.

2. ACTIVITIES

This is what I call the contractual and coverage formulas offered by reinsurers to the ceding companies to protect operations and which naturally, depends on their needs. It is logical that the evolution of insurance itself modify such needs and the following suppositions? are possible:

- A reduction in "proportional reinsurance", increasing the dimension of many direct insurance companies and logically, their retentions capacity. It does not seem probable for the creation of new entities to compensate this trend. But the constant appearance of new risk in social life will produce an increase in insurance risk and in many cases in proportional reinsurance.
- Increase in "non-proportional reinsurance", specially for high retention layer to complement or substitute proportional treaties, offering this possibility to specialized reinsurers

and undoubtedly to Lloyds and the so-called London market. These reinsurance covers, probably more sophisticated than the present ones, will increase slowly in importance, and will also increase the risk of the reinsurers, requiring not only advanced techniques but a high degree of solvency.

- Increase in "peak" reinsurance regarding fire risks, "technical", and mostly civil liability, whose underwriting through insurance and reinsurance companies should become more sophisticated so as to avoid the great problems of the past. It seems probable that many reinsurers will need high degree of training in analysis of direct risk for general liability as "star" service to their ceding companies. In this sense, it seems indispensable to use computerized methods, expert systems and sophisticated programs, hardly within reach of medium size insurers.

- Use of proportional "integral protection covers", by one or many, jointly or combined with financial aid and technical or administrative counseling. In this line, there will be policies with "quota share with assistance", which will require a close link between the ceding companies and the reinsurers, either for launching or increasing the operations of a company or for the reestablishment of "technical balance". This will lead to a type of "merchant bank" operations which, while respecting the independence of the ceding companies will assist them for a long period.

This protection will be only offered by professional reinsurers and not by "ocasional aficionados", who at some time or another have proliferated in world insurance. This activity will require important funds available, and most important, highly professional people to help the technical, financial, and management activities, going into the consulting area, the same as is starting with auditors and their customers regarding accounting certifications, developing in an interdisciplinary manner. Other forms are also emerging: "insurance agent and tax advisor", "broker-risk manager and security consultant", and the aforementioned auditor and consultant.

All these cases and probably many others, imply that insurers and reinsurers will be forced to enter the area of technological services of several types: "use of computer means", "management expert systems", "product quality maintenance", and probably many others so far unknown in our profession.

3. MARKETS

Reinsurance is offered in markets where operations are either specialized or grouped together, acquiring its own dynamics for complying with its targets and creating centres of accesories and a regular demand for their services.

To this effect, and without trying to make a doctrine of it, the present principal markets could be described thus:

- The London Market, mostly dominated by Lloyd, which concentrates an awesome number of facultative covers and not proportional covers, and which is the first world reinsurance center due to the amount and quality of their brokers and underwriters.
- The Proportional Market, controlled by the large reinsurers who regularly visit the ceding companies from their head offices or from direct offices with local services, and which offer complementary technical assistance. This market is mainly used by the small and medium sized ceding companies who need, to a greater or lesser degree, advice and assistance. They originate, although not exclusively, in the great European reinsurance companies of the 19th century, which to a great degree collaborated to the formation of many national insurance markets, a task which today's insurance should be thankful for and which shows the "efficient social work" of institutions apparently, not really, with the only objective of profitable results.
- The Reciprocity Market, among direct insurers, originally in the hands of very specialized brokers who carried out a very personal task in closely linking distant companies. Almost 25 years ago, MAPFRE entered a reciprocal treaty with Kyoei in Japan, made by Fester Fothergill and Hartung (presently Greig Fester). Now this market, after reciprocal surprises, is mainly centered on the Baden-Baden meeting or on local arrangements with friendly colleagues.

- Local Placement Markets, in a great degree for facultative covers within a same geographical area, for internal distribution of circumstantial surplus. This has been important in the last decades and in countries with currency problems, but it can also be important in Europe in the future.

These different "markets" will continue, although each one will be modified, mainly as consequence of the transformation of computers and the improvement on immediate communications at reduced cost which must affect substantially most reinsurance transactions. The telegram, telex and lately telefax, have produced substantial adjustments in the underwriters and execution of operations, but the future change, quite transcendental, could be the "screen transactions", with basic data grouped for analysis in "expert programs", and with viewing of the parties so as to maintain personal contact within the technical sophistication which will surely come.

In the next 20 years, software programs and expert systems will proliferate, permitting complete automatic analysis of each facultative cover, or even, of the proportional treaties, coordinated with internal computer data from the ceding parties and from the original insurers today unknown in the reinsurance market.

It will also be easy to obtain precise information on the ceding company portfolio, as well as original information in non proportional acceptances, which if not quoted based on a

very precise knowledge of the risks entailed and their geographical distribution may originate problems in the future. Another possibility will be the creation of historical data base of treaties that will avoid underwriting mistakes.

At the same time, it will be imperative to eliminate written borderous, which will be automatically transacted and will talk computer to computer, integrally coordinating operations from the ceding companies, the reinsurers, and the retrocessionaries. this will surely eliminate the "antitechnical techniques" which today shape reinsurance, and will dramatically reduce correspondence, telex, telefax and personal interviews. Besides, it will be possible, and it will be demanded by both parties and the intermediaries, the immediate transfer of funds, as it occurs today in cash transactions of modern banking.

All this will surely demand the coordination or integration of computer systems in insurance and reinsurance companies. This is already being done at MAPFRE, when we are already underwriting a transaction in the "intelligent terminal" of one of our 160 direct offices (we call them "capilares"), which not only registers the transaction in the original insurance company (there are six territorial MAPFRE SEGUROS GENERALES companies), but at the same time registers the cession to the reinsuring company CORPORACION MAPFRE, and simultaneously, this transfer to the world retrocesionaries where this is necessary. This system in operation since January 1, 1988, limits itself to obligatory treaties, but I have no doubt that in a short

period of time, it will be extended to the facultatives as well.

Besides, the above combined with a world system, or at least European, of computer information, can offer incalculable possibilities of which I am sure you are all aware, for which reinsurers must start preparing as of today.

As consequence of all these factors, the reinsurance market will be increasingly a world market, and it shall also be more competitive, and why not? more exciting than today. A pity for those of us who will not see it. We envy those of you who can contribute to create it, to make it dynamic and to find areas and "havens" of new service for reinsurer, that will enhance the existence of reinsurance in the "great world market of reinsurance", which will surely be created within the next century.

4. REINSURERS

It is not difficult to suppose that if the reinsurance market and its nature changes, the leading roles will also change reinsurance brokers, underwriting agencies, and most of all, reinsurance companies which are the ones risking their own funds offering capacity to direct insurers.

The function of brokers will decrease in proportional treaties, due to the improvements mentioned in communications and because their nature demands personal and immediate knowledge of

management and management systems, not easy through intermediaries. On the other hand, they will dominate in the non proportional covers, which need many underwriters, will dominate, and so will be the facultative covers, specially those linked to great industrial operations.

The "underwriting agencies" have had and have a prominent specific role in direct insurance and were more important before the expansion with direct branches of the big insurance companies. In reinsurance, the experience of the last years has not been satisfactory, and its possible future will be limited to very specific activities, once the "innocent capacity" which has provided them an ephemeral success period has disappeared.

But, the leader of reinsurance are the reinsurance companies, but this are of quite different nature: exclusive reinsurers, "pure" they have been called; or "great reinsurers" with net worths accumulated over many years and leaders in the proportional market; or medium size professional reinsurers; or reinsurers integrated in direct insurance companies; off-shore reinsurers; national reinsurers, with or without monopolies, "reinsurance departments" of direct insurers and Lloyds and others, whose only difference is their special legal structure.

Within this group, and this is not the time to go into detail on this subject, the "pure reinsurers" tend to integrate, with greater or lesser autonomy, into direct insurance groups, with a common strategy and captive internal cessions which facilitates the balance of their results. MERCANTILE AND

GENERAL is associated with British PRUDENTIAL, PRU-RE to American PRUDENTIAL, AMERICAN RE to AETANA LIFE AND CASUALTY. With the same effect, but different source is the strategy of SWISS RE creating a great direct insurance group, whose premiums already exceed those of reinsurance.

In this situation we would have to stress the difference between those who maintain absolute independence for their reinsurance company, such as Munich Re, even though it has ties with ALLIANZ, and those who, even though independent, include reinsurance within global strategy, not only regarding insurance but financial services also, precisely the case with the company of which I am president.

It also seems inevitable that public reinsurers disappear slowly with or without monopolies, another "exclusive reinsurers" which may disappear.

As consequence of the possible decrease regarding the needs of reinsurance, these professional reinsurers, shall be less numerous, but with greater influence, in many cases, coordinated or integrated with very large insurance companies which consider reinsurance as an instrument for international presence and the distribution of their risks.

The larger foreseeable size for non-proportional reinsurance will offer possibilities to specialized and "flexible" insurers, for brokers and for Lloyds, although logically, professional reinsurers will have a prominent participation in

this area, and those with large funds may become the end recipients of target risks, since the basic objective of reinsurance is to maintain the capacity of direct insurers to face the great risks which will not cease to increase.

It is important to notice that even with the theoretical reduction of reinsurance needs the proportion of reinsurance premiums to insurance premiums has remained stable (from 15 to 17%) in the last 30 years.

It will be difficult to see truly autonomous large professional reinsurers emerge in the future, although we shall see those dependent on the large direct insurers. In another aspect, one could ask how long some medium size professional reinsurers could keep themselves outside the influence of a direct group. The most efficient and with very "vocational management", could survive and develop in future decades, but some will lose their independence even with the strong desire of continuing independently. The question is, how will they face the menace of take-over bids with speculative investors, anxious of using their apparently idle funds? And under such conditions, would it not be better to depend on their direct insurer colleagues?

We must think of the future of the medium size "national reinsurers" with principal customers from small insurers which have carried out an important function in the local markets and which in some way are the symbol of independence of a nation. They will have an important function in countries with limited markets where a "tutor" is necessary for small insurance

companies, maybe being the retailing vehicle for the large reinsurance companies, as well as permanent "sting" for the dominant insurance groups with a tendency towards integration into financial groups, which favors inefficient managements which would drive away from insurance the very people whom they should serve.

But against what appears logical, formulas may emerge to adapt to different situations and to create unexpected solutions, with directions and tendencies which not only escape me, but most of the analysts in our profession, for example, the steel industry, where the large companies of the beginning of the century, have not been able to survive the competition, there have emerged others small and medium ones, with different technology, which obtain high benefits and increase market shares.

In any case, I believe leading reinsurers in the future, the present ones, or those which may emerge, will probalbhy have the following characteristics:

- Important capitalization with ample liquid funds not only to offer capacity to their customers, but to aid them financially in their reestructuration needs or initial support.
- Medium and high executives with management, administrative, and financial knowledge to carry out consulting functions, and even derive from these, part of their income.

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- High technical specialization to be an instrument for technological transfers, offering the direct insurers the possibility of survival without need for research, which will be only possible for the large insurers in each market.
 - Extensive geographical presence to serve directly and personally the ceding company and their problems and provide them the assistance when they so require, and to provide them with direct knowledge of each market and their individual protagonists.

I do not know if this is what you expected, but this is all my limited experience can provide, and in any case, these ideas, which in a great part proceed from my collaborators in MAPFRE, are all that can be offered by a retired insurer in a country almost developing, to an audience as prepared and specialized as offer the first reinsurance market in the world.

Thank you.

Ignacio Hernando de Larramendi.