

THE Review

WORLDWIDE REINSURANCE

DEC 2009/JAN 2010

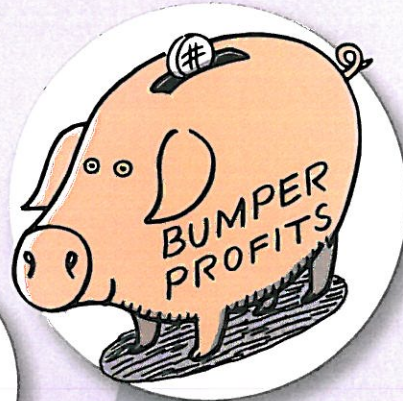
www.thereview.biz

AN INFORMA GROUP PUBLICATION
ESTABLISHED 1869

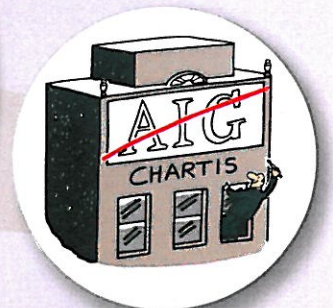
**SPECIAL
EDITION**

**PLUS 2009
IN REVIEW**

Property
Regulation
Modelling
Risk Management
Claims
Emerging markets
Life reinsurance
Legal
Asia markets



**BOUNCING
BACK**
So what is
the big picture
for 2010?



In recent months, two occurrences have brought about a dramatic surge in the demand for structured risk transfer solutions; the current financial crisis on one hand and the stricter solvency requirements of national insurance supervisory authorities on the other. All major reinsurers carry non-traditional risk transfer solutions in their product lines, in some cases possessing more than ten years of experience of how to legally, transparently and successfully implement non-traditional risk transfer products.

So what exactly are structured risk transfer products (SRT)?

With SRT products, the re/insurance industry can offer its clients a multitude of different risk management solutions. On one hand, they enable clients to control risks and protect their own balance sheets. On the other hand, solvency capital can be custom tailored and made directly available.

A COMPLEMENTARY FUNCTION

SRT solutions were created to protect against risks either not comprehensively or efficiently hedged – or not at all – by traditional re/insurance companies. In addition, they ensure that re/insurers are able to offer solvency capital that is no longer efficiently or sufficiently made available – or not at all – by other capital providers such as banks or hedge funds. Therefore, SRT solutions are not a form of competition to traditional re/insurance and capital repertoires, but function as a complement to them.

SRT: THE FACTS

SRT re/insurance and capital solutions can be divided into the following categories:

- Retrospective re/insurance solutions: these consist of a protection or a buy-out of existing loss reserves;
- Prospective re/insurance solutions: protection against expected future loss events.

Retrospective and prospective covers can also be understood as a direct form of capital, for instance, as subordinated capital, instead of a re/insurance solution. In this case, it would be considered 'conditional or contingent capital'.

In general, SRT products are characterised by the following features:

- Liability limits aggregated over the year and/or over the term of contract that are much lower than with comparable traditional re/insurance products;
- A type of experience account that the SRT provider sets up for the client over the term of contract and which is financed through part of the premium;
- A type of refund from this experience account at the end of the term of contract if fewer losses occur than expected;
- The calculation of interest on the premium amounts that go into the experience account;
- A contract drawn up for a term of several years.

With SRT derivatives, it is important to make sure that the form of capital made available upon occurrence of the contractually agreed technical risk event complies with the solvency regulations of the respective national insurance oversight authority.

The final word

The financial crisis and a tougher stance from regulators means that non traditional reinsurance is the flavour of the year, says **Thomas Renggli**

TRANSPARENCY AND RISK TRANSFER

With all SRT products, the effective risk transfer from the client to the provider is of essential importance. No risk transfer or only a virtual risk transfer would in principle be allowed, but it would have to be reflected in such a way that it might not be possible to achieve the intended balance sheet effects. Yet how is a significant risk transfer to be defined? The following central questions present themselves: Is it the difference between liability limits and premium? Or is it the occurrence probability of the loss event? Or is it the risk category per se?

It is clear to all parties – and in most contracts, it is also the case – that SRT contracts (must) exhibit a significant difference between liability limits and premium for the provider. It can be that this difference ends up being less than in classical re/insurance through a savings mechanism or other instruments such as additional premiums.

In calculating the risk transfer, the Expected Reinsurer's Deficit formula (ERD) has established itself as a suitable measure. It is generally calculated as follows: The occurrence probability of a loss for the provider is multiplied with the average loss in case of loss and divided by the discounted premiums for the SRT product. This value must amount to at least one percent to constitute a sufficient risk transfer.

The provider must be able to clearly identify the nature of the risks ceded and the degree of the risk. Clear rules in regard to the degree of the risk transfer have in some cases already been defined by the supervisory boards, such as the above-described ERD.

Risk tests furthermore depend on mathematical models on which they are based. There is no doubt that different insurance theory approaches lead to different risk test results. The quality of the analytical methods and the resulting statements in regard to risk transfer are of paramount importance and must be disclosed in full to clients, supervisory authorities, rating agencies and auditors.

So-called 'black box pricing' is not to be

recommended. SRT programmes that do not contain sufficient risk transfer are not prohibited per se. They just have to be clearly identified as such. In this case, however, it is possible that certain effects can no longer be achieved due to their classification as a derivative or credit loan instead of as re/insurance. The provider should supply the buyer with the according ERD risk test. By means of a mathematical distribution, the provider demonstrates in which cases he would have to pay such and such an amount toward losses over the paid premium. The ERD test can also be scenario-based (instead of stochastic).

Finally the definition of the risk categories for which there might not be any classical risk transfer markets but which can nevertheless be included in SRT contracts if the parties are in agreement. For instance, these include a linkage of various conditions for the definition of loss (double trigger with technical and financial risks) or weather risks.

In addition, SRT contracts must be clearly and transparently formulated to avoid misunderstandings and any room for interpretation. Moreover, it is necessary to be aware if such a contract involves a re/insurance or banking product (derivative: right to a capital injection when a certain relevant condition occurs), if the provider possesses such

- THE BRIEF**
- ▶ SRT solutions offer re/insurers capital not sufficiently or efficiently available by other providers
 - ▶ SRT solutions protect against risks not hedged by traditional re/insurers
 - ▶ SRT solutions not a form of competition to traditional re/insurance
 - ▶ Niche will significantly increase its share of the overall risk transfer market
 - ▶ This is particularly true for classes that are difficult to place

COMPARISON OF VARIOUS RISK MANAGEMENT TOOLS

COMPARISON	TRADITIONAL RE/INSURANCE	STRUCTURED TRANSFER SRT	SECURITISATION (CAT BONDS)	CONTINGENT (SOLVENCY)-CAPITAL	DOING RISK NOTHING
Profit & loss protection	yes	yes	yes	no (or indirect only)	no
Balance sheet protection	yes	yes	yes	yes	no
Cash-outflow in no-loss scenarios	relatively high	relatively low	low	low (dependent on interests)	zero
Cash-outflow in loss scenarios	high cashback	low cashback	high cashback	quick cash (dependent)	high
Insurance/risk management budget volatility	low	very low	medium	low	high
Risk management strategy	security	participative	leveraged	dependent strategy	gambling
Capacity available/markets	big	limited	very limited today	very limited today	—
Recovery after losses	no, but...	inherent in product	no	yes	self funding / SIR
Efficiency of market	very high	high	medium	medium-high	—
Flexibility to adopt concept	low (1 year deals)	high (early comm)	medium	low	high
Accounting treatment	known	dependent on structure	known	dependent on structure	known
Tax treatment	known	dependent on form	known	known	known
Market density	high	medium	medium-high	low	—
Signals prudent risk management	yes	yes	yes	yes	probably not
Provider/market	Re/insurers	sophisticated re/insurers	Capital markets	sophisticated re/insurers, banks, private placement	—
Creates rating capital	yes	yes, but...	yes	no, if not triggered	no
Creates solvency capital	yes	yes, but...	yes	no, if not triggered	no
Creates economic capital	yes	yes	yes	yes	no

licences and which supervisory authorities are to be consulted if necessary.

Traditional, one-year re/insurance products are purchased to protect or to replace capital. For SRT transactions the same goals apply. Yet these solutions transfer less risk than their traditional counterparts, which ties up less of the provider's capital. Of course, this should ultimately be reflected in the price. Clearly formulated SRT products with significant risk transfer (though potentially less than in traditional re/insurance and capital solutions) have firmly established themselves as an integral part of re/insurance and banking terminology.

Flexibility is a decisive factor in multi-year SRT transactions. In the case of unforeseen, changing framework conditions during the term of contract, both parties have the right to amend or terminate the contract, although this is of course not allowed to occur to the detriment of one party or the other party. Corresponding contract terms (commutation rules) should be carefully drawn up.

SUCCESS FACTORS

There are many reasons why clients opt for SRT solutions. A main reason undoubtedly lies in the fact that such solutions facilitate more moderate and hence more efficient

ways of dealing with the capital of the provider because of the more moderate nature, the provider is bound for a longer period or it has become simply impossible in certain credit markets for the client to obtain new solvency capital.


For the provider, SRT solutions can be advantageous if the insured risk categories are not correlated or even negatively correlated to the other traditional business (such as drought insurance to traditional flood risk that the re/insurer assumes in a certain region).

The key success factors for SRT products are transparency, flexibility and correlation of the risk class: transparency in regard to a clear contract design and comprehensible risk tests. Flexibility to be able to adapt multi-year contracts when market conditions have changed and, finally, a correlation with better diversification of the overall portfolio of the provider.

SRT re/insurance and capital solutions are an integral part of product lines in today's re/insurance industry. While SRT contracts sometimes transfer fewer risks than classical re/insurance, serious SRT providers always offer risk tests. Yet if a transaction exhibits insufficient risk transfer, this has to be clearly communicated to the supervisory authority, the tax authori-

ties, the rating agencies and the auditors. One or another target effects might be lost as a result. Other advantages such as the long-term connection with the SRT provider as well as the contract conditions are maintained.

INCREASING SHARE

SRT products will not replace the traditional re/insurance and banking products in the foreseeable future. Nonetheless, this niche will significantly increase its share of the overall risk transfer market from the currently estimated level of 10%. This is particularly true for risk classes that are difficult to place or in areas where clients are looking for customised solutions. The discussion regarding SRT often leads clients to think about their entire risk management approach. The buyer always wants to have a choice and also expects non-standardised products. And through the SRT offering, the provider enjoys an enhanced basis for discussion with its clients, which might open up additional possibilities for the sale of further products. 

Thomas Renggli is head of the Structured Risk Transfer department at Scor.